

## EXECUTIVE SUMMARY

Global public debt dynamics did not improve in any material way in 2025, and the outbreak of war in the Middle East has added a new source of fiscal pressure to an already strained global landscape. The conflict has material global reach, disrupting energy supplies, tightening financial conditions, and forcing governments to choose between shielding their populations from price spikes and preserving fiscal space. Its fiscal impact is highly asymmetric. Energy-importing countries, particularly low-income developing countries, face the largest costs, while the pool of potential beneficiaries is narrower than in past energy shocks, as major Gulf exporters are themselves directly affected by the conflict.

The sharp surge in policy uncertainty that dominated the economic outlook a year ago has receded from its peak, but underlying fiscal and geopolitical pressures have not eased. Although the global economy showed resilience, the fiscal picture has worsened. Global gross government debt rose to nearly 94 percent of GDP in 2025, and on current trajectories, it will reach 100 percent by 2029, a level previously reached only in the aftermath of World War II.

A central concern is not only the elevated level of global debt but also the trajectory implied by current fiscal settings. Higher interest rates and heightened market sensitivity to fiscal news suggest that the space to accommodate this trajectory is narrowing. The global fiscal gap—the difference between projected primary balances and the levels needed to stabilize the debt ratio—has all but disappeared, from a cushion of more than 1 percent of GDP a decade ago to near zero today. The shift represents a deterioration that is structural—that is, it reflects policy choices that have expanded permanent spending on entitlements or reduced revenues, particularly in some of the largest economies. Even in countries where debt dynamics have improved, public debt levels in many cases remain above their peaks during the COVID-19 crisis. In addition, interest payments have risen sharply in just four years, from 2 percent to nearly 3 percent of global GDP as governments refinance maturing debt at today's higher rates. With borrowing costs expected

to remain elevated, the combination of weak primary positions and rising debt-service burdens leaves no room for complacency.

The *United States* is running a general government deficit of 7 percent to 8 percent of GDP despite operating near full capacity, with no debt consolidation plan in sight, and its gross debt is projected to reach 142 percent of GDP by 2031. *China's* near-term fiscal expansion, aimed at supporting domestic demand amid deflationary pressures, has widened the country's overall deficit to nearly 8 percent of GDP, and persistent large deficits are expected to push its debt toward 127 percent of GDP by 2031. The global fiscal challenge extends well beyond these two economies. In *Japan*, higher inflation, GDP growth, and smaller primary deficits are improving debt dynamics, but sovereign yields have climbed to record highs, with potential spillover effects for other countries. In *Europe*, several members of the *European Union* have activated escape clauses from the union's rules regarding deficits to accommodate increasing defense spending. The outlays for this spending will likely prove persistent and highlight the fiscal trade-offs faced by countries with limited fiscal space. Emerging and frontier market economies generally enjoyed favorable market access in 2025, helped by a weaker dollar, but debt levels in these markets remain elevated, with issuance volumes halved and maturities shortened sharply for lower-rated borrowers. Among the world's poorest countries, interest payments have reached historic highs relative to revenue, and declining amounts of aid are creating gaps that some countries have been unable to finance. The war in the Middle East threatens to reinforce adverse financial and commodity price dynamics—through higher global interest rates, dollar appreciation, and energy price surges—exacerbating macroeconomic pressures in emerging market and developing economies.

The fiscal outlook has deteriorated further since the April 2025 *Fiscal Monitor*. Global debt-at-risk three years ahead now stands near 117 percent of GDP, with a gap of roughly 20 percentage points between the median projection and the right tail, underscoring

heightened downside risks. Several reinforcing forces could weigh on the fiscal outlook. The conflict in the Middle East could further strain government finances through higher food and fuel prices, tighter financial conditions, lower activity, and rising defense outlays; in a scenario of prolonged conflict, global debt-at-risk could increase by an additional 4 percentage points. Separately, a correction in artificial intelligence–related asset valuations, in which US stocks fall by 20 percent with spillovers to global financial conditions, could raise global debt-at-risk by a further 2.4 percentage points.

Protectionist pressures and geoeconomic fragmentation continue to push governments toward industrial subsidies and trade-related support that have uncertain payoffs in terms of productivity, raising the risk that primary balances will fall short of debt-stabilizing levels if growth underperforms. Domestic instability further heightens fiscal pressures: Within countries, social unrest has increased across income groups, and surges in such unrest are associated with lower growth and wider primary deficits. At the same time, pressures on the independence of central banks, whether overt or implicit, can lift inflation expectations and risk premiums even for highly rated economies, eroding the credibility that keeps borrowing costs contained.

The structure of markets for sovereign debt is also shifting in ways that amplify vulnerabilities, with these changes most evident in advanced economies. As central banks unwind their balance sheets, private (and often leveraged) investors have become the marginal buyers of government bonds. Hedge funds now play a larger role in intermediation, absorbing issuance through trades that can unravel quickly when volatility spikes. By contrast, a selected group of major emerging markets has moved in a different direction, increasingly relying on local currency issuance absorbed by domestic investors (October 2025 *Global Financial Stability Report*). The increase in the US Treasury security supply is compressing the safety premium that US Treasuries have traditionally commanded—an erosion that pushes up borrowing costs globally. Some governments, notably those of systemic economies such as the *United States*, have also shortened the maturity profiles of their debt to manage near-term interest bills, increasing exposure to sudden shifts in short-term funding conditions. The transmission is global: Supply-driven increases in US

yields spill over almost one for one to foreign bond markets, disproportionately affecting countries reliant on external financing.

The window for orderly fiscal adjustment is narrowing. Advanced economies with large debt loads need concrete, well-sequenced consolidation measures, not aspirational medium-term targets. For the *United States*, the arithmetic is inescapable: Stabilizing the country's debt path will require action on both revenue and expenditure, including spending on the major entitlement programs. European governments must reconcile defense commitments with aging-related pressures through tangible shifting of spending priorities.

Emerging markets should address contingent liabilities, phase out fiscally draining fuel subsidies, and broaden tax bases as central elements of credible medium-term fiscal plans. For *China*, near-term fiscal expansion focused on boosting consumption and supporting the property sector should continue until reflation is durable. Stabilizing *China's* debt will require significant consolidation over time, tax and social security reforms, and debt restructuring of local government financing vehicles. For low-income countries, declining levels of external aid make domestic revenue mobilization essential, and evidence suggests that well-executed reforms to tax administrations can deliver meaningful gains.

Given already depleted fiscal buffers, policy responses to higher energy costs should be tightly calibrated, targeted to vulnerable households and viable firms, and consistent with monetary policy efforts to contain inflation. Broad-based price subsidies should be avoided where they carry large fiscal costs, are difficult to unwind, or suppress domestic price signals in ways that spill over to global commodity markets. Domestic fuel and gas prices should continue to reflect international price movements and support demand adjustment, even when temporary targeted support is in place.

Across all country groups, fiscal policy must become more forward-looking and structurally anchored as countries manage the effects of the energy price shock. Safeguarding the independence of central banks and the integrity of fiscal frameworks is essential for both advanced and emerging market economies. Clear communication of fiscal realities and enhanced transparency can help anchor expectations and build support for needed adjustment.