Risks facing the global economy

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Introduction

Good morning.

I would like to thank the Geneva Association and its Managing Director Jad Ariss, as well as Andreas Berger, the CEO of Swiss Re, for inviting me to speak at this impressive event.

As well as providing insurance services to the general public, insurance companies are increasingly important financial intermediaries in the global economy. The Bank for International Settlements (BIS) follows developments in the insurance sector closely, both because of its implications for the economy and financial markets and because we host the International Association of Insurance Supervisors (IAIS) in Basel. I am confident that the insurance industry, as one of the pillars of the non-bank financial intermediary sector, will remain an area of key interest to the analytical work of the BIS going forward.

Today I would like to share with you my views on four risks facing the global economy and financial markets. I hope to provide food for thought as you consider the investment strategies of your firms.

My key message is that, while the global economy remains broadly on track for a soft landing, the world stands in a very different place than before the pandemic in 2019. The constellation of longer-term risks has evolved, and certain themes deserve closer attention than in the past.

1. Inflationary backdrop since the Covid-19 shock

First, I would like to discuss the inflationary backdrop.

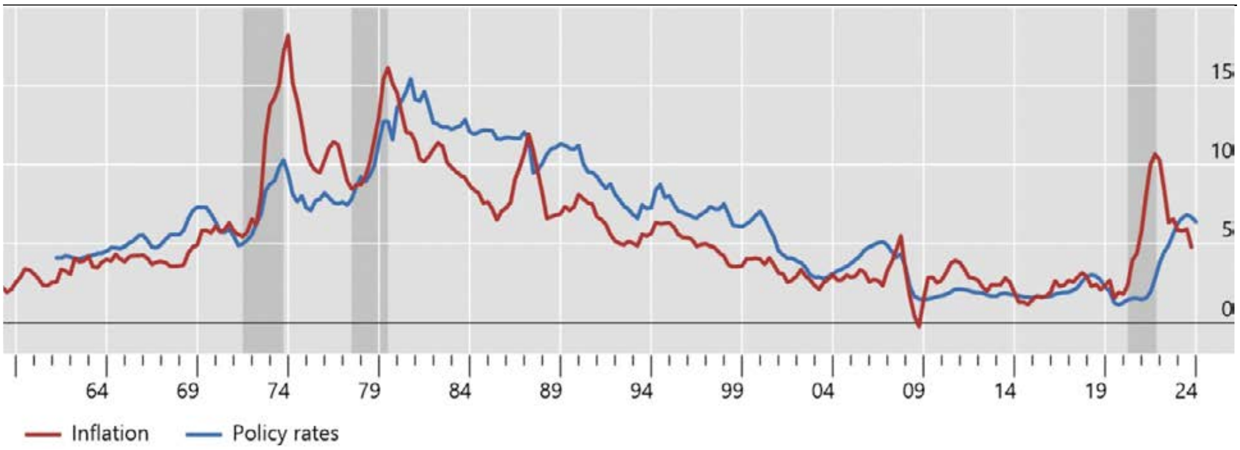
Here there is some good news. Inflation has come down significantly, thanks in large part to decisive central bank actions to restore price stability, slow aggregate demand and prevent the shift to a high inflation regime. Indeed, the balance of risks has become more tilted to the downside in major advanced economies, although some emerging market economies (EMEs) still face significant challenges in controlling inflation.

Success was not a given. The combination of significant aggregate demand stimulus during the pandemic, widespread supply constraints due to lockdowns and related measures, and the energy price shock resulting from Russia's invasion of Ukraine in early 2022 triggered the largest global inflationary outbreak in more than 40 years, as shown in Graph 1.

Monetary policy and inflation[1]

In per cent

Graph 1



[1] GDP-PPP weighted averages for 10 AEs (AU, CA, DK, EA, GB, JP, NO, NZ, SE and US) and 10 EMEs (CL, CO, IN, KR, MX, MY, PH, TH, TR and ZA). Shaded areas represent persistent inflation periods.

Sources: LSEG Datastream; Global Financial Data; national data; BIS.

But Graph 1 also shows that central bank policy actions were effective. Compared with previous inflationary outbreaks, their response was timelier and more decisive.

Inflation has fallen. And its decline has come at a surprisingly small cost to economic activity. The widely predicted recession has not transpired (and of course we must knock on wood at this point in the cycle).

What does this all mean for monetary policy going forward? While the direction of policy is now clearer in most countries, the appropriate size and pace of easing remain quite uncertain, for several reasons. Confidence is greater that economies are now cooling and that inflation is converging to target; however, some uncertainty remains as to the extent of the slowdown. Moreover, a fast pace of easing could contribute to a further build-up of financial vulnerabilities such as leverage and exposure to the carry trades, as I will discuss later in this talk.

Perhaps most importantly, there is no guarantee that inflationary pressures will remain as low as they were in the decade before the pandemic.[1] For one, as I will discuss in more detail later,

[1] BIS, "Laying a robust macro-financial foundation for the future", *Annual Economic Report 2024*, chapter I, June 2024, pp 1–40.

supply disruptions may be more frequent and intense than in the past, not least due to geopolitical tensions. The period of low inflation for long may be over.

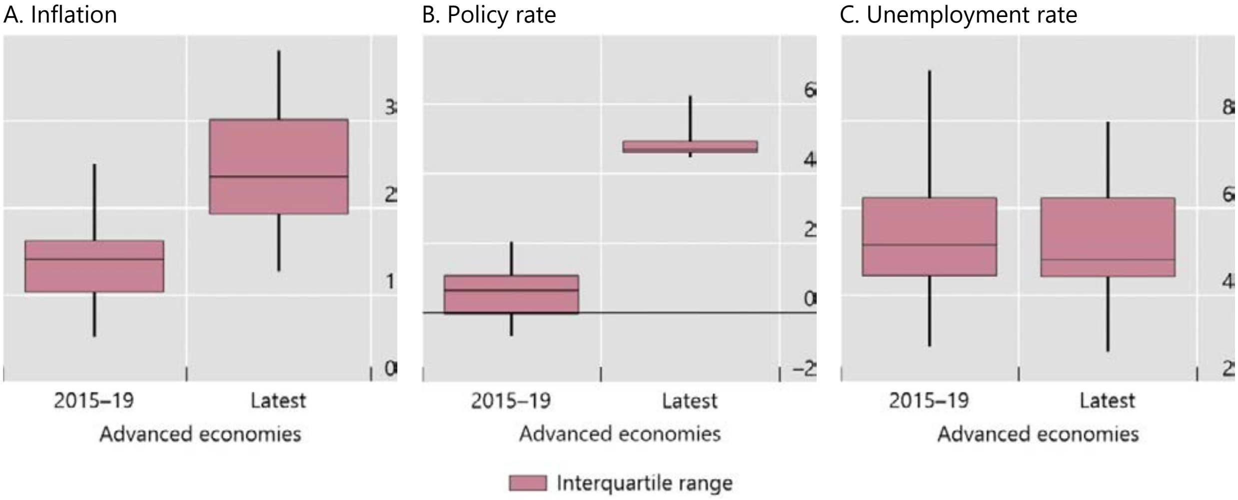
Central banks must be prepared to deal with persistently higher inflationary pressures. As Graph 2 suggests, higher interest rates may be needed to keep inflation at target. That is, the natural rate of interest – where monetary policy is neither boosting nor slowing the economy – may be higher now than before the pandemic.[2]

Central banks should not rush to cut policy rates too rapidly but should adjust the pace of policy rate reductions based on incoming evidence. As a result, asset managers and financial institutions need to be ready to deal with an environment of consistently higher real rates in the long run.

Higher policy rates may be needed to have inflation at target[1]

In per cent

Graph 2



[1] Distribution of the simple average across AU, CA, DK, euro area, GB, JP, NO, NZ, SE and US for the specified time period.

Sources: OECD, *Economic Outlook*; national data; BIS.

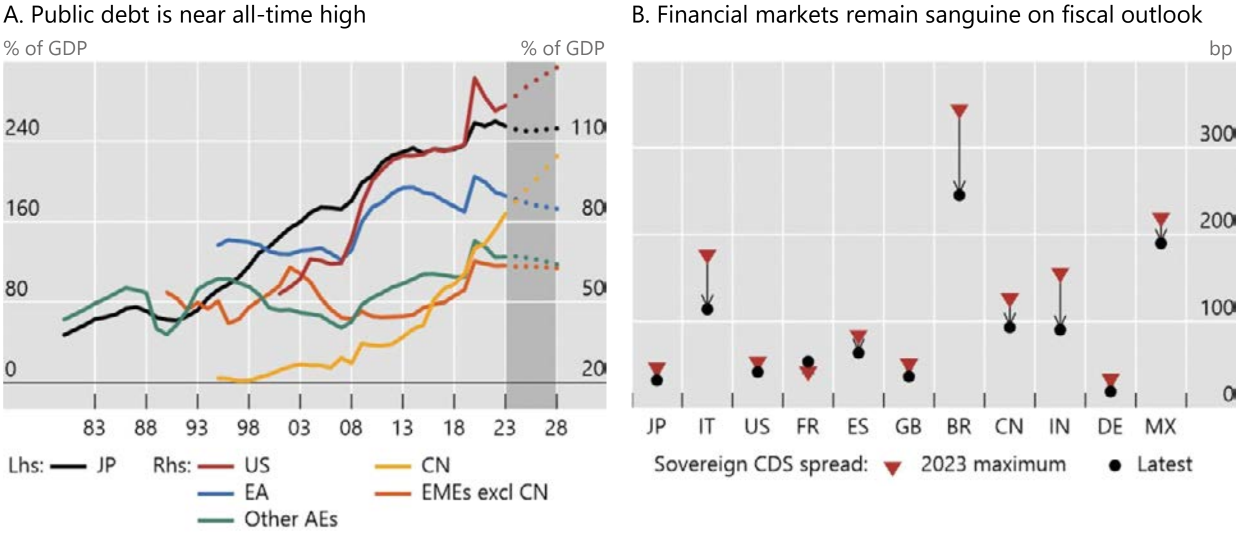
2. The challenges posed by asymmetric fiscal policy

Next, I would like to touch on the challenges posed by asymmetric fiscal policy, observed in many advanced and emerging market economies alike. What do I mean by asymmetric? Namely, while central banks did their job and adjusted monetary policy, fiscal policy has not been correspondingly adjusted in the wake of the pandemic. As a result, fiscal positions are becoming an ever greater concern.

[2] G Benigno, B Hofmann, G Barrau and D Sandri, "Quo vadis, r*? The natural rate of interest after the pandemic," *BIS Quarterly Review*, March 2024, pp 17–30.

Despite the significant escalation in public debt in the aftermath of the pandemic, governments have for the most part retained investor confidence. As we can see in Graph 3, while public debt is near all-time highs and projected to increase further or at best stabilise in major economies, financial markets remain sanguine about the outlook. Although there have been instances of rising yields, these increases have overall not been excessively pronounced.

Greater public spending demand with dwindling fiscal space — Graph 3



Sources: IMF, *World Economic Outlook*; S&P Global Market Intelligence; BIS.

One reason for this resilience may have been investors' expectations that consolidation would eventually occur once conditions improved. But such confidence may not last forever. Investors will at some point want clarity about fiscal strategies. Failure to deliver fiscal consolidation could pose a material risk to both macroeconomic and financial stability.

In fact, a key theme of our Annual Economic Report last year was that the lack of prompt fiscal consolidation could ultimately constrain central banks' room for manoeuvre.[3] Monetary and fiscal policies must operate within a jointly determined "region of stability" to maintain the trust of the public and financial markets. If they do not, inflationary expectations can become unmoored.

Since fiscal consolidation is not a given, what risks might investors face? High debt levels would imply higher interest payments, and that is even if interest rates were to fall to pre-pandemic levels, which in my view is unlikely.

[3] BIS, "Monetary and fiscal policy: safeguarding stability and trust", *Annual Economic Report 2023*, chapter II, June 2023, pp 41–83.

There is also the possibility of higher risk premia and greater sensitivity to policy rates across investments, as benchmark government securities would be seen as riskier. Moreover, historically high volumes of public debt issuance could test the intermediation capacity of bond markets.

Changes in market perceptions of risks may take time to occur and then do so very suddenly, resulting in an abrupt repricing of public debt. Such sharp repricing could put the financial system at risk and, especially in EMEs, reignite inflation through currency depreciation.

In sum, central banks cannot deliver good macroeconomic performance on their own. Governments around the world need to focus on the hard task of long-term fiscal consolidation. A failure to correct unsustainable fiscal trajectories poses major risks to growth, inflation and financial stability.

3. The supply side: global doldrums vs US sparks

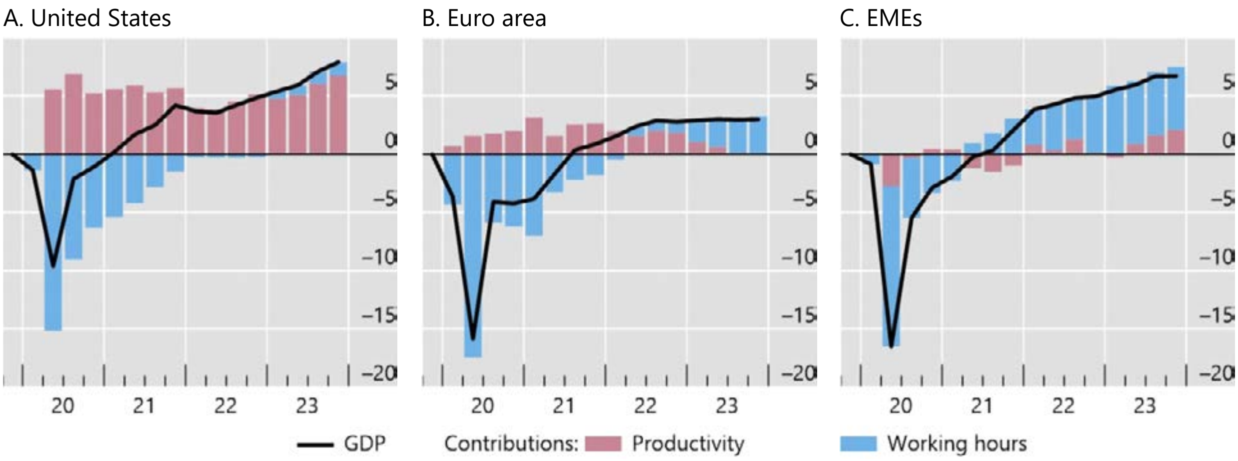
The persistent stagnation in productivity growth represents a third significant risk for the global economy. Sluggish productivity growth could make it harder to curb inflation and erode confidence in the sustainability of public debt.

As we can see in Graph 4, the statistics are disheartening. Labour productivity growth is trailing already weak pre-pandemic trends in most economies.

Productivity has been sluggish as employment underpins economic growth[1]

Cumulative changes since Q4 2019, in per cent

Graph 4



[1] GDP-PPP weighted averages for regions. Euro area = AT, BE, DE, EE, ES, FR, IE, IT, LT, NL, PT, SI and SK; EMEs = CZ, HU, IL, MX and PL.

Sources: OECD; LSEG Datastream; national data; BIS.

The United States stands as a notable exception. There, productivity growth has been robust. This performance is in line with strong business dynamism and investment starting around the Covid-

19 crisis, partly spurred by expansionary fiscal policy. In particular, incentives for investment in high-tech manufacturing and clean energy have catalysed private investment.

By contrast, in most other countries, a lack of business dynamism and weak investment are pervasive. For instance, in Europe, the investment share of GDP has been significantly lower than that in the United States over the past decade.

For advanced economies as a whole, low investment accounts for around half of the slowdown in productivity since 2010. In many instances, uncertainty about the economic outlook and excessive regulation have diminished firms' willingness to invest. Additionally, training and education appear to be significant factors weighing on productivity in EMEs.

How can economies reverse these trends? The European Commission's report on competitiveness highlights a range of opportunities in the energy, digital, defence and innovation sectors that could help mitigate the decline in investment. Part of the solution lies in implementing structural reforms that make it easier to start a business, foster competition and encourage investment. Unfortunately, such reforms have been lagging in many economies since well before the pandemic. Consolidating fiscal positions and rationalising public expenditure could also free up resources to bolster public investment, thereby developing essential infrastructure and improving human capital.

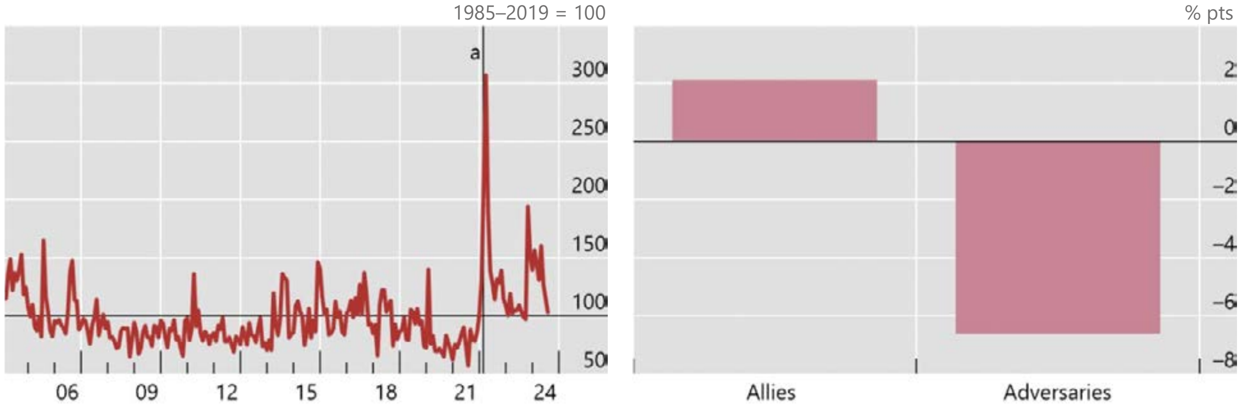
Productivity is also threatened by a factor less amenable to domestic structural reforms – the slowdown and, in some cases, reversal of globalisation, coupled with the recent increase in geopolitical tensions. Trade fragmentation can lead to less specialisation and higher costs as well as longer and less responsive supply chains, and it can slow the spread of technological innovation across countries. As can be seen in Graph 5, in recent years, international trade volumes have grown more slowly between countries that are further apart geopolitically[4] An escalation of geopolitical tensions could lead to even more dramatic trade fragmentation, exacerbating already sluggish productivity trends and contributing even more to high, unwelcome inflation.

[4] H Qiu, D Xia and J Yetman, "Deconstructing global trade: the role of geopolitical alignment," *BIS Quarterly Review*, September 2024, pp 35–50.

Estimated impact of geopolitical distance on quarterly trade growth rates — Graph 5

A. Geopolitical risk index[1]

B. Reconfiguration of the volume of trade flows following Russia's invasion of Ukraine[2]



[a] Russian invasion of Ukraine (24 February 2022).

[1] The index refers to the number of articles related to adverse geopolitical events as a share of the total number of articles in 10 newspapers each month. [2] Changes in average quarter-on-quarter growth for volume weighted by values between two periods: Q2 2021–Q1 2022 and Q2 2022–Q1 2023. Allies are country pairs whose ideal point distance is below the 25th percentile in the sample, while adversaries are those above the 75th percentile.

Source: Qiu et al (2024).

Beyond its marginal impact on trade flows, the geopolitical situation also creates tail risks for inflation and growth. Several hotspots have the potential to escalate into full-blown crises. Should tensions increase further, commodity prices could surge, value chains could be more severely disrupted, and confidence could be shattered – reminiscent of the disruptions witnessed during the pandemic. Wars can bring a much broader toll, including the reduction of productive capacity.

4. Market volatility: a long-lasting feature of the landscape?

Finally, let me touch on financial markets and the volatility that we have seen in recent times.

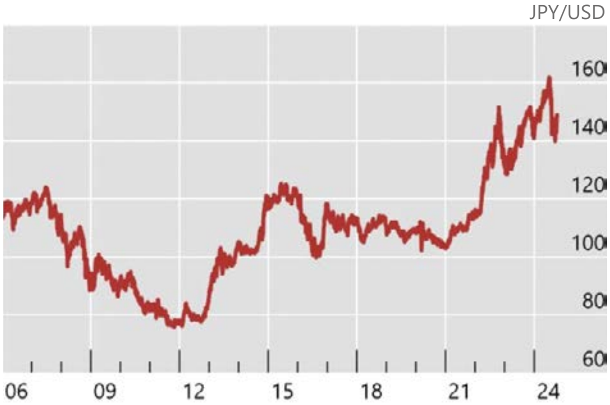
In several cases, such volatility reflects the realization of vulnerabilities that built up during the long period of exceptionally easy monetary and financial conditions that followed the Great Financial Crisis (GFC). The bank liquidity squeeze of March last year is one example of volatility caused by the vulnerability to higher rates of a few institutions that took on excessive liquidity risk.

Another example of market volatility that appears to have its roots in earlier easing is the carry trade unwind episode of early August this year. At that time, markets reacted sharply to hawkish Federal Reserve and Bank of Japan policy meetings and a disappointing US labour market release, leading to a sharp equity market correction in the United States and turbulence in Japan.

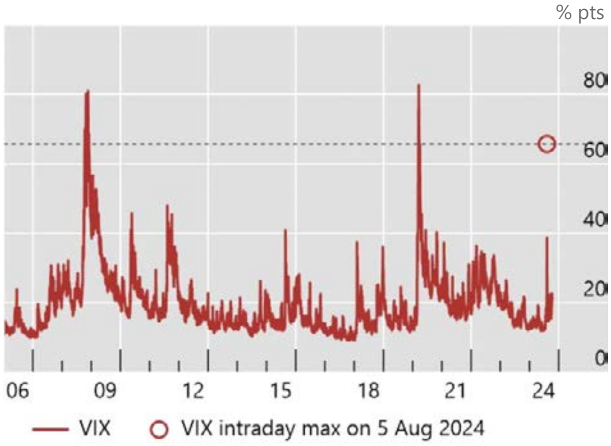
Highly leveraged positions, including foreign exchange carry trades, came under significant pressure, and the stock market experienced a sell-off. Currency carry trades unwound amid shifting interest rate expectations and increased volatility, leading to intense but brief currency fluctuations. Notably, as we can see in panel A of Graph 6, the Japanese yen – a common funding currency – appreciated sharply, while carry trade investment currencies like the Mexican peso faced substantial depreciation pressures. The equity downturn and currency repricing had global spillovers, with the VIX spiking to levels typically observed only during periods of market turmoil, such as the Covid-19 crisis or the GFC, as we can see in panel B of Graph 6. The intensity of these movements in response to seemingly minor news underscores the critical role of amplification caused by the unwinding of leveraged trades.

The VIX spiked during the carry-trade unwind episode — Graph 6

A. Yen-dollar exchange rate



B. Intraday VIX spike was extreme but short-lived



Sources: Bloomberg; national data; BIS.

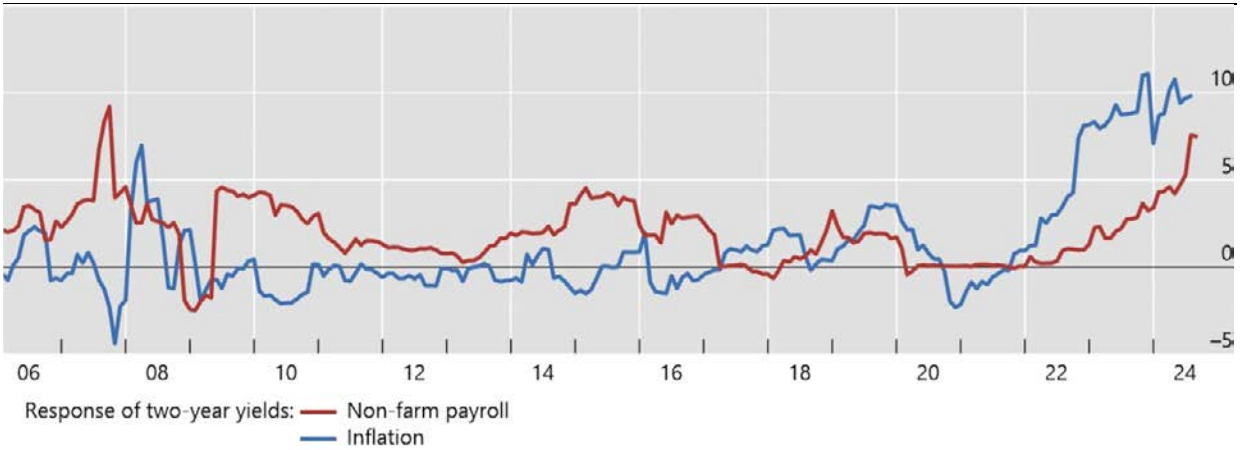
That said, the volatility spike was short-lived, and most markets had recovered within the week. So ultimately the market volatility was contained. But such spikes are not the first, and neither will they be the last, episodes of market turbulence in this financial cycle.

The sharpness of the financial market moves may in part reflect an increased sensitivity of markets to macroeconomic news – what some describe as “hypersensitivity” – particularly to employment data.[5] This sensitivity has been noted by many and has been analytically documented by BIS researchers in Graph 7. Beside leverage, this sensitivity may also be due to the influx of algorithmic traders and other fast-moving agents that now play a large role in many asset classes.

[5] D Xia and S Zhu, “Markets’ increasing response to labour market conditions in the United States”, *BIS Quarterly Review*, box A, September 2024, pp 4–5.

Response of US two-year treasury yields to economic surprises[1]

In basis points Graph 7



[1] Non-farm payroll and inflation surprises are the difference between the actual release and the Bloomberg median forecast. The panel shows the coefficients estimated from regressing two-year yield changes on these surprises using a 24-month rolling window. The sample period spans from January 2004 to September 2024.

Source: *BIS Quarterly Review*, September 2024.

Unfortunately, future episodes may not resolve as quickly, or in such a benign manner, as the latest one. Future volatility outbreaks may spill over to other markets and could hurt some key intermediaries and other market players, with detrimental effects on the real economy.

Indeed, one cause for concern is that recent financial market volatility has occurred in an environment where overall financial conditions have remained rather loose in the United States and other advanced economies. In many markets, valuations are still stretched and credit spreads are tight by historical standards. Moreover, BIS banking statistics suggest that not all leveraged positions in currency markets were unwound following the episode in August.[6] A material tightening in financial conditions could prove even more disruptive.

Risks might also be hidden in more opaque corners of the non-bank financial system. One such area that the BIS has been examining over the past few years is private equity and credit markets. The exposure of key parts in the financial system, including some insurance companies, to these markets should not be overlooked. For instance, asset-intensive reinsurance, where many reinsurers owned by private equity manage assets of insurers and guarantee their liabilities,[7] creates financial stability concerns should private equity markets face a downturn due to rising interest rates and credit risks.

[6] P McGuire and G von Peter, "Sizing up carry trades in the BIS statistics", *BIS Quarterly Review*, box D, September 2024, pp 16–18.

[7] F Garavito, U Lewrick, T Stastny and K Todorov, "Shifting landscapes: life insurance and financial stability", *BIS Quarterly Review*, September 2024, pp 21–34.

5. Wrap-up

Let me conclude. I described four interrelated risks today that bear continued observation: (1) We cannot be sure that real rates will return to the levels they were pre-pandemic. (2) Fiscal policy may not be restrained as much as needed to restore financial stability. (3) The productivity trend is worrisome, implying a supply side of the economy that is not particularly favourable to subdued inflation and robust output growth. And (4) greater market volatility, and the potential for detrimental spillovers to other markets and financial intermediaries, may be a permanent feature of the landscape.

None of these challenges are insurmountable. But nor will they solve themselves. I remain confident that, in time, policymakers will identify and adopt the policy measures needed to address them. But, as those of you in this room well know, only by being prepared for rainy days can we ensure resilient growth and financial stability over the long term. I look forward to hearing your comments and questions. Thank you.