FOREWORD

The global financial system has so far weathered the war in the Middle East and the energy shock it brought with a degree of resilience. Markets have remained broadly orderly, corrections have been contained, and short-term funding markets have continued to function. Yet, this resilience should not be taken for granted. Because shocks could worsen, it is essential to focus on the remaining vulnerabilities and the policies that could ameliorate them.

Part of the resilience so far reflects the nature of the shock itself and the way it has unfolded in markets. News related to the war has oscillated between escalation and de-escalation, including the recent two-week ceasefire. This ebb and flow has generated bouts of volatility in energy prices and asset prices, but it has not yet triggered the kind of sustained market drawdowns that give rise to acute liquidity stress, margin calls, and forced deleveraging. Uncertainty has been high, but outcomes have not led to a disorderly exit of investors.

More broadly, historical experience suggests that geopolitical risks tend to have a limited and often short-lived effect on global asset prices, as documented in previous issues of the *Global Financial Stability Report*. This pattern has again been evident, particularly in advanced economies, where equity and bond markets have adjusted but not destabilized. Emerging markets have been more sensitive to shifts in global risk sentiment, reflecting their greater exposure to volatile capital flows and risk-sensitive investors.

That said, the contained market impact of geopolitical shocks do not imply that vulnerabilities are benign. Rather, it may indicate that markets have not fully priced more adverse scenarios.

Structural Resilience

Alongside these circumstantial factors, there are more durable, structural reasons that the global financial system has so far absorbed recent shocks. The starting point for households and corporates is meaningfully stronger than in previous episodes of stress, with cash buffers accumulated during the postpandemic recovery providing a cushion against higher energy prices, tighter financial conditions, and income volatility. Structural resilience has also been supported by a broadly well-capitalized banking sector, strengthened by post–global financial crisis reforms, with higher capital and liquidity buffers enhancing loss-absorbing capacity and limiting the propagation of stress.

Major emerging markets have strengthened their resilience over the past decades. Improved policy frameworks have made monetary and fiscal institutions more credible, supporting stronger growth in several regions. In periods of war, however, asset prices seldom reflect the plight of more vulnerable economies that are suffering from energy and—should the conflict persist—food insecurities. This not only poses an imminent challenge but also tends to introduce additional fiscal spending and external borrowings that weaken fundamentals.

Structural improvements in the functioning of bond and short-term funding markets, supported by the responsiveness of central banks and the availability of standing facilities, have helped—such as the Federal Reserve's Standing Repo Facility and the Bank of England's Contingent NBFI Repo Facility. At the same time, expanded central clearing in government bond, repo, and derivatives markets has reduced counterparty risk, improved netting—and therefore the capacity for the system to manage large transactions during volatile periods—and increased transparency.

Resilience Not Guaranteed, Amplification Risks Ahead

The current conflict remains highly unpredictable. The circumstantial factors could give way to a prolonged war, triggering stress through channels not yet fully apparent. Such risks underscore the continued relevance of the *Global Financial Stability Report*'s vulnerability-based framework. It is not sufficient to assess risks solely through the lens of recent market performance. Instead, policymakers must assess how vulnerabilities—such as leverage, maturity and liquidity mismatches, and interconnectedness—can amplify strains in the financial sector.

Chapter 1 of this report examines how existing vulnerabilities could interact with adverse shocks to generate amplification effects. Some vulnerabilities are more urgent, such as elevated debt-to-GDP levels, rollover risks, and the bank–sovereign nexus. They all make bond markets more fragile to amplification, including through liquidity problems and forced selling by option sellers, leveraged exchanges funds, and hedge funds. Other vulnerabilities are growing but may be less urgent. Cases in point include private credit, where the most problematic structures, such as retail and semiliquid funds, are still a moderate share of the market, and sizeable investments in artificial intelligence that could raise debt levels and interconnectedness in the financial system.

Emerging markets face additional challenges. As Chapter 2 shows, cross-border portfolio flows have become increasingly dominated by nonbank investors, some of which are highly sensitive to global risk conditions. In periods of stress, when carry trades unwind and risk appetite shifts, emerging markets can face capital outflows and tighter domestic financial conditions, with adverse implications for macrofinancial stability.

Constrained Policy Headroom and Financial Stability

These vulnerabilities are compounded by constrained policy headroom, which is closely intertwined with financial stability risks. High volumes of sovereign bond issuance needed to finance chronically large and persistent fiscal deficits limit the scope for fiscal policy to act countercyclically. At the same time, persistent inflation pressures can reduce the scope to use monetary policy to stabilize financial conditions during stress.

Given these policy constraints, it is paramount to safeguard financial stability through timely monitoring of market vulnerabilities, swift action to address them, targeted macroprudential policies to mitigate risk buildup, and effective crisis preparedness. Close monitoring of financial institutions should include oversight of banks and nonbanks. A well-targeted policy framework also requires ensuring that backstops such as central bank liquidity facilities are operationally ready and can be deployed swiftly to support market functioning. In emerging markets, the IMF Integrated Policy Framework offers guidance on appropriate foreign exchange rate intervention and capital flow management measures. All this is predicated on strong governance frameworks for central banks and financial sector supervisors, as well as rigorous implementation of international standards. Strengthening data collection, closing information gaps in nonbank finance, enhancing cross-border cooperation, and completing key regulatory reforms remain central to this effort.

As the global financial system navigates an increasingly complex risk environment, the task for policymakers is not to predict the next shock, but to ensure that vulnerabilities are understood, buffers are rebuilt, and the system remains capable of absorbing stress without amplifying it. In that sense, the resilience observed so far is best viewed not as an endpoint, but as a reminder of the work that remains to be done.

Tobias Adrian
Financial Counsellor