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CLOUDS ON THE HORIZON OF THE GLOBAL ECONOMY: THE IMPORTANCE OF TAKING A LONG VIEW*

Abstract

From a macro-financial perspective, clouds are gathering on the horizon of the global economy due to the convergence of two powerful forces. On the one hand, a financial cycle has lost momentum while the regulatory cycle is pushing to weaken the financial system, raising the risk of financial instability. On the other hand, an inexorable deterioration in public finances is undermining their sustainability and represents the biggest medium- and long-term risk to monetary, financial and macroeconomic stability. In the background, political and geopolitical developments exacerbate these challenges. Finding adequate solutions requires adopting a long-term view, regaining safety margins and abandoning the "growth illusion" – the view that protracted expansionary monetary and fiscal policy can raise sustainable growth.

Keywords: Financial Cycle; Regulatory Cycle; Public Finances; Monetary Policy; Long View; Safety Margins; Growth Illusion
JEL: Classification: E30; E44; E50; G20; G28; H60

Riassunto

Nuvole all'orizzonte dell'economia mondiale: l'importanza di una veduta lunga

In un'ottica macro-finanziaria, nubi si addensano all'orizzonte dell'economia mondiale a causa della convergenza di due potenti forze. Da una parte, un ciclo finanziario ha perso slancio mentre il ciclo regolamentare spinge verso un indebolimento del sistema finanziario, aumentando il rischio di instabilità finanziaria. Dall'altra parte, un inesorabile deterioramento delle finanze pubbliche ne compromette la sostenibilità e rappresenta il principale rischio di medio e lungo periodo per la stabilità monetaria, finanziaria e macroeconomica. Sullo sfondo, gli sviluppi politici e geopolitici aggravano ulteriormente queste sfide. Trovare soluzioni adeguate richiede l'adozione di una "veduta lunga", il recupero di "margini di sicurezza" e l'abbandono della "illusione della

* Speech delivered on occasion of the Honorary Degree in International Relations awarding ceremony at the University of Genova, November 25th, 2025.

DOI: 10.65644/EIIE.079.01.0037

crescita" – l'idea secondo cui politiche monetarie e fiscali espansive protratte nel tempo possano innalzare la crescita sostenibile.

INTRODUCTION

I would like to thank the Vice-Chancellor and the Department of Political and International Sciences of the University of Genoa for awarding me this honorary degree. It is a great honour for me to be here with you today at this ancient and prestigious university. For someone like me, who has spent almost his entire life abroad, this has even greater significance and a special flavour.

In this speech, I would like to share with you some personal reflections on the challenges facing the global economy. I will focus, in particular, on those relating to the link between macroeconomics and finance. These are momentous challenges with distant origins. I would like to draw on my long professional experience, spent studying economics and analysing policy, first at the OECD in Paris and then, for almost 40 years, at the Bank for International Settlements (BIS) in Basel.

The common thread running through this speech – and here I am also inspired by my late colleague Tommaso Padoa-Schioppa – is the need to take a 'long view'[1]. It would be unrealistic to expect market participants to take a long view, but it is appropriate to expect economists and, above all, economic policymakers to do so. After all, as Jean Monnet once asked, what is politics if not the art of making possible what is necessary?

From a macro-financial perspective, clouds are gathering on the horizon of the global economy due to the convergence of two powerful forces. On the one hand, the upward phase of the financial cycle has lost momentum or seems to have turned just as the regulatory cycle is pushing to weaken the defences of the financial system. All this entails a higher risk of financial instability in the coming years. On the other hand, as Carlo Cottarelli observed in his Lectio Magistralis at this university almost ten years ago[2], an inexorable deterioration in public finances is undermining their sustainability. In the medium and long term, this represents the biggest risk to the monetary, financial and macroeconomic stability of the global economy.

[1] See Tommaso Padoa-Schioppa (2009).
[2] See Cottarelli (2017).

And all this is happening in a political and geopolitical context that encourages these developments further and complicates finding adequate solutions.

In the remainder of my speech, I would like to delve deeper into the purely economic aspects without, however, completely neglecting the more political and geopolitical ones.

ECONOMIC FORCES

Let me begin with the economic forces, first and foremost the link between the financial cycle and the regulatory cycle, and then the sustainability of public finances.

The Financial and Regulatory Cycles

I have devoted much of my professional life to studying financial instability and, in particular, its link with the financial cycle. By financial cycle, I mean the interaction between credit, risk-taking and asset prices (particularly real estate), which generates expansions (or booms) followed by contractions (or busts) [3]. The financial cycle is much longer than the business cycle – at least in terms of how the business cycle is normally measured[4]. As a rule, its duration is estimated to be between 16 and 20 years on average, compared with eight to ten years for the business cycle.

The financial cycle marks the timing of the most significant episodes of financial instability – those with the greatest impact on economic activity. Consider, for example, the banking crises in the Nordic countries and Japan in the early 1990s, or the Great Financial Crisis (GFC) of 2008, or, going further back in time, the Great Depression of the 1930s. These crises tend to occur a few years after the peak of the cycle, when asset prices collapse and credit growth slows sharply or contracts.

Of course, it is one thing to examine this link with hindsight; it is quite another to identify it in real time. Today, we have a whole range of indicators at our disposal to detect it, both aggregate and disaggregated ones. But these indicators remain inevitably imperfect. And the link between the cycle and crises, as well as the intensity of the latter, is variable. This certainly does not diminish

[3] For an extensive analysis of the financial cycle, see Borio (2014a) and references therein. And for some of the underlying mechanisms at work, with a focus on the procyclicality of the financial system, see Borio *et al.* (2001).
[4] There is also a medium-term cycle that moves remarkably in sync with the financial cycle (Aldasoro *et al.*, 2023).

DOI: 10.65644/EIIE.079.01.0037

the epistemological value of the concept as a tool for better understanding economic processes, but it does limit its usefulness for forecasting purposes.

With this qualification in mind, if we look at the economic and financial picture from this perspective, the signs are far from reassuring. After a long period characterised by high risk-taking, the financial cycle is losing momentum or appears to have entered a downward phase in many countries, especially in advanced economies and above all in the United States – the epicentre of global finance. Following a very long period of extremely low interest rates, serious financial strains have already emerged. Just think of the failures among US regional banks in March 2023 – which did not turn into a major crisis only thanks to the timely and massive intervention of the authorities – or the failure of Credit Suisse – a bank considered globally systemic. And while these strains have essentially reflected interest rate risk – i.e. valuation losses linked to a rise in interest rates – the far more dangerous credit risk has only recently begun to emerge in a significant way. This is what has caused the failure of First Brands and the problems of some regional banks in the United States.

The positive aspect is that the banking system has a greater capacity to cope with losses, largely thanks to the strengthening of prudential regulation and supervision following the GFC[5]. The biggest risks today lie with non-bank financial intermediaries (NBFIs), which have grown exponentially in the wake of the crisis – partly owing to the very crackdown on the banking system. Just think of the often very opaque risks arising from the link between private credit and private equity and, more generally, those in the asset management sector. Or of the transfer of risks from the banking sector to private markets through structured instruments reminiscent of those that emerged before the GFC. Or, again, of the link between the insurance and reinsurance sector, on the one hand, and private market, on the other, which at the system-wide level implies less capital backing more illiquid and risky assets[6]. More generally, the link between the banking sector and NBFIs is very tight but not very transparent. So, even if the overall picture is certainly not as worrying as it was before the 2008 crisis, we should expect further episodes of financial instability. This is where the regulatory cycle comes into play. Regulation has failed to keep pace with developments in the financial system. The authorities have deliberately shifted some of the risks

[5] For a review, see Borio *et al.* (2020). A novelty of the post-GFC approach was the adoption of a macroprudential overlay globally. For an early detailed elucidation and advocacy of the approach, see Crockett (2000) and Borio (2003).
[6] See Garavito *et al.* (2024).

outside the banking sector – an inevitable result of tighter regulation there. However, this shift has not gone hand in hand with an adequate strengthening of controls on NBFIs. And today, there is growing pressure globally to ease regulatory and supervisory constraints on banks as well, in the illusory belief that this will lead to stronger economic growth. The GFC is only a distant memory that is fading fast, while political and financial industry pressures are mounting. The imperative is to deregulate, sometimes under the pretext of 'simplifying'. But simplifying does not mean diluting. In the long term, there is no tension between economic growth and regulation – quite the contrary. As history teaches us, it is at times like these that supervision needs to be strengthened, not weakened.

The (un)Sustainability of Public Finances

Let me now turn to public finances.

Although I have devoted much of my professional life to issues related, so to speak, to the 'excesses' arising from private sector behaviour – the financial cycle above all – over time I have become more concerned about those arising from the public sector. The unsustainability of public finances can cripple the economy, as a result of inflation or financial instability, and more often than not as a result of both.

The mechanisms are well known.

As regards inflation, history teaches us that, even leaving political pressures aside, high government debt can significantly restrict the room for manoeuvre of monetary policy. This occurs when the credibility of fiscal policy or the creditworthiness of the government is seriously questioned. In such a situation, tightening monetary policy would only exacerbate concerns and fuel inflation, typically through an uncontrolled exchange rate depreciation – a manifestation of so-called '*fiscal dominance*'.

As regards financial instability, the mechanisms are both direct and indirect[7]. The direct mechanisms relate to the private sector's exposure to losses on government debt. Many of you will remember the vicious circle, or '*diabolic loop*', triggered by banks' exposure to sovereign debt

[7] For a detailed analysis of the link between fiscal policy and financial instability, see Borio *et al.* (2023).

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DOI: 10.65644/EIIE.079.01.0037

during the euro area debt crisis in 2011. The indirect mechanisms relate to the fact that, when financial instability erupts, it is the soundness of public finances that ultimately guarantees the solvency of the financial system. The central bank can act as lender of last resort, but it cannot address insolvency. As we have seen time and again in past crises, only the government can do that. If market confidence in the solvency of the state fails, the financial system loses its safety net.

All this highlights the close link, too often forgotten, between monetary policy and fiscal policy[8]. Not only because both operate through 'intertwined' balance sheets – those of the central bank and the government. Not only because their transmission mechanisms overlap, particularly through financial conditions. Or even because, obviously, both policies have a significant impact on the economy. But above all because, fundamentally, both guarantee the state privileged access to resources – respectively through the issuance of money and the power to tax. And because they support each other: monetary policy can prevent the *technical* default of the state, while the power to tax ultimately supports the value of money.

Now, if we look at the state of government debt globally, the signs are alarming. On average, after a steady increase since the 1980s, the debt-to-GDP ratio has reached historical peaks, similar to, or even higher than, those reached during the Second World War. And the outlook is far from reassuring. Stylised projections made by my former colleagues at the BIS indicate that, in the absence of consolidation, debt-to-GDP ratios are set to rise further in the long term, even if interest rates remain below growth rates[9]. This increase is even more pronounced when the impact of demographic ageing, the green transition and increased defence spending due to geopolitical tensions is taken into account.

Furthermore, if interest rates were to exceed growth rates again, this self-reinforcing dynamic would be much stronger. To get an idea of the possible impact, suffice it to say that the cost of servicing debt is now not far from historic lows due to low interest rates. But it would end up exceeding its historical peak if, all else equal, interest rates were to return to their mid-1990s levels – quite normal ones from a long-term perspective.

[8] See Borio and Disyatat (2021) and, for a comprehensive analysis, BIS (2023). The notion of a corridor of stability originates from Leijonhufvud (2009) but was applied to the economy as a whole.
[9] See BIS (2023) and, for an update, Hernández de Cos (2025), who also analyses the corresponding financial stability risks linked to the NBFI sector.

Of course, some are counting on the effect of the current wave of technological innovation – especially that linked to artificial intelligence – to revive growth. And I must admit that I, too, have always been optimistic about technological progress in general. But hope is not a strategy. And, in any case, the impact of the latest innovation wave does not seem likely to significantly change the picture just presented.

How did we get to this situation? In short, because of the political inability to take difficult but far-sighted decisions. This inability is fuelled by a certain '*growth illusion*'. I am referring to the idea that growth can be strengthened in a *sustainable* way through expansionary fiscal and monetary policies, even at the cost of reducing those 'safety margins' that only a prudent use of such policies can deliver.

Many parties are responsible for this situation. Financial markets, unable to give warning signals in time. Rating agencies, too reluctant to downgrade debt, or in any case only able to do so belatedly. I would also dare say international organisations such as the OECD and even, to a lesser extent, the International Monetary Fund, which has only recently begun to raise serious concerns. And then those academics who, faced with an exceptionally long period of exceptionally low real interest rates, even *negative* in nominal terms, spoke of a '*New Normal*' with no end in sight, which would effectively eliminate budgetary constraints.

And I don't feel comfortable excluding central banks from some of the responsibility either. My research indicates that, contrary to popular belief, central banks can have a long-lasting effect on real interest rates[10]. Furthermore, the coexistence of low and stable inflation with low unemployment is not an unequivocal sign that the interest rate is at its equilibrium level – the so-called 'natural interest rate'. On the contrary, prior to the GFC, low interest rates most likely contributed to instability in the long run, fuelling the financial imbalances I discussed earlier[11]. And once the crisis was over, even with the recovery already well under way, keeping them low or even reducing them further, even to negative nominal levels, through the expansion of central bank balance sheets – '*quantitative easing*' – did not have the desired effect[12]. Inflation remained

[10] See Borio *et al.* (2022) and Borio (2021a).
[11] On the link between monetary policy, interest rates and risk-taking, introducing the notion of the risk-taking channel of monetary policy, see Borio and Zhu (2012).
[12] In part, the response was driven by concerns with the costs of deflation, i.e. of a falling aggregate price level. However, the empirical evidence does not point to a systematic link between deflation and weak economic activity (e.g., Borio *et al.* (2015)). This is why economists such as Feldstein (2015) and Rajan (2015) talk about the 'deflation bogeyman'. Borio (2024) discusses the limited effectiveness of very low interest rates and balance sheet policies, including quantitative

below the desired target and monetary policy, just like fiscal policy, lost valuable safety margins, contributing to the sudden post-Covid inflationary surge.

This search for those responsible reminds me of Agatha Christie's murder mystery *Murder on the Orient Express*, when Poirot discovers that all the passengers are guilty. Well, we all are, to some extent.

WHAT NEEDS TO BE DONE AND THE POLITICAL AND GEOPOLITICAL CONTEXT

In light of these considerations, what should economic policies do to limit the risks looming on the horizon? First and foremost, they should maintain a 'long view' and not allow themselves to be distracted by short-term economic trends, which are sometimes distorted by short-sighted fiscal, monetary and prudential policies.

This means abandoning the *growth illusion* I stressed earlier. It means recognising the importance of maintaining safety margins, or 'buffers', in the implementation of monetary and fiscal policies to cope with both future recessions, which will inevitably occur, and more unpredictable and exogenous shocks, such as Covid. It also implies fiscal and monetary policies that remain clearly within a 'zone' or 'corridor' of stability to support the economy, regulatory policies that strengthen the defences of the financial system, and the rediscovery of structural policies that allow market forces to boost the economy in a sustainable way.

First and foremost, fiscal policy must regain sustainability. All too often in my career, I have witnessed what I would call a Saint Augustinian attitude towards fiscal consolidation – of the type "Lord, give me chastity and continence, but not yet". Even when the need for consolidation is recognised – and this does not happen that often – it is difficult to find the courage to implement it and the wherewithal to get the electorate to accept it. As Jean-Claude Juncker, then President of the European Commission, admitted: "We all know what to do; what we don't know is how to get re-elected after we've done it".

easing (QE); it also includes references to empirical work supporting this assessment. On the implications for operating frameworks as well as for the size and composition of central bank balance sheets, see Borio (2023).

For its part, monetary policy must not lower its guard against inflation risks and, at the same time, must gain a keener awareness of its medium-term impact on financial stability[13]. This awareness is necessary not to give in to the temptation to lower interest rates excessively and thus lose valuable room for manoeuvre[14]. This is even more important in the current macro-financial environment, given the exuberance of financial markets and the state of the financial cycle.

Finally, prudential policy must never lose sight of the inherent instability of the financial system. In any sector of the real economy, an increase in supply lowers prices, which in turn stabilises supply. The same is not true of the financial sector: there, an increase in supply, in the form of an expansion of credit and financing capacity, instead boosts the prices of financial and real estate assets, in a self-reinforcing process that can generate financial imbalances. Deregulating the real economy is therefore welcome, but we must safeguard the essential constraints on the financial system.

The current political and geopolitical context is not conducive to the necessary adjustments. We are witnessing a retreat from globalisation and heightened geopolitical tensions. Partly due to the inability to manage the impact of trade and migration flows, the centre of gravity of the political spectrum has shifted and is putting pressure on the safety margins of the three policies analysed so far – monetary, fiscal and prudential. A striking example is the growing questioning of the principle of central bank autonomy – a principle that I consider to be an essential element of 'institutional hygiene'[15]. The current context is also testing the mechanisms of international cooperation needed to respond adequately to the economic challenges of a world that, despite all the changes under way, remains deeply integrated.

[13] For an early analysis, see Borio and Lowe (2002) and for a subsequent one making the case and reviewing the issues, Borio (2014b). For a critical assessment of the intellectual challenges facing monetary policy, see Borio (2021b); for a more recent evaluation of the limitations of inflation targeting, Borio (2024); and for a review of monetary policy challenges over the past thirty years or so, BIS (2024).
[14] Aiming at a low inflation rate and not being especially concerned about gradually falling prices would be consistent with Volcker's (1983) and Greenspan's (1994) definition of price stability, seen as a (range of) inflation rates that have no material effect on behaviour. On this, see in particular Borio, Lombardi, Yetman and Zakrajšek (2023).
[15] See Borio (2019).

DOI: 10.65644/EIIE.079.01.0037

CONCLUSION

To conclude, the global economy has shown surprising resilience in the face of the political and geopolitical shocks of the past year, particularly the trade war under way. But if we want to understand the most important economic challenges ahead, we need to look beyond our immediate surroundings. Only then will it be possible to see the gathering storm clouds on the horizon – storm clouds that could undermine global macroeconomic and financial stability. The safety margins essential for implementing an adequate response to such instability are perilously shrinking. In every field of activity, the need to maintain safety margins is a fundamental strategic consideration, so why should it not also be so for macroeconomic stabilisation policies?

A change of course is needed. The real question is whether the world's political class is up to the task – whether it has sufficient awareness and capacity to implement it. Sometimes I am reminded of Don Abbondio's quip: "Courage, if you don't have it, you can't just give it to yourself!"

You may think that the picture I have painted is too pessimistic. And perhaps you are right. But I have always believed that Gramsci was right when he noted that to achieve ambitious goals, we need 'the pessimism of the mind and the optimism of the will'. Today, as throughout my career, I believe that the best contribution I can make to changing reality is to provide an analysis that I hope is lucid, but also certainly honest and disenchanted. It is up to the political class to take on the much more difficult task of transforming this analysis into real change through concrete and determined choices.

Thank you.

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