



FOREWORD

Financial conditions have eased since our April 2025 *Global Financial Stability Report*, as policy uncertainty has receded somewhat, major central banks have become more accommodative, and the US dollar has weakened. Equity markets have rebounded to record highs, corporate and sovereign funding spreads are at historically narrow levels, and global funding liquidity remains abundant.

However, the ground is shifting beneath this seemingly tranquil surface. Valuations of risk assets appear stretched, especially as the global economy slows, and concentration risks in certain segments have reached historic highs. History reminds us that asset prices can abruptly correct following booms in the technology sector. To the extent that stock market-driven wealth effects support strong consumption, a correction could have broader implications for the real economy. Higher long-term yields on major sovereign benchmarks—most notably for US Treasuries and euro area bonds—could reverberate across the system, influencing hedging strategies and reshaping correlations with risky assets. Structural improvements in market resilience, including central clearing and leverage requirements, should help, although they remain a work in progress in many jurisdictions.

Concerningly, many advanced economies—especially those with the most elevated debt levels—have yet to present credible strategies to stabilize rising debt trajectories, even as new spending pressures emerge. With more fiscal risks, a higher level of term premia could become a defining feature of global financial markets in years to come. In this environment, central bank independence is integral to ensure monetary policy continues to focus on maintaining price stability and anchoring inflation expectations.

One of the most troubling shifts is the potential erosion of the hedging role of longer-term bonds, exposing fragilities in the financial sector-sovereign nexus. Financial sector exposure to sovereign assets remains elevated across both banks and nonbanks. While banks globally are generally well capitalized, a vulnerable subset persists in most jurisdictions, and banks' exposures to nonbank financial intermediaries

are expanding. Therefore, stress in sovereign bond markets can transmit directly to banks or indirectly through nonbanks. Stress tests for nonbanks in this report reveal considerable scope for sell-offs in benchmark bonds.

The growing size of nonbank financial intermediation could amplify these vulnerabilities. While helpful in facilitating capital market activities and channeling credit to borrowers, their expansion raises the specter of risk-taking and interconnectedness in the financial system. A key challenge revolves around the limited visibility into balance sheets and the interconnectedness of nonbank financial institutions. Stronger data and disclosures are critical to both diagnose vulnerabilities and guide policy responses during stress events.

Growing macrofinancial uncertainty can strain even the highly liquid foreign exchange market, as we discuss in Chapter 2. Such uncertainty may raise funding costs, impair liquidity, and heighten foreign exchange volatility—effects that are notably pronounced in emerging markets. These pressures can also spill over into other asset classes, triggering broader negative feedback loops, most evident in the presence of significant currency mismatches and fiscal vulnerabilities. These considerations are especially relevant given US dollar softness and a substantial increase in foreign exchange hedging demand this year.

The evolving risk environment carries significance for emerging markets and developing economies (EMDEs). As discussed in Chapter 3 of this report, for emerging markets with strong fundamentals, a shift toward financing themselves in local currencies has stabilized bond yields and bolstered market liquidity during periods of global stress. By contrast, emerging markets and developing economies with weaker policy credibility and limited domestic savings remain dependent on foreign currency borrowing, and may also overly rely on domestic banks to buy government bonds. Although funding costs remain contained for most EMDEs so far this year, new major shocks could still test their resilience.

At the same time, new financial market innovations, such as stablecoins backed by short-term government securities, have introduced new participants in

sovereign debt markets and payment systems. In weaker economies, these developments may lead to currency substitution and reduce the effectiveness of policies, like monetary policy. They could also alter the bond market structure with potential implications for credit disintermediation. Possible runs on stablecoins may also generate forced sales of reserve assets, potentially disrupting market functioning.

Navigating these challenges will require continued vigilance by policy authorities. Our primary recommendations emphasize fiscal discipline to ensure debt sustainability, a close monetary policy focus in line

with central bank mandates, and strengthening financial sector supervision. Reinforcing the independence and credibility of central banks helps to anchor expectations and bolster confidence in the policy framework. We also advocate for enhanced reporting and oversight of nonbank financial institutions, ongoing efforts to improve the efficiency of local bond markets, and implementation of internationally agreed prudential standards, including on cryptoassets.

Tobias Adrian
Financial Counsellor