EXECUTIVE SUMMARY

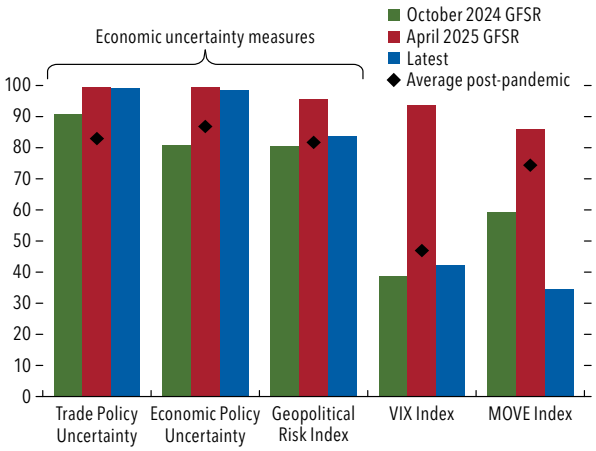
Shifting Ground beneath the Calm

Global financial markets appear calm despite continued trade and geopolitical uncertainty (Figure ES.1). However, this issue of the *Global Financial Stability Report* highlights several signs of shifting grounds in the financial system that could raise vulnerabilities if associated risks are not addressed. Accordingly, the IMF's growth-at-risk framework shows that risks to global financial stability remain elevated (Figure ES.2). Policymakers are urged to stay vigilant and respond promptly to changing circumstances.

The first sign that the ground is shifting is the continued appreciation of risk asset prices. Markets appear to downplay the potential effects of tariffs on growth and inflation. IMF staff models show that valuations of some risk assets have once again become stretched after the brief correction from the April 2 tariff announcement by the United States. Meanwhile, the US dollar has depreciated by 10 percent so far this year, having decoupled relative to wide US–G10 interest rate differentials in the months following the announcement (Figure ES.3), amid concerns about US policy uncertainty, and as investors reassessed the dollar's decade-long bull run. Any further abrupt correction of asset prices could be exacerbated by these changing asset correlations, straining financial markets. For example, foreign exchange markets have undergone structural shifts in recent years yet have not experienced significant dollar weakness (see Chapter 2).

Another crucial sign is that debt has continued to shift toward the government sector as expanding global fiscal deficits propel sovereign bond issuance. In major advanced economies, sovereign bond markets increasingly depend on price-sensitive investors, exerting upward pressure on term premiums and long-term yields. In emerging markets, governments have turned to domestic investors for financing. Although this has reduced reliance on foreign currency debt, it may yet create fragilities such as a stronger bank-sovereign nexus (see Chapter 3).

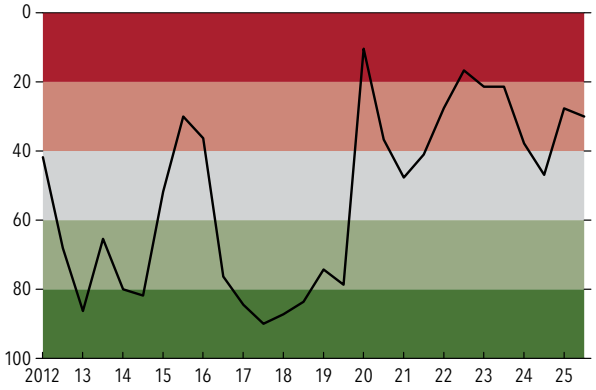
Figure ES.1. Economic Uncertainty and Financial Volatility
(Percentile)



Sources: Bloomberg Finance L.P.; Baker, Bloom, and Davis 2016; Caldara and others 2020; Caldara and Iacoviello 2022; and IMF staff calculations.

Note: Percentiles are derived from monthly data since January 1997. "Average postpandemic" is the average percentile since January 2022. The latest levels for the VIX and MOVE indices are as of October 2, 2025. GFSR = *Global Financial Stability Report*; MOVE = Merrill Lynch Option Volatility Estimate; VIX = Chicago Board Options Exchange Volatility Index.

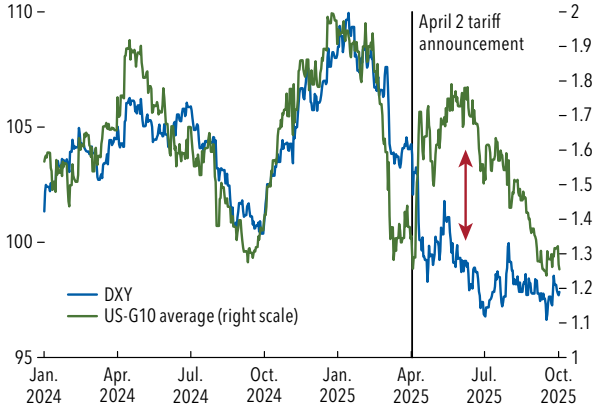
Figure ES.2. Near-Term Growth-at-Risk Framework Forecast
(Historical percentile rank)



Sources: Bank for International Settlements; Bloomberg Finance L.P.; EUROPACE AG/Haver Analytics; IMF, International Finance Statistics database; and IMF staff calculations.

Note: The black line traces the evolution of the fifth percentile threshold (the growth-at-risk metric) of the near-term forecast densities, where the lower percentiles represent a higher downside risk. The intensity of the shading depicts the percentile rank for the growth-at-risk metric; the quintiles with the lowest percentile ranks are shaded the brightest red and the highest are brightest green.

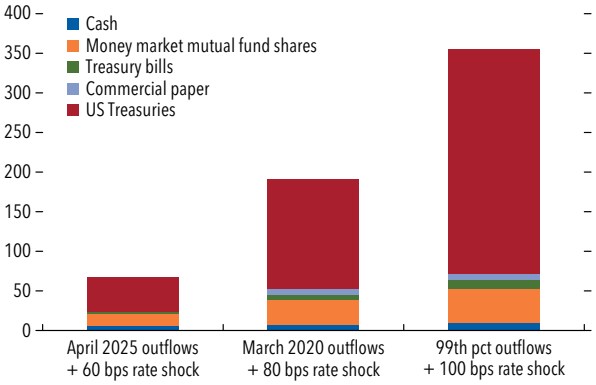
Figure ES.3. US Dollar versus Interest Rate Differentials
(Index, left scale; percent, right scale)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.

Note: The US-G10 average is the nominal 10-year interest rate differential between the United States and the average of the G10 countries. DXY is the US dollar index, which indicates the general international value of the dollar.

Figure ES.4. Forced Sales of Bond Funds under the Waterfall Approach
(Billions of dollars)



Sources: Lipper; Securities and Exchange Commission N-PORT; and IMF staff calculations. N-PORT data are taken from the second quarter 2025 batch, retaining only submissions for the first quarter of 2025.

Note: Under the "waterfall" approach, US Treasuries are sold after cash and other liquid assets are depleted. See Online Annex 1.4 for more details. bps = basis points; pct = percentile.

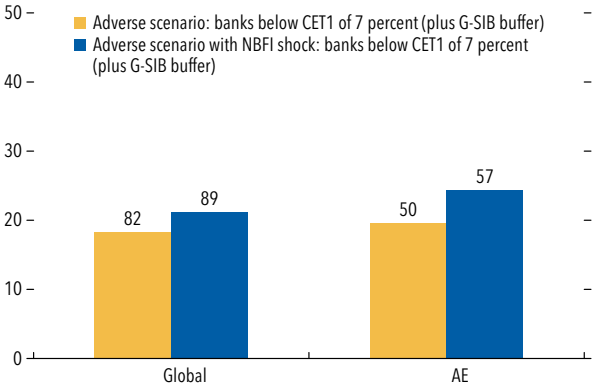
Finally, the growing size of nonbank financial intermediaries (NBFIs) and deepened ties with banks have heightened their sectoral interconnection. This *Global Financial Stability Report* documents the expanding role of NBFIs in core sovereign bond markets and corporate debt markets, including through the participation of retail investors in private credit. Such links raise the specter of excessive risk taking and interconnectedness in the financial system.

Vulnerabilities and Uncertainties

These shifts can cause vulnerabilities in the financial system. Although sovereign bond markets in major advanced economies have stabilized since the abrupt sell-off prompted by the April 2 tariff announcement, steepening yield curves, more negative swap spreads, and the erosion of convenience yields indicate that bond market functioning is on shakier footing. Bond market functioning could be tested if yields rise abruptly—for instance, a scenario analysis for bond mutual funds shows that forced US Treasury liquidations as a result of large fund outflows and an abrupt increase in yields could reach almost $300 billion (Figure ES.4). Given the crucial role of core sovereign bonds as benchmarks and collateral, their deterioration has implications for the broader financial markets.

In the banking sector, capital ratios have improved. In an adverse macroeconomic scenario, the IMF's Global Stress Test reveals that about 18 percent of global banks by assets would see their Common Equity Tier 1 capital ratio fall below the important threshold of 7 percent plus a G-SIB buffer. However, additional shocks to NBFIs could increase this share of weak banks by assets to 21 percent, highlighting the linkages between banks and NBFIs (Figure ES.5).

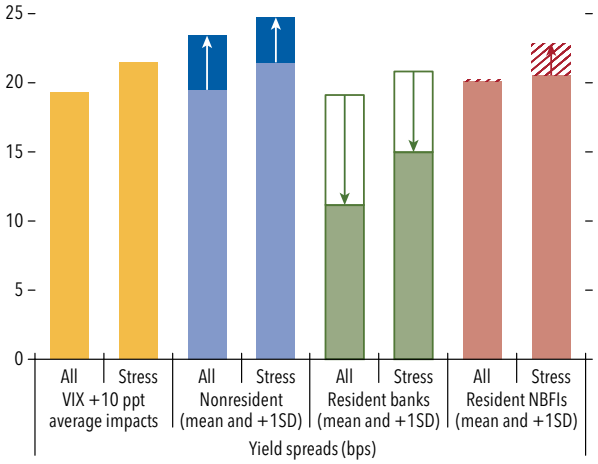
Figure ES.5. Share of Total Assets of Weak Banks, by Region
(Percent of assets, vertical axis; number of banks, bars)



Sources: Call report data; European Banking Authority; Fitch Connect; Fitch Solutions; S&P Capital IQ Pro; and IMF staff calculations.

Note: The figure shows the number of banks falling below the 7 percent CET1 ratio plus a G-SIB buffer under the IMF Global Bank Stress Test adverse scenario, with an additional NBFI shock for euro area and US banks. The NBFI shock assumes that risk weights increase from 20 percent to 50 percent and all available commitments are drawn. AE = advanced economy; CET1 = Common Equity Tier 1 capital; G-SIB = global systemically important bank; NBFI = nonbank financial intermediaries.

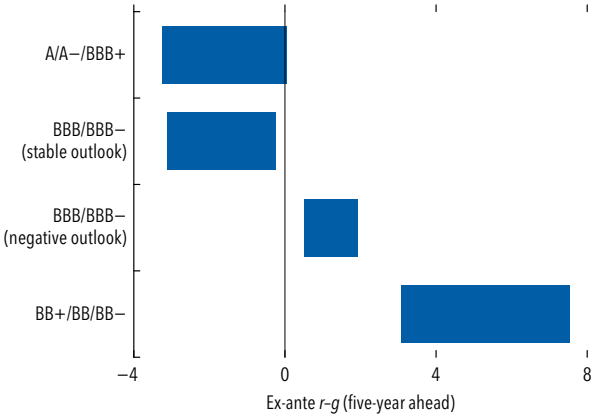
Figure ES.6. Effects of Investor Composition on Emerging Market Local Bond Market Sensitivity
(Basis points)



Source: IMF staff calculations.

Note: Bars indicate the estimated impact on yield spreads of a 10-percentage-point increase in the VIX, along with the effects of a one standard deviation increase in investor participation for nonresidents, resident banks, and resident NBFIs. Solid bars indicate an amplification effect; hollow bars indicate attenuation. Shaded bars indicate statistical insignificance. See Online Annex 3.1 for more information. "Stress" refers to a subsample in which the VIX is above its 75th historical percentile. The sample is Brazil, China, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Poland, Romania, South Africa, Thailand, and Türkiye. bps = basis points; NBFIs = nonbank financial intermediaries; ppt = percentage point; VIX = Chicago Board Options Exchange Volatility Index.

Figure ES.7. Estimated "*r–g*" (Five-Year Ahead) in Emerging Markets, by Average Credit Rating Band
(Percent)



Sources: Bank of England; Bank of Japan; Bloomberg Finance L.P.; Citi; Consensus Economics; EUROPACE AG/Haver Analytics; European Central Bank; Federal Reserve Bank; J.P.Morgan; London Stock Exchange Group; and IMF staff calculations.

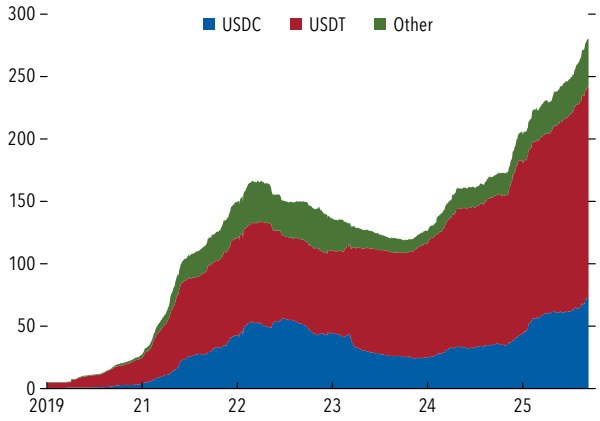
Note: The *r–g* estimates are computed from current 5-year, 10-year, and implied 5-year forward yields, considering differences in the term premium. Inflation and growth estimates are from Consensus Economics or, when unavailable, from *World Economic Outlook* database forecasts. The credit ratings are the median ratings from three international rating agencies. Data include 14 major emerging markets: Brazil, Chile, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Peru, the Philippines, Poland, Romania, South Africa, and Thailand. *r* = long-term real interest rates; *g* = long-term growth rates.

Emerging market government debt has grown significantly across most countries, but its structure has increasingly diverged. Emerging markets with stronger economic fundamentals have been able to finance debt largely from domestic resident investors in local currency (see Chapter 3). The shift toward local government bond markets is empirically associated with increased resilience to global shocks—an increase in the resident investor share is associated with a decline in the sensitivity of emerging market bonds to shocks to the VIX, the Chicago Board Options Exchange's Volatility Index (Figure ES.6). Nonetheless, increased local currency financing may create other fragilities, such as a stronger bank-sovereign nexus. For weaker emerging market economies, on the other hand, debt service burden is mounting, with long-term real interest rates (*r*) that are higher than long-term growth rates (*g*) (Figure ES.7). That could expose emerging markets to funding risks, as fiscal consolidation would be challenging for them (see the October 2025 *Fiscal Monitor*).

The corporate sector has been resilient so far, although tariffs could put pressure on corporate profit margins in some sectors, adversely affect debt-servicing abilities, and make stretched corporate equity and bond valuations vulnerable to corrections. In a scenario whereby additional tariffs are phased in and at the same time firms face higher refinancing costs, the share of corporate debt with an interest coverage ratio falling below 1 would reach 55 percent in some countries. A weak tail of firms appears to already be struggling in the current environment. Despite the wave of restructurings, liquidity remains strained among the more vulnerable borrowers in the leveraged loan and private credit markets. This has contributed to an increase in borrower downgrades.

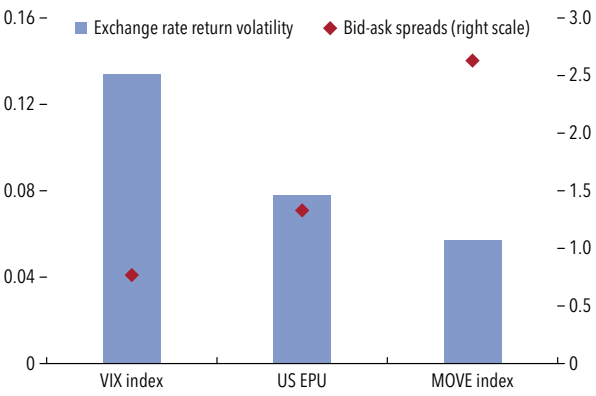
Stablecoins are growing rapidly and playing a larger role in financial intermediation, led by stablecoins pegged to the US dollar (Figure ES.8). The continued growth of stablecoins could have three main financial stability implications: (1) weaker economies may face currency substitution and reduced effectiveness of policy tools, (2) bond market structure could change with potential implications on credit disintermediation, and (3) investor runs out of stablecoins may generate forced selling of reserve assets. Potential

Figure ES.8. Stablecoin Market Cap
(Billions of dollars)



Sources: Bloomberg Finance L.P.; Reuter 2025; and IMF staff calculations.
Note: USDC = US Dollar Coin, issued by Circle Internet Group Inc.; USDT = US Dollar Tether, issued by Tether Limited.

Figure ES.9. Effect of an Increase in Macrofinancial Uncertainty on Foreign Exchange Market Conditions
(Percentage points, left scale; basis points, right scale)



Sources: Baker, Bloom, and Davis 2016; Bloomberg Finance L.P.; LSEG Datastream; and IMF staff calculations.
Note: The figure depicts the response of weekly excess exchange rate return volatility (bars) and bid-ask spreads (diamonds) against the US dollar after large macrofinancial uncertainty shocks. Macrofinancial uncertainty is measured using the Chicago Board Options Exchange Volatility Index (VIX), the US Economic Policy Uncertainty (EPU) index, and the Merrill Lynch Option Volatility Estimate (MOVE) index. Large uncertainty shocks are defined as dummy variables equal to 1 when the AR(1) residual error term of the respective indicator exceeds two standard deviations.

systemic effects would be conditional on stablecoins' continued growth.

Despite deep liquidity, global foreign exchange markets remain vulnerable to episodes of increased macrofinancial uncertainty. As Chapter 2 shows, flight to quality and increased demand for hedging during such periods can raise foreign currency funding costs and impair foreign exchange market liquidity, reflected in wider bid-ask spreads and heightened exchange rate return volatility (Figure ES.9). These pressures may be exacerbated by structural fragilities in the foreign exchange market, including large currency mismatches, concentrated dealer activity, and increased NBFI involvement. Strains in foreign exchange market conditions can spill over into other asset classes, tightening broader financial conditions and potentially posing risks to macrofinancial stability. Moreover, the expansion of foreign exchange trading has heightened settlement risk—the possibility that one party delivers currency without receiving the countervalue. Operational risks to foreign exchange market infrastructure, such as technical failures and cyberattacks, further threaten market functioning.

Policy Recommendations

Macroeconomic stability is crucial to financial stability. For tariffed jurisdictions facing weaker demand, a gradual easing of the policy rate could be appropriate. For countries where inflation is still above target, central banks need to proceed carefully with any monetary easing and maintain their commitment to price stability. This cautious approach would also help temper further valuation pressures on risk assets. Central bank operational independence remains crucial for anchoring inflation expectations and enabling central banks to achieve their mandates.

Urgent fiscal adjustments to reduce deficits are crucial to protect the resilience of sovereign bond markets. High debt and delayed fiscal adjustments in many countries could further raise borrowing costs for governments, underscoring the need for more ambitious fiscal measures to reduce sovereign risks. Improvements in market structure—such as expanding central clearing for cash bond and repo transactions to lower counterparty risks, improving balance sheet efficiency, and boosting transparency—would also enhance bond market resilience. Standing liquidity facilities are vital to backstop these markets.

Even though a softer US dollar has tempered the external headwinds faced by emerging markets in recent months, these markets remain vulnerable to changes in investor sentiment. When signs of fragility such as rising inflation expectations and surges in exchange rate and capital flow volatility are observed, emerging markets should use foreign exchange interventions, macroprudential measures, and capital flow management consistent with the IMF's Integrated Policy Framework,

provided that these measures do not impair progress on necessary fiscal and monetary adjustments. Further developing local bond markets by enhancing macroeconomic fundamentals—such as raising domestic financial savings and strengthening fiscal and monetary credibility—is essential to increase debt-carrying capacity. Other policies to deepen emerging market bond markets include enhancing the predictability and transparency of debt issuance, developing efficient repo and money markets, strengthening primary dealer frameworks, and diversifying the investor base.

The IMF's Global Stress Test underscores the importance of improving capitalization to address risks from weak banks. Implementation of internationally agreed-upon standards that ensure sufficient levels of capital and liquidity, notably Basel III, is paramount during times of high economic uncertainty. The efficiency of regulations should be ensured by reviewing any undue complexity without undermining the overall resilience of the banking sector or international minimum standards. National authorities should strengthen the financial sector safety net to protect the banking sector against potential financial stability risks from weak banks. This includes establishing emergency liquidity assistance frameworks, ensuring that banks can quickly access central bank funding, and advancing recovery and resolution frameworks to manage shocks without systemic disruption or taxpayer losses.

Effective regulatory oversight of NBFIs and digital assets such as stablecoins calls for improved data collection, coordination, and analysis, including across borders. To address liquidity mismatches in investment funds, it is key to further improve and expand the availability and usability of liquidity management tools. To address the risks that crypto assets such as stablecoins could pose to macroeconomic and financial stability, policymakers should implement the Financial Stability Board's high-level recommendations, including establishing effective risk-management frameworks, safeguarding anti-money laundering/combating the financing of terrorism measures, and ensuring that relevant authorities have the powers they need and can cooperate effectively.

To address financial stability risks arising from stress in the foreign exchange market, policymakers should enhance surveillance, including systematic foreign exchange liquidity stress testing that captures interactions with underlying vulnerabilities. It is essential to close foreign exchange data gaps and ensure that capital and liquidity buffers in financial institutions are adequate and supported by robust crisis management frameworks. Strengthening the global financial safety net—including through sufficient international reserve buffers and an expanded network of central bank swap lines—could help mitigate foreign exchange market volatility. This effort would also benefit from a macroeconomic policy mix aligned with the IMF's Integrated Policy Framework. Enhancing the operational resilience of key foreign exchange market participants, including against cyber risks, and promoting broader use of payment-versus-payment arrangements could further reduce settlement risks.