The Monetary Policy Dilemma

Note written by Jacques de Larosière[1]

The world is shocked from the war launched against Iran by the United States and Israel.

This war was supposed to be local and quick: the missile strikes on Iran were intended to destroy that country's military capabilities in a matter of weeks.

However, due to Iranian resistance and reactions, the conflict is set to drag on. Iran has sought to "internationalize" this war by setting the entire Middle East ablaze. The situation has taken on global proportions, with rising hydrocarbon prices and disruptions to trade. According to observers, this situation portends serious stagflation on a global scale.

The U.S. leadership now appears, after more than three months of war, to be facing a conflict whose complexity and full international implications it does not seem to have fully grasped. Furthermore, the new administration in Washington is pursuing its agenda of dismantling the multilateral order that has ensured global prosperity since 1945.

Has this crisis – whose full international consequences have not yet been assessed – disrupted financial markets? The answer is no: markets have remained calm and efficient, and monetary policy has not shifted.

Let us examine this strange convergence: that of a potential severe global crisis that the markets do not seem to care about.

I will structure my remarks around three questions:

1. Can the resilience of financial markets last?
2. What can we expect from monetary policy in such a context?
3. What should we make of developments in digital currencies and market fragility?

1. The Resilience of the Markets is Surprising. Can it last?

A resident of Sirius who knew nothing about the war in Iran and the Middle East and followed only the movements of the financial markets would have a calm and positive view of our planet's prospects.

1.1 Stock markets have been calm and resilient since the start of the war in Iran (February 28, 2026)

Stock markets have been on the rise for years, but the uptrend continued after the start of the war in Iran. One reason for this strong market performance is the hope that the conflict will not drag on. The markets have "voted" for an end to hostilities before the end of June 2026, which demonstrates remarkable confidence in their ability to predict and influence the future.

This chart shows that since the start of the conflict with Iran (February 28, 2026), the S&P 500 has gained – after a brief dip in March – a maximum increase of 7% on May 10, 2026. Stock markets soared from record to record in April and May.

In the bond markets, there has been a certain rise in rates. But optimists note that these movements are in line with the trend in inflation, which is on the rise, even though it was, until April 2026, fairly close to the official target of 2%.

1.2 Foreign exchange markets have been relatively calm despite a turbulent environment, but certain exchange rate distortions have worsened:

The euro has remained stable over the past year.

The dollar has weakened slightly, but only modestly (-2.7%) given the scale of the macroeconomic imbalances in the United States.

The yen has plummeted. But this is the result of a long-standing, systematic policy of lowering interest rates.

As for the yuan, it has lost 7% against the euro over the past year. In terms of relative competitiveness (in purchasing power), according to the IMF, the yuan is undervalued by 16% relative to the

1. Speech delivered by Jacques de Larosière at the Global Official Institutions Conference (GOIC) on 18 June 2026.

CHART 1.
Stock Market

Source: Zonebourse.com

Eurozone, thereby giving Beijing a considerable export advantage.

But, overall, nothing is disrupting the calm in the markets, which continues to hold.

1.3 Government pressure on central banks to lower key interest rates continues. But not any more intensely than usual

Admittedly, President Trump has continued his pressure. But the Fed has not really given in (the Fed did, admittedly, cut rates by 0.25% in December 2025, but it cited the weakness of the labor market to justify this move).

The pressure will continue. But a man like Kevin Warsh (whom I know personally and hold in high regard) will never do anything he considers contrary to his country's interests.

To the question: "How long will the calm in the financial markets last?" the answer will depend heavily on the U.S. authorities. If they appear mired in a war with no obvious way out, and the conflict continues, it seems possible – if not probable – that the markets will eventually react to the crisis and, in particular, to the prospect of the conflict continuing indefinitely.

Since the start of the war in Iran, long-term bond yields have been rising (see chart), highlighting the uncertainty surrounding inflation expectations. But the higher oil prices get, the higher long-term rates climb, reflecting households' concerns about the future of inflation.

Since January 2023, 10-year rates have risen:

In the U.S., from 3.5% to 4.2%.

In France from 3% to 3.5%.

In Japan from 0.5% to 2.2%.

Stock and bond markets are dependent on the basic assumption that the conflict will end before July. If, on the contrary, it appears that the conflict is likely to drag on, a market downturn would be all the more plausible given the looming threat of stagflation.

It is important to understand that this is a "vicious cycle".

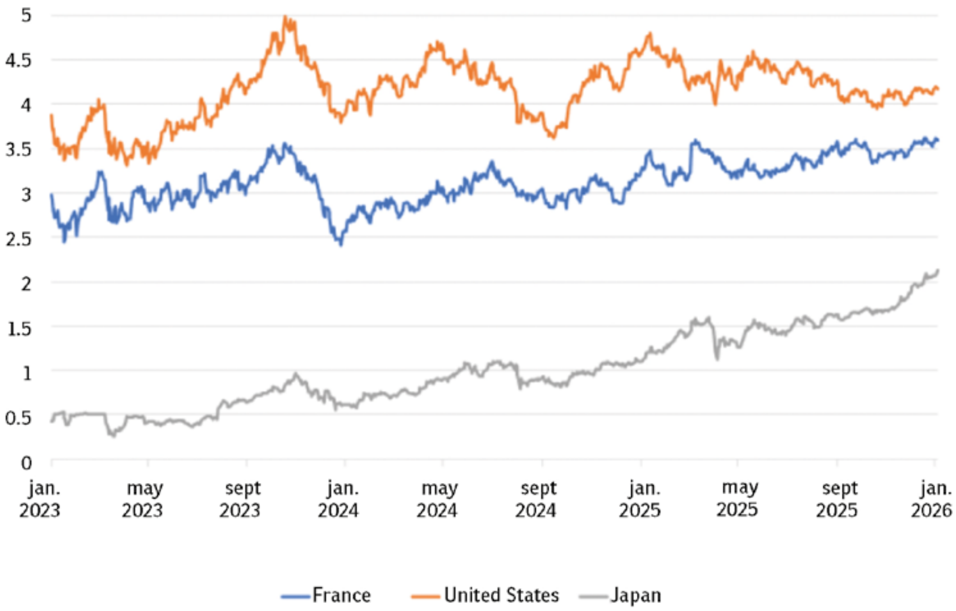
The markets are operating on the basic assumption that the conflict with Iran will be resolved by June 2026[2]. If it appeared that the war were to continue indefinitely, the markets would be forced to adopt an alternative – and necessarily pessimistic – scenario. The markets would turn downward, and after an initial wave of selling, the "Minsky Moment" could emerge...

All major international organizations are saying it: stagflation is just around the corner.

The IMF, in particular, offers an **interesting analysis** in its "Global Stability Report" (April 2026) **of the**

2. Given the significant decline in oil inventories, severe supply disruptions could occur if the conflict drags on and/or the Strait of Hormuz remains closed, as strategic hydrocarbon reserves appear increasingly insufficient.

CHART 2.
Interest rate on 10 years sovereign bonds



Source: BLOOMBERG

"**systemic** vulnerabilities" that could emerge should tensions escalate with a prolonged conflict in the Middle East.

- **The sharp rise in debt – both private and public – is a concern for the IMF.** As governments are forced to roll over their debt at higher rates, the risk of market destabilization intensifies. In turn, these tensions risk exacerbating the vicious cycle between sovereign risk and banking risk.
- Regarding **private credit**, the report highlights a rise in defaults. For now, these defaults are generally low in number and are being resolved through selective renegotiations or new debt without immediate interest payments. But if these defaults were to multiply and spread more widely among companies, there would be cause for concern about contagion (though the scale of the problem is still limited).
- **Lending to emerging markets** has largely been carried out by "non-bank" entities that could reverse their positions and drag the countries in question into episodes of acute crisis with adverse macroeconomic effects, as well as a surge in capital outflows aimed at unwinding positions.
- **The responsiveness and fiscal flexibility of many governments have diminished**. And massive calls by governments to the markets to finance their debt could widen spreads and increase tensions.
- **The foreseeable rise in inflation** could prevent monetary policy from supporting the markets. The foreseeable rise in key interest rates could slow the cycle of massive investments planned in artificial intelligence, as these increasingly rely on debt. Such a reversal could trigger a correction in stock markets dependent on AI.
- **Option sellers** could turn the market against itself, as they are sensitive to fluctuations in the underlying stocks and would thereby trigger increased stock market volatility and downward spirals.

2. What Can We Expect From Monetary Policy in the Current Context?

Inflation, driven by rising energy prices, has returned with a vengeance.

Often, episodes of rising oil prices are temporary and followed by declines. We therefore tend to look "through" energy prices, which do not have the power to structurally alter the inflation curve. But the current situation is complex.

Rising oil prices (which have climbed from $60 per barrel at the start of the war to $110 today) have already seeped into consumer price indices. In the United States, these have just risen to 3.5% over a three-month period, well above the 2% target set by central banks.

So, even if oil prices were to fall and return to their pre-Iran conflict levels, consumer prices would still have risen in the meantime. However, we see that these prices, once incorporated into overall inflation, do not tend to return entirely to their pre-crisis levels. Experience shows, in fact, that **after the crisis subsides**, the **price level will remain higher than it was before the price hike**. It is this relative inelasticity of the price level that poses a problem and leads us to the conclusion that the current sharp increases affecting consumer price indices cannot be fully reversed (see the Elias Krieff study on this subject).

This relative inelasticity of the price level is often overlooked, but it is a key element of the problem.

2.1 Stagflation, stemming from the conflict, is beginning to emerge and poses a real threat

It is well known that, among the effects of the Iran war, **the impact on production processes is among the most severe.**

With the unrest in the Middle East and disruptions to passage through the Strait of Hormuz, **we are witnessing significant supply disruptions**. There are numerous examples of this. One can cite agriculture, particularly in Asia (in India, Vietnam, etc.), which has been hit hard by difficulties in securing fertilizer supplies. Part of the spring planting season has already been affected. The Philippines have been seriously affected and have been declared a "disaster area".

However, these disruptions to the production system cannot be fully overcome, and production losses will reduce GDP in 2026. The same applies to supplies as diverse as medicines, semiconductors, and aluminum packaging…

In all these areas, the decline in production has already occurred, and growth forecasts are beginning to be revised downward.

It is too early to assess the exact extent of this emerging stagflation. This will depend, to a large extent, on the duration of the conflict. Disruptions in production chains could, of course, be partially resolved, but that will take time. Such uncertainties (Rogoff calls it the most serious threat of stagflation ever seen) are not good for productive investment, which is, however, a prerequisite for future growth.

2.2 Not all countries are equally affected

The countries most affected are obviously those that are most dependent on hydrocarbon imports. And among this group of countries, the most vulnerable are those with high levels of public debt and little remaining fiscal leeway. Implementing "mitigating measures" to reduce the loss of purchasing power caused by rising energy prices requires a minimum of fiscal leeway. A country like France no longer has such leeway and is forced to increase its borrowing to cover these increased subsidies.

The lower-left quadrant of the attached chart (countries that are both dependent on hydrocarbon imports and heavily indebted) shows just how severely a country like France is affected.

It is therefore impossible, based on this analysis, to assert that the effects of the conflict will be "reversible". The most likely scenario is that the world will fall prey to high stagflation (in 2026-27) and that the markets will have been hardly vigilant in foreshadowing this development.

2.3 What can central banks do in such an environment?

So far, with the exception of Norway, which has just raised its key interest rate, central banks have remained inactive. The Fed was, as always, torn between the duty to control inflation and the need to prevent rising unemployment. As for the ECB, it is still seeking the lowest possible key rates. (Its latest cut, in May 2026, allowed it to return to a zero key rate in real terms despite the harmful effects – increasingly recognized as such – of this strategy).

Central bank governors have therefore procrastinated… But the situation is becoming uncomfortable.

In a context of abundant liquidity, with inflation at 3.5% heading toward 4% – and QT virtually nonexistent (at least in the US) – it seems difficult for central banks to remain inert, unless they want to give the impression that the fight against inflation has now been abandoned[3].

Furthermore, **the macroeconomy still rests on a dual foundation: monetary policy and public finances**. Both must play a role in the fight against inflation. The situation in France could be characterized as follows. Inflation is trending above the 2% target set by the central bank. Given the two major factors – namely, the looming threat to public debt and public finances on the one hand, and the sheer volume of liquidity on the other – I believe we must understand that doing nothing today risks having consequences that we might regret later. To call a spade a spade, I think it is very difficult to

3. Producer prices in the United States, linked to the conflict in Iran, have risen by 6% over a 12-month rolling period (statistics as of mid-May 2026). This increase is the sharpest since 2022.

imagine that we would do nothing under these circumstances. Given the abundance of liquidity, it would be a salutary gesture of warning and vigilance for the future if we signaled an interest rate hike very soon. Doing nothing, turning a blind eye – standing idly by – would be a monetary policy move that would be difficult to explain.

Monetary policy cannot be conducted in isolation from fiscal policy. If fiscal policy remains lax – which it is – monetary policy must be all the more restrictive. If, on the other hand, fiscal policy were to restore a certain degree of discipline, then monetary policy would face less pressure. The two are therefore inextricably linked. And, if within this pair, fiscal policy continues to go off the rails without reform, what should monetary policy be? In principle, it should be tighter than it would be if the fiscal side demonstrated a greater sense of responsibility. However, I do not see this sense of responsibility materializing on the fiscal side. I do, however, see two major factors: on the one hand, the slide into debt, and on the other, the impact of the war in Iran on oil prices. I would feel very uncomfortable if I heard someone say: "Well, these things are important, but we don't yet see a strong influence on current inflation indices (the CPI). Therefore, we shouldn't do anything." In reality, since the ECB's monetary policy is less restrictive than in the U.S. and the U.K., it would be normal for Europe to raise interest rates.

There is, moreover, an interesting debate in the US regarding **the desirable size of the Fed's balance sheet.**

Until last year, the Fed was making progress in its effort to reduce its balance sheet through QT. By not reinvesting maturing securities, the Fed managed to reduce its market presence by $2 trillion (or 7% of GDP).

However, for some time now, the Fed's balance sheet has been growing again (+$200 billion since December 2025). The central bank's securities purchases are intended to keep reserves at a high level to better control short-term rates.

Mr. Kevin Warsh views a very large central bank balance sheet as an aberration and a way for the Fed to intervene in the fiscal sphere, which is not its domain.

Mr. Stephen Miran, a close advisor to the President, also believes that the Fed's presence in the market must be reduced as much as possible to avoid encouraging the distortions for which the government is responsible. Ultimately, a smaller balance sheet will better protect the boundaries between monetary and fiscal policy.

Miran wants to end the Fed's "regulatory dominance" and dismantle the incentives given to banks to increase their reserves with the Fed.

These views are set to be debated. Should the balance sheet be reduced in the traditional manner (through securities sales) or adapted to the new regulatory framework à la Miran?

To be continued...

I would add that in his Senate hearing on April 21, 2026, the new Fed Chair gave the impression that he was a strong personality.

He emphasized that the Fed's independence would be central to his role as Fed Chair;

He confirmed that he intended, over time, to lower key interest rates and gradually reduce the institution's balance sheet;

He was highly critical of the monetary policy pursued between 2021 and 2023, which he believes was ineffective in containing inflation.

Finally, a Fed Chair who is leaving the beaten path of "unconventional policy"!

3. But at the Same Time, Significant Changes Are Emerging Both in the Realm of Digital Innovation and in the Area of Excessive Leverage in Financial Markets

While some senior political leaders are bent on starting wars and undermining the multilateral free-trade system that has been in place since 1945, significant monetary and financial developments are taking place without much attention being paid to them.

3.1 The age-old dilemma. Can a national currency also be an international currency?

This is the age-old – and ever-present – dilemma.

How to preserve the dollar's international role while avoiding its appreciation, which risks undermining the competitiveness of American industry; despite the damage the United States inflicts upon itself (and in particular through sanctions that undermine the dollar's acceptability), the fact remains that the existence in the United States of the world's largest financial market – broad, deep, and liquid – keeps the dollar in its preeminent position. No one can compete with this market.

Despite its growing budget deficits, U.S. Treasury bonds remain the dominant benchmark.

The global market for government bonds is $140.7 trillion, of which $55.3 trillion is issued by the U.S. (39% of the total), with 31% held by non-residents and 14.6% by the Fed.

The worsening fiscal trajectory of the U.S. has hardly altered these figures, although the announcement of President Trump's tariff policy was accompanied by a 40-basis-point widening of spreads on U.S. sovereign debt.

In contrast, Eurozone countries issued €10 trillion (of which 35% is held by the ECB and 22% by non-residents).

Japan has issued $7.8 trillion worth of debt, equivalent to 250% of its GDP. The Bank of Japan holds 52% of these bonds.

In summary, the general deterioration of fiscal policies raises questions about the quality of the securities issued and explains the rise in gold, a safe-haven asset that now accounts for 15% of reserves held by central banks.

The Chinese sovereign bond market – $21 trillion – though large, is issued primarily by local and illiquid entities. The portion that is, in principle, "marketable" amounts to approximately $2 trillion, which is relatively negligible.

A slow erosion of the dollar's share in global reserves is certainly worth noting (the dollar's share in central bank reserves has fallen from 72% to 58% since 1999), but there is no sign of a "replacement" for the dollar, whose market remains dominant and is characterized by its liquidity and depth.

Nevertheless, the international "system" is crumbling.

Settlements of commercial transactions are increasingly taking place in the currencies of the contracting states. And settlement platforms centered on the renminbi are multiplying.

These advances in instant payments are driven by the desire to reduce transaction costs and be less subject to the volatility of exchange rates for a few major currencies.

This transition to the Instant Payment System (IPS) is developing rapidly. More than 100 countries are now moving in this direction (see Hung Tran: "The global push for local-currency cross-border payments is intensifying" – Econographics, May 20, 2026).

These advances are intended to improve the efficiency of the payment system, not to replace the dollar as an international currency. However, inevitably, these new settlement methods will tend to reduce the dollar's role as an intermediary currency in international trade.

3.2 The rise of stablecoins

These instruments are developing under the influence of the U.S. "Genius Act" of July 2025.

The market capitalization of these assets, fully backed (one-to-one) by the U.S. dollar, is growing rapidly. It reached $317 billion in April 2026. This figure could rise to $3 or $4 trillion by 2030, as noted in a recent study by Hung Tran[4].

Stablecoins are payment methods that can be used at low cost on the blockchain 24 hours a day. As such, these payment methods represent an improvement over traditional solutions.

From a monetary perspective, stablecoins increase the velocity of money compared to the slower turnover of bank deposits.

In principle, this increased velocity has inflationary implications. However, the requirement for issuers to hold 100% of the value of stablecoins in dollars makes this system similar to "narrow banks". These new payment methods are not covered by deposit insurance and, as a result, are not included in the M aggregates.

While stablecoins are purchased with cash, the fact remains that these payment methods are not included in M0, even though they are a tokenized form of currency in circulation.

Currently, stablecoin issuers hold $182 billion in U.S. Treasury bills – representing 57% of their reserves – with the remainder held as bank deposits or certificates of deposit.

This $182 billion still represents only a small percentage of the total T-Bills, which amount to $6.3 trillion. It is possible that, in the future, if demand for stablecoins increases, the Treasury will issue more T-Bills.

The acquisition of stablecoins using bank deposits does not change the amount of deposits. The concern is rather that the foreseeable growth of stablecoins could lead to some disintermediation of the banking system: indeed, stablecoin users might well transfer their bank deposits into stablecoins.

The risks associated with stablecoins can be analyzed as follows:

4. See Hung Tran's article: "Stablecoins' Potential Effects on the Monetary System", Policy Center for the New South, PB26/26. I drew inspiration from this article in the text above.

- stablecoins introduce – in the realm of payments – the risk of cyberattacks;
- the risk of a loss of collateral ("depegging"). There have been 9 instances where collateral fell below 100%;
- The risk of dollarization of foreign payment systems appears relatively low given the $16 trillion held by banks outside the U.S. However, the proliferation of stablecoins points toward an increased role for the dollar internationally and a decline in interest rates on Treasury bills.

3.3 The ECB is continuing its painstaking work on the issuance of a central bank digital currency

The digital euro is supposed to have all the characteristics of a central bank currency, just like the banknotes and coins it is not meant to replace but to complement.

This highly technical issue is progressing slowly in Frankfurt. But I would tend to side with the opinion of Mr. Bailey, Governor of the Bank of England, who finds it strange that certain central banks want to become operational themselves on a technical issue concerning digital means of payment. Why not leave this matter to the private sector?

The central goal of this push toward a central bank digital currency is driven by the desire to restore the sovereignty of the payment system – sovereignty that has been compromised for 22 of the 27 European countries, which are exclusively dependent on the American systems Visa and Mastercard.

Before taking a stance on complex issues and questionable solutions, it would seem wise to pause the process and ask independent bodies to conduct comparative analyses.

3.4 Excessive market leverage. Several risk-laden phenomena are currently emerging

a) Leverage increases when retail investors make greater use of margin debt.
These investors borrow from brokers using their existing investments as collateral.
The amount of margin debt in use reached a record $1.2 trillion by the end of December 2025. Added to this is an additional $250 billion in leveraged exchange-traded funds (ETFs).
Overall, the high degree of leverage that characterizes these retail investments can cause their valuations to swing both up and down. But at the expense of the system's stability.

b) **Hedge funds** are betting with less and less of their own money and are increasing their debt, particularly with banks.
The value of Treasury bill swaps (long cash positions combined with short futures positions to exploit small valuation differences) has risen significantly in recent times. When interest rates and the value of instruments move contrary to expectations, hedge funds incurring losses are forced to unwind their positions and sell assets, which creates new tensions in the markets.

c) The rise of private credit introduces new vulnerabilities.
The market has grown from $500 billion in 2010 to $1.3 trillion by the end of 2025, and the trend continues to expand. (It is expected to reach up to $5 trillion in the near future).
Private credit is predominantly accompanied by "covenant-lite" contracts, as was the case before the 2007–2008 crisis.
Private credit funds are investing more in collateralized loan obligations (CLOs) to improve their performance. However, transparency and quality suffer as a result.
There is also a surge in "continuation deals," which allow "non-banks" to sell debt to themselves. The cash generated by these debts is then re-lent to companies whose already very high debt levels are rising (these "continuation deals" have grown from $4 billion in 2024 to $15 billion in 2025).

d) **Non-bank debt[5] is increasingly linked to banks**
The amount of bank loans to various types of non-banks (CLOs, asset-backed securities, insurance companies, private equity firms, hedge funds, etc.) has grown at an accelerated pace. The outstanding balance of these loans is high, reaching $2.5 trillion.
For their part, banks have accumulated $1.5 trillion in leveraged loan exposures (a 12% increase since 1997).
The Fed's report on financial stability at the end of 2025 notes that the financial system's leverage is "significant".

However, experience shows that excessive debt is a source of vulnerability.

The risks highlighted above – which are partly linked to the uncertainties surrounding President Trump's policies – should serve as a warning to authorities if we are to avoid a recurrence of the tensions that led to the 2007-2008 crisis.

5. "Non-banks" accounted for 41% of the European Union's financial sector assets at the end of 2023.

In conclusion, I believe it is worth noting that despite the resilience and calm of the markets, vulnerabilities are evident.

The wave of stagflation stemming from the war in Iran is very real (inflation is projected to reach 4% in 2026–27, with growth expected to decline by at least 1%, based on current estimates).

A global economy whose lifeblood – *i.e.*, trade – is disrupted is an economy whose very foundations are threatened.

That said, the dollar will remain the international currency for a long time to come. This is due to the power, liquidity, and size of the U.S. financial market.

A number of vulnerabilities that predate the Middle East conflict must be addressed if we are to avoid a debt crisis.