Global Financial Stability Report April 2025

Key Drivers of Heightened Financial Stability Risks
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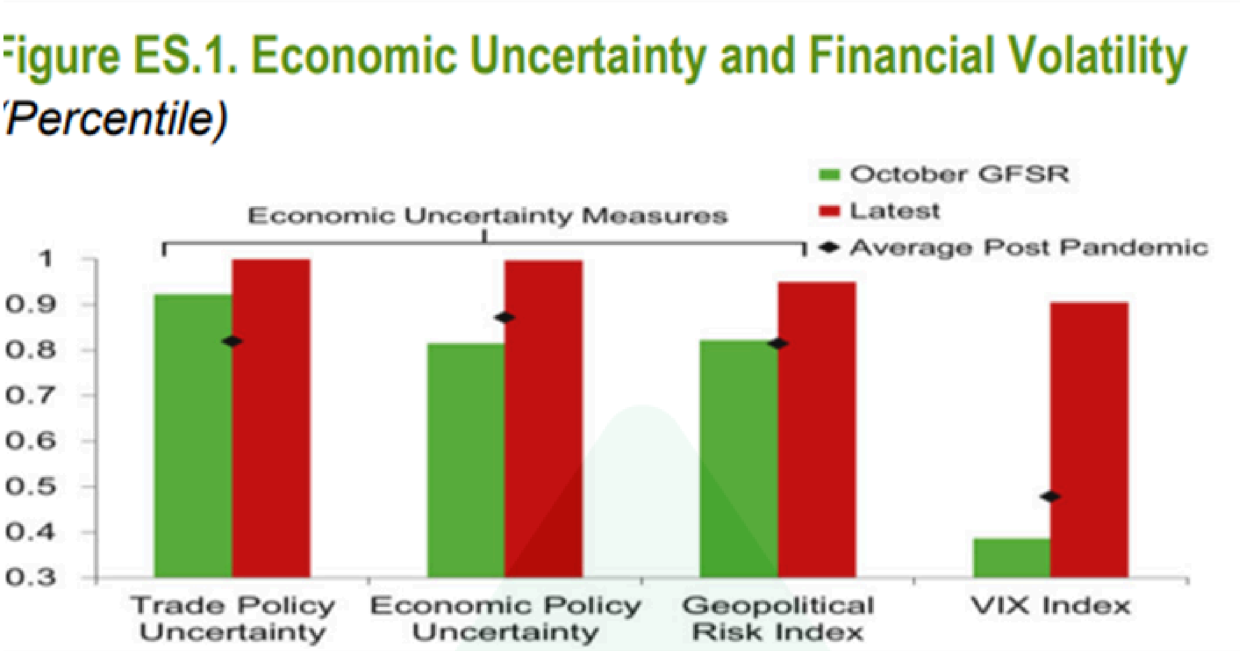
Title: Enhancing Resilience amid Uncertainty

The **October 2024 Global Financial Stability Report** had underscored a stark warning: **global financial fragilities have intensified** amid rising economic uncertainty and tightening financial conditions. The rapid escalation of U.S. tariffs and subsequent international responses have exposed vulnerabilities across **asset markets, financial institutions, and sovereign debt**, increasing downside risks to economic growth and stability.

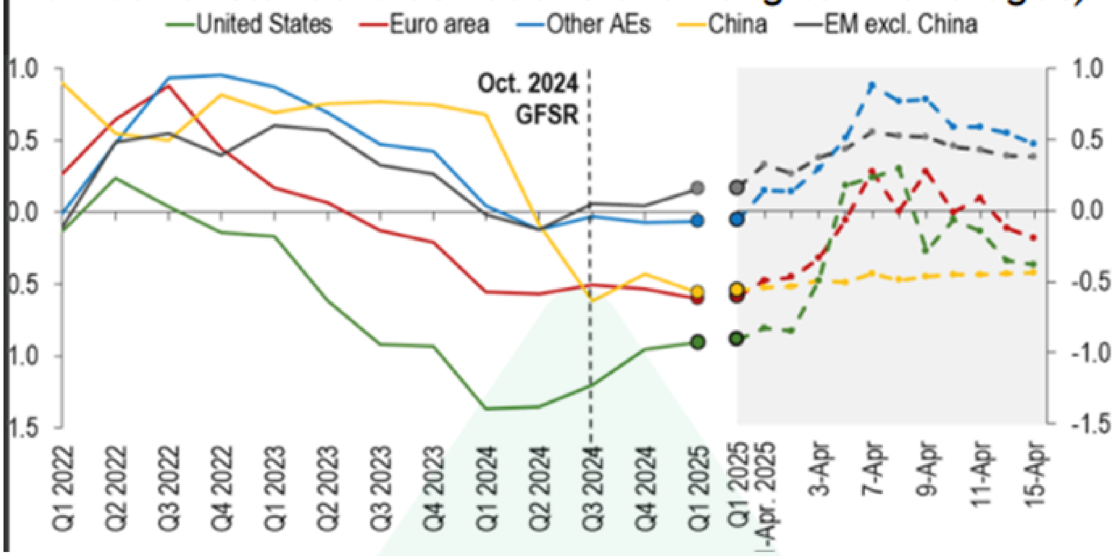
Against the heightened volatility of asset prices, this **Global Financial Stability Report April 2025** assesses that global financial stability risks have increased significantly, primarily due to the tightening of global financial conditions



Key Drivers of Heightened Financial Stability Risks

1. **Asset Valuations, Leverage, and Volatility**
    - The report highlights **stretched asset valuations**, growing leverage in the financial system, and unusually **low pre-shock market volatility**, making global markets prone to sharp corrections.
    - Following the U.S. tariff announcements (especially on **April 2, 2025**), global markets experienced a **sharp repricing of risk assets**, with spikes in **volatility across equity, bond, and currency markets**.
2. **Tighter Global Financial Conditions**
    - The IMF's **Growth-at-Risk model** confirms a significant rise in **macrofinancial downside risks**.
    - Despite recent turmoil, **equity and corporate bond valuations remain elevated**, leaving room for further corrections if the macroeconomic outlook worsens.
    - Persistently high **policy uncertainty** and negative economic surprises have further increased market fragility.

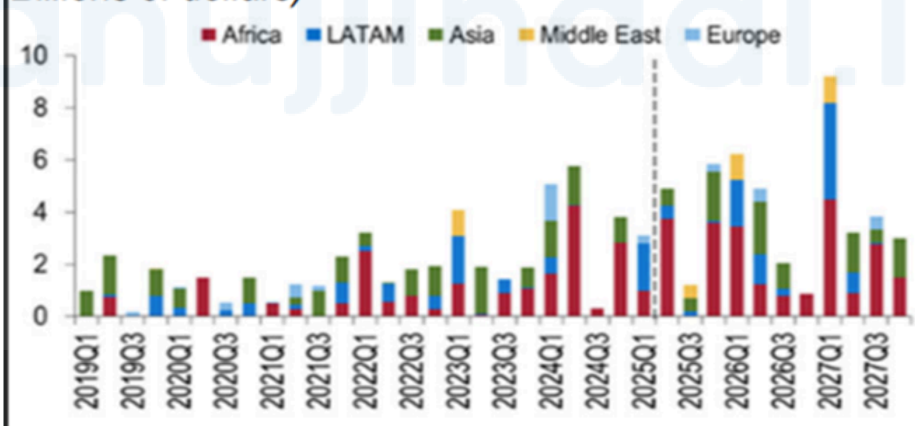
Figure ES.2. Financial Conditions Index
(Number of standard deviations over long-term averages)



Impacts on Emerging and Frontier Markets

- **Emerging markets** are particularly vulnerable: their **currencies and stock markets have depreciated**, weakening growth prospects.
- Expectations of monetary easing have reduced **carry trade returns**, raising the risk of **capital outflows**.
- In **frontier economies**, **high yields and maturing debt** pose significant **refinancing risks**, particularly in a volatile global financial environment.

Figure ES.3. Upcoming International Maturing Debt of Frontier Economies
(Billions of dollars)



Systemic Risks in Financial Institutions

1. **Leverage in Nonbank Financial Intermediaries**
   - Hedge funds and asset managers have **increased leverage** while deepening ties with the banking system.
   - This raises concerns over **forced deleveraging**, margin calls, and investor redemptions—especially in poorly managed institutions.
   - Certain **hedge fund strategies** have seen a steady rise in leverage (Figure ES.5), threatening market stability during sell-offs.

Figure ES.4. US Bank Credit Issued to Nonbank Financial Intermediaries

(Percent of term loans and commitments and shareholders' equity)

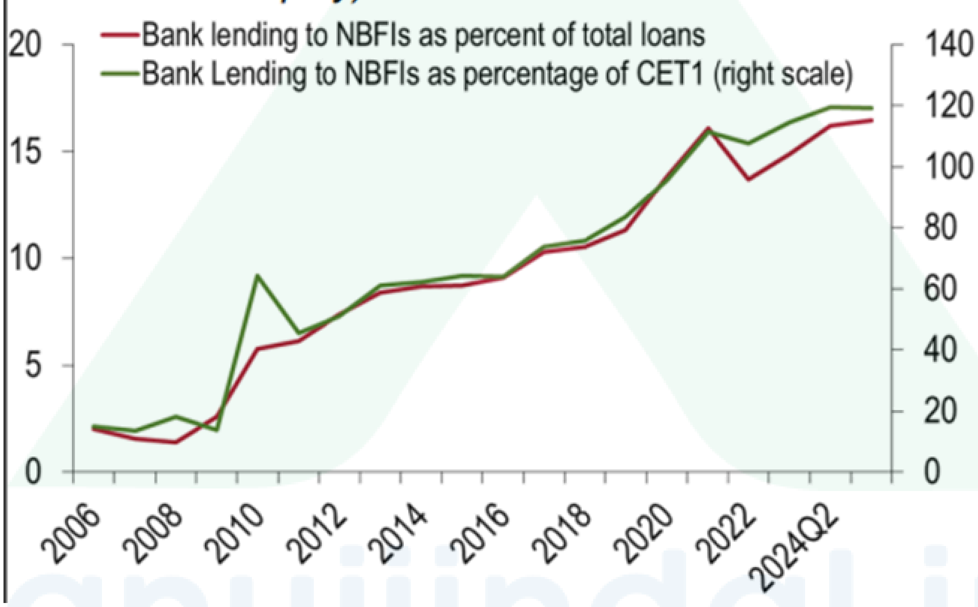
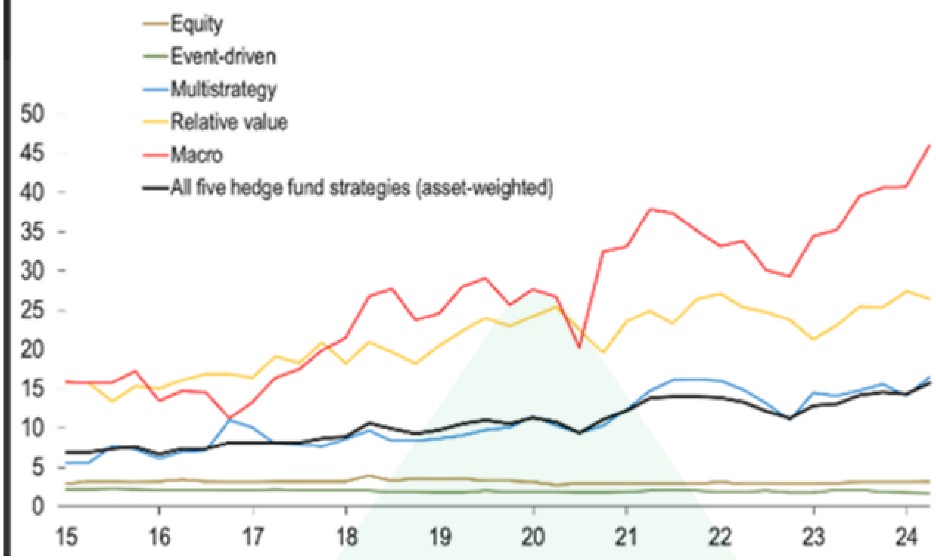
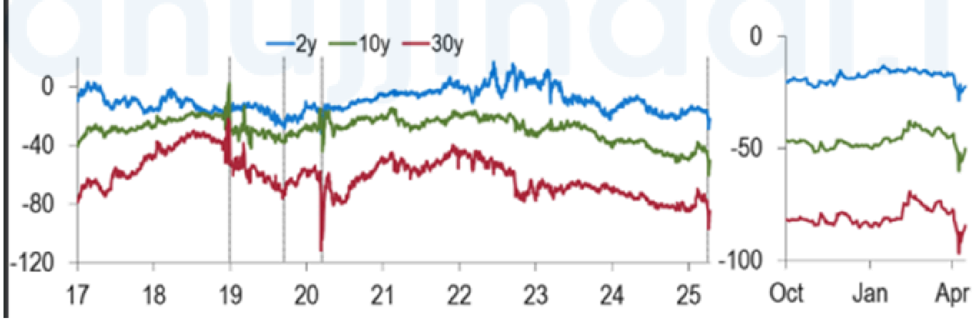


Figure ES.5. Ratio of Gross Notional Exposure to Net Asset Value



1. **Sovereign Bond Market Pressures**
   - **High government debt levels**, particularly in advanced economies, may amplify risks.
   - Strategies like **leveraged basis trades in sovereign bond markets** could unwind under stress, impairing liquidity (Figure ES.6).
   - **Emerging markets** with the **highest real borrowing costs in a decade** face the dual burden of **higher refinancing and fiscal pressures** (April 2025 Fiscal Monitor).

Figure ES.6. Swap Rates Minus Treasury Bond Yields
(Basis points)



Rising Policy and Geopolitical Uncertainty Pose Risks to Corporates, Households, and Global Markets

As financial conditions tighten and **policy uncertainty escalates**, corporate and household sectors are facing increasing stress. The latest IMF analysis reveals that **widening credit spreads**, **asset repricing**, and **geopolitical tensions** could trigger further instability, especially in sectors vulnerable to **refinancing shocks** and **asset value corrections**.

Corporate Sector Pressures: Refinancing Risks and Credit Concerns

- **Global corporate bond spreads** have widened recently, reflecting **investor concerns about slower corporate earnings** due to economic headwinds.
- A notable share of **soon-maturing corporate debt** was issued at **fixed rates well below current market yields**.
    - Firms with **weaker balance sheets** may find it difficult to refinance their obligations at higher costs, increasing the risk of defaults.
- Rising **credit spreads** amplify the refinancing burden, particularly for **highly leveraged corporates**, and could dampen investment and employment.

Household Sector Exposures: Wealth Effects from Asset Repricing

- The risk of a **sharp correction in equities and other financial assets** could affect **household wealth**.
- Households today **hold a larger share of financial assets in equities and investment funds** compared to pre-pandemic levels.
    - A decline in asset prices may reduce household consumption through **negative wealth effects**, especially in advanced economies.
- **Commercial real estate (CRE)** is another pressure point.
    - Weaker-than-expected CRE valuations and persistently **high interest rates** could lead to **negative equity situations**, making loan refinancing difficult for property owners.

Geopolitical Risks as a Potential Catalyst

- **Geopolitical risk**—particularly from **military conflicts**—is emerging as a significant trigger for financial market sell-offs.

- Chapter 2 of the IMF report highlights that such risk events often lead to:
  - **Sharp declines in stock markets**
  - **Increases in sovereign bond spreads**, especially in countries with **limited fiscal space** or **low foreign exchange reserves**
- **Cross-border spillovers** from geopolitical risks are likely, especially through **trade and financial linkages**.
  - Countries integrated into global supply chains or heavily dependent on foreign capital may face intensified impacts.

IMF Recommends Policy Toolkit to Mitigate Rising Financial Stability Risks

In light of elevated global financial instability, the IMF outlines a **comprehensive policy toolkit** aimed at containing risks from asset price corrections, leveraged institutions, sovereign bond turbulence, and geopolitical shocks. The focus is on **prevention, preparedness, and crisis resolution**—all key to safeguarding global macro-financial stability.

Crisis Preparedness and Liquidity Support

- Authorities must be **ready to counter financial instability**, especially under scenarios of severe market stress:
  - Ensure that **financial institutions can access central bank liquidity**.
  - Be prepared to intervene in **core bond and funding markets** when market function deteriorates.
  - Provide liquidity support to **nonbank financial intermediaries**, using strong safeguards to limit systemic risk.
- Stress testing and scenario analysis must factor in **geopolitical risks**, particularly for countries with limited fiscal or external buffers.

Reinforcing Banking Sector Resilience

- Given the rising leverage and **interconnectedness between banks and nonbanks**, a strong banking system remains essential:
  - Maintain adequate **capital and liquidity buffers** in line with **Basel III** norms.
  - Ensure **intensive and independent supervision** to identify and correct emerging risks.

- Supervisors must enhance assessments of **bank-nonbank linkages**, especially as nonbanks continue to grow in systemic importance.

Managing Nonbank Financial Sector Risks

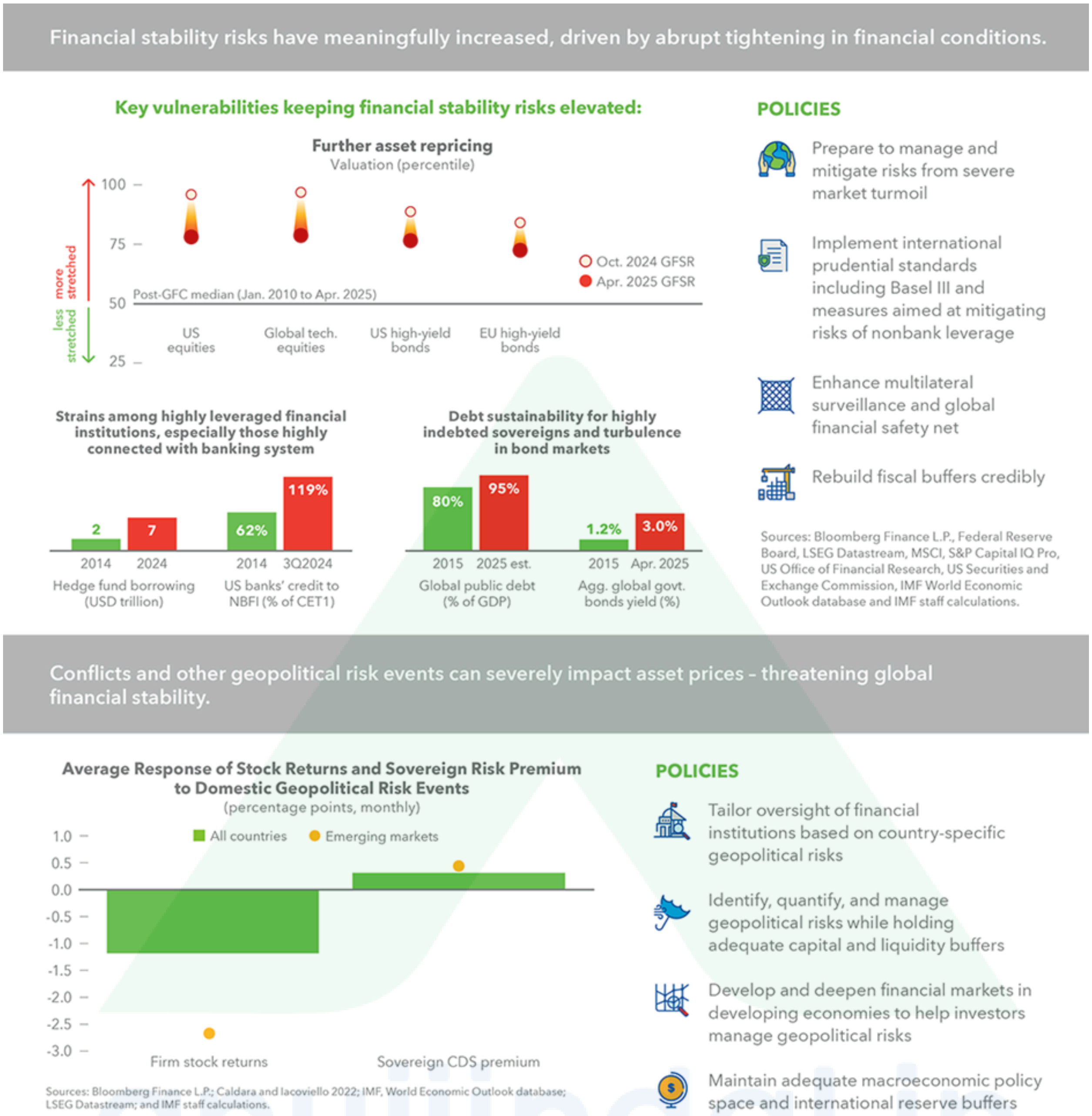
- **Nonbank financial intermediaries (NBFIs)** must be brought under stricter oversight:
    - Implement **enhanced reporting requirements** to facilitate a cross-sectoral understanding of risk.
    - Differentiate between institutions engaged in **excessive risk-taking** versus those positively contributing to financial intermediation.
- Use **macroprudential tools** judiciously:
    - **Tighten** where buffers are weak and leverage is high.
    - **Release** buffers in times of stress to maintain credit flow and avoid amplifying downturns.

Debt Sustainability and Fiscal Policy Space

- High debt levels across most countries make **credible fiscal strategies** critical:
    - **Liability management operations** should be proactively employed to smooth refinancing risks.
    - For debt-distressed nations, **early engagement with creditors** can help avoid default and restore market access.
- Countries must **rebuild fiscal buffers** while supporting growth and essential public spending.

Crypto Assets and Cross-Border Financial Risks

- With the rapid growth of **crypto assets**, jurisdictions must:
    - **Preserve monetary sovereignty** and strengthen monetary frameworks.
    - Manage **capital flow volatility** and apply **clear tax treatment**.
    - Implement the **IMF–FSB road map** to develop regulatory and supervisory capacity.
- The **interconnectedness of financial systems** means that shocks in one jurisdiction can spill over globally.
    - This reinforces the need for **multilateral surveillance** and an effective **global financial safety net**.



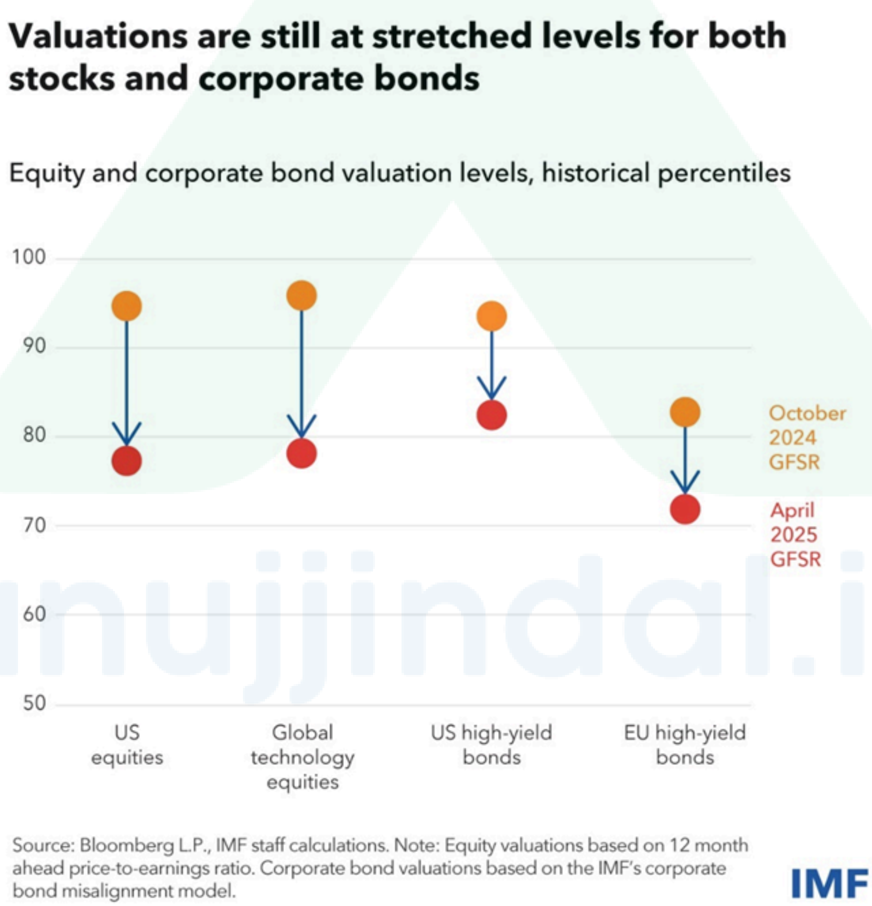
Chapter 1: Enhancing Resilience amid Global Trade Uncertainty

Chapter 1 assesses that global financial stability risks have increased significantly. This assessment is supported by three key forward-looking vulnerabilities: (i) valuations remain high in some key markets; (ii) some highly leveraged financial institutions and their nexus with banking systems; and (iii) risks of market turmoil and challenges to debt sustainability for highly indebted sovereigns.

Capital markets are at the core of economic dynamism—channeling funds, allocating capital efficiently, and supporting economic growth. However, the latest *Global Financial Stability Report* by the IMF warns that **financial stability risks are rising**, driven by tighter financial conditions, growing sovereign debt, and increased interlinkages between banks and nonbanks. These risks are deemed **macro-critical** in the current climate of high uncertainty and geopolitical tensions.

Three Core Vulnerabilities in Capital Markets

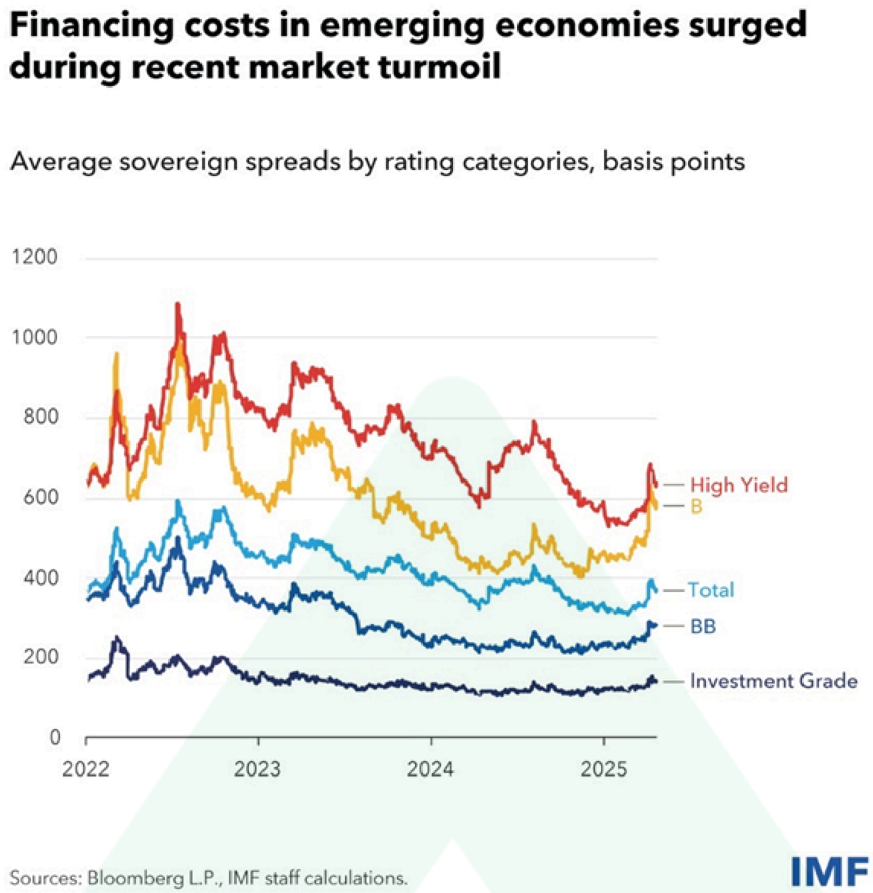
1. **Market Concentration and Valuation Pressures**
    - Global capital markets are increasingly **concentrated**, with the U.S. now accounting for **55% of the global equity market**, up from 30% two decades ago.
    - Despite recent corrections, some **asset valuations remain elevated**, posing risks of further sell-offs under uncertain economic conditions.



1. **Bank–Nonbank Nexus and Leveraged Exposures**

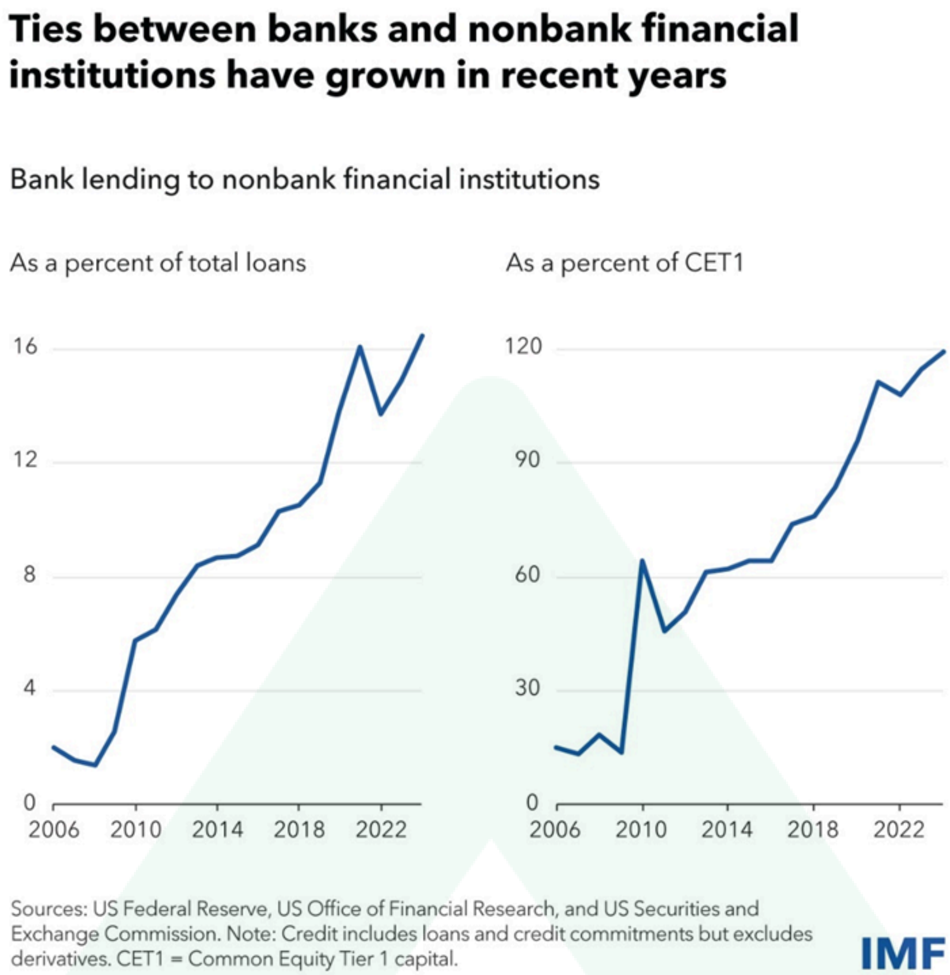
- Nonbank Financial Institutions (NBFIs) have grown substantially since the 2008 crisis and are now closely interconnected with banks.
  - In the U.S., **NBFI borrowings equal 120% of banks' CET1 capital**.
  - Banks support NBFIs via credit lines, repos, and derivative exposures, making both sectors vulnerable to **contagion risks**.
- Segments such as **hedge funds and private credit** are particularly exposed:
  - Hedge funds' **highly leveraged strategies** may lead to forced selling in turbulent markets.
  - **Private credit** funds, which serve smaller borrowers, face rising credit risks as global growth slows.

2. **Sovereign Debt and Government Bond Market Strains**
   - Global **sovereign debt has surged to 93% of GDP**, up from 78% a decade ago.
   - Bond market infrastructure hasn't kept pace, raising volatility risks—especially in **emerging markets** with widening sovereign spreads.
   - Given the foundational role of government bonds in financial markets, any instability here poses **system-wide threats**.



Role of Banks in Amplifying or Mitigating Risks

- Banks are not only key lenders but also crucial **market-makers in capital markets**.
- Their growing ties to NBFIs require **robust prudential standards** and risk management.
- **Systemically important banks (G-SIBs)** use risk mitigants like collateral and exposure caps, but cannot control clients' broader leverage—underscoring the risk of **hidden vulnerabilities**.



Policy Recommendations for Financial Resilience

1. **Containing Nonbank Risks**
   - Enforce **enhanced reporting requirements** to develop a systemwide view of NBFI activity.
   - Distinguish between **productive financial intermediation** and **excessive risk-taking**.
   - Build on **Financial Stability Board** minimum standards to reduce systemic risks from nonbank leverage and interconnections.
2. **Banking Sector Safeguards**
   - Ensure **full, timely, and uniform implementation of Basel III** across jurisdictions.
   - Maintain **adequate capital and liquidity buffers**, especially in light of banks' growing exposure to NBFIs.

- Prudent risk management is essential to guard against **amplified shocks from NBFI channels**.

3. **Strengthening Sovereign Debt Markets**

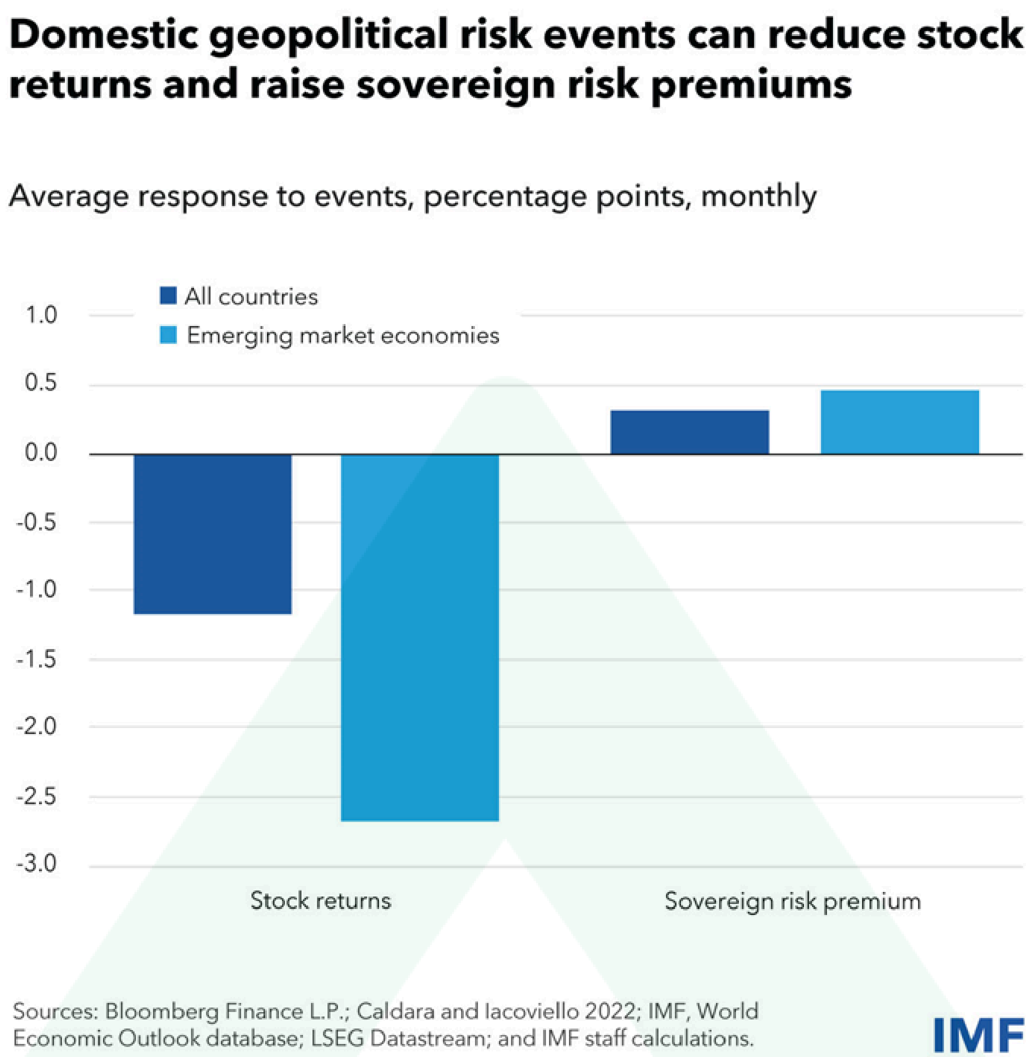
- Advanced economies should:
    - Promote **central clearing** to reduce counterparty risks.
    - Ensure **market intermediaries are sound and resilient**.
- Emerging markets should:
    - Use **credible fiscal and debt management frameworks**.
    - Leverage IMF–World Bank **Medium-Term Debt Strategies**.
    - Develop **domestic bond markets** to diversify investor bases and reduce dependence on volatile external financing.

Chapter 2: Geopolitical Risks: Implications for Asset Prices and Financial Stability

Global geopolitical tensions—from military conflicts to diplomatic flashpoints—are rising sharply, creating new headwinds for economic and financial stability. According to the latest *Global Financial Stability Report* by the IMF, these risks can severely disrupt trade, investment, and capital flows, triggering market volatility and financial contagion, particularly in **emerging market economies**.

Impact of Geopolitical Risks on Financial Markets

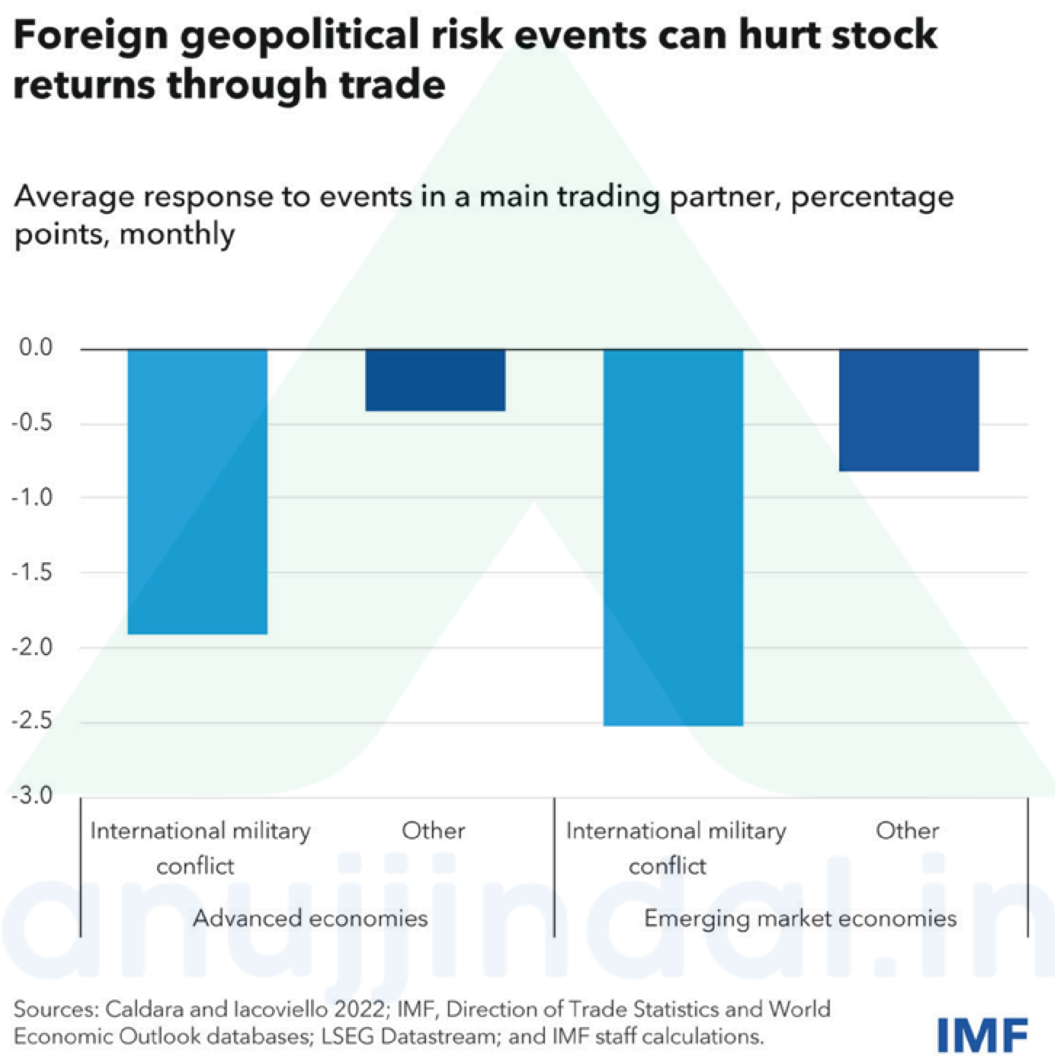
1. **Asset Price Volatility and Investor Uncertainty**
    - Geopolitical shocks are **difficult to price**, owing to their **rarity, unpredictability, and wide-ranging effects**.
    - When such events occur, stock markets tend to **drop sharply**:
        - The **average monthly global equity return** falls by **1 percentage point**.
        - In **emerging markets**, this drop is more pronounced at **2.5 percentage points**.
    - **Military conflicts** hit the hardest, with emerging market stocks declining by **5 percentage points—twice the impact** of other geopolitical events.



2. **Sovereign Risk Premiums Rise**
    - In the aftermath of geopolitical events:
        - **Advanced economies' risk premiums** rise by **30 basis points**.
        - **Emerging markets' risk premiums** rise by **45 basis points**, and sometimes much more depending on fiscal vulnerabilities.
    - Countries with **high debt, low foreign reserves**, and **weak institutions** are particularly vulnerable, facing **up to fourfold increases** in sovereign spreads.
3. **Cross-Border Spillovers and Contagion**
    - Geopolitical shocks in one country often affect **its trading partners**.

- For example, stock prices in countries with **strong trade ties to the conflict zone** fall by **2.5% on average**.
- Risk premiums also **increase sharply** in these partner countries, especially in emerging markets.

- The **contagion effect** is stronger in nations with existing macroeconomic imbalances.



Transmission Channels and Systemic Risks

- **Macroeconomic uncertainty** increases for months after a geopolitical event, prompting **investors to demand higher risk premiums**.
- A sudden asset price decline affects:

- **Banks**: They may **tighten credit**, reducing private sector lending.
- **Investment funds**: They experience **lower returns** and **higher redemption pressures**.

- These effects amplify systemic vulnerabilities, weakening both **financial institutions and real economic activity**.

Policy Recommendations: Building Resilience

1. **Strengthen Risk Management in Financial Institutions**
   - Regulators and institutions must **allocate resources to identify, assess, and manage geopolitical risks**.
   - **Stress testing frameworks** should be expanded to incorporate geopolitical scenarios.
2. **Maintain Capital and Liquidity Buffers**
   - Banks and nonbanks should hold **sufficient capital and liquidity reserves** to absorb potential losses during periods of geopolitical stress.
3. **Enhance Financial Market Depth in Emerging Economies**
   - Developing economies must focus on:
     - **Deepening local financial markets** to diversify investor participation.
     - **Building credible fiscal buffers** and **maintaining adequate international reserves** to weather external shocks.