


A Diagnosis of the Current State of the Global Financial System

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The Global Financial System May Be in a Perilous State

- Great uncertainty
- High level of debt—and particularly problematic among developing countries and emerging markets
- Central bank independence being attacked
- Global trading system in shambles
- The US dollar-based global financial system at risk?

High Level of Debt Particularly Problematic in Developing Countries and Emerging Markets

- A series of shocks—Covid-19 pandemic, Russian invasion of Ukraine, post-pandemic/war inflation, high interest rates, oil and food prices
 - Many countries had become over-indebted before, in era of near-zero interest rates
- There is no real system globally for resolving excessive indebtedness
 - **Outcomes are deficient: Too Little, Too Late**
 - **From 1970 - 2014, more than half of the restructurings with private creditors were followed by another restructuring with private creditors or default within 5 years**

Jubilee Commission Report

- Provides a diagnosis of underlying problems
- Blueprint for reforms that would help resolve current problem and make a recurrence less likely
 - Reforms in global financial architecture, debt contracts, legal frameworks in jurisdictions in which the debt is issued
 - Major debt forgiveness twenty-five years ago (last Jubilee)
 - A development crisis as much as a debt crisis—countries spending more on servicing their debt than on education, health, or development investments
 - Lowering prospects for future income/growth, increasing pressures for migration

One Key Problem

Private capital flows are procyclical for developing nations and countercyclical for advanced nations

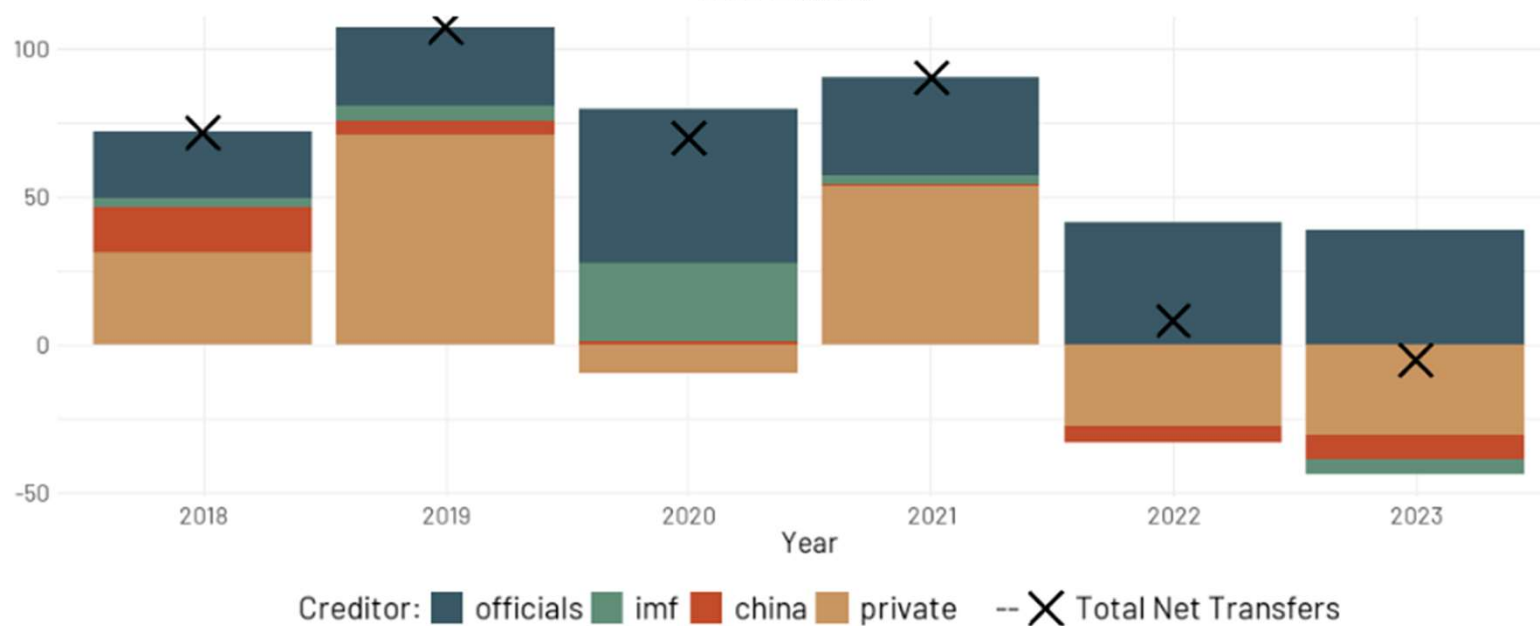
- **Latin American debt crisis of the 1980s and today's debt and development crises are examples of this asymmetry**

Another Related Problem

Hidden bail-outs of the private sector by the international financial institutions

- Reduce incentives for good lending by private sector
- Means money that was supposed to help development and address climate change isn't really doing that

Net transfers on external debt by creditor type for low and lower middle income countries USD Billion



Note: Official creditors include MDB and ex-China bilateral creditors. Private creditors include PPG, non-guaranteed debt, and short-term debt

Source: Diwan, Harnoy-Vernier and Kessler (2025) based on World Bank International Debt Statistics 2024 data.

Soaring US Debt

- “Big Beautiful Bill” showed wanton disregard for deficits/debt
 - Most regressive bill
 - Debt/GDP projects for 2050 ranging from 145% to 200%
 - Forecasts for tariff revenue overly optimistic—don’t adequately take into account changing global supply chains
 - Debt would be manageable with appropriate policies
 - But long-term growth will be hurt by attacks on universities, cutbacks in science and technology, immigration policy, chaos in trade, etc.

Central Bank Independence Being Attacked

- Stability of financial system requires confidence in *fiat money*—accepted as a means of payment/store of value simply because of *trust*
- Without adequate monetary management, there will be a loss of confidence, and inflation
- Have always been some disagreements about what this entails—e.g. balancing multiple objectives
- But what Trump has done has gone over the line—direct control of the Federal Reserve
 - By an administration that shows little evidence of any understanding of economic fundamentals

Global Trading System in Shambles

- Undermining the international rule of law/destroying the rules-based system
- In an attempt to extract more of the value of global supply chains for the US
 - But simultaneously destroying the stability of those global supply chains
 - Wreaking havoc in the global economy
 - Destroying old order, but not replacing it with anything
 - Major change in geoeconomics/geopolitics
 - Hard to forecast where things might settle
 - “Supply shocks” will give rise to inflationary pressures, especially in the US
 - And the corresponding demand shock will weaken growth—prospects of stagflation
 - In Europe, increased defense spending main hope for strong economy

The US Dollar-Based Global Financial System At Risk?

- Old “order” is being rapidly destroyed and replaced by Trumpian chaos, not a new order
- Markets dislike uncertainty, chaos
- Weakening of dollar reflects weakening confidence in US
- Mar-a-Lago accord is a proposal for default
 - Why hasn't dollar weakened further, long-term real interest rates increased more (has increased from around 2% before election to 2.5% today)?

A New World Financial Order?

- Less centered on US dollar
 - US limited and declining share in global trade, GDP—decline accelerated by Trump
 - US power had rested on “soft power” and management of multilateral system— all destroyed by Trump
- Would move even further and faster if there were more confidence in EU and euro
 - Weak trade “deal” —already being undermined by US over digital regulation
 - Europe needs to be less reliant on US, restore economic and defense sovereignty
- Key questions: How long will the chaos last? How quickly will a new order be created? And what will it look like?