

EXECUTIVE SUMMARY

Global Financial Markets Confront the War in the Middle East and Amplification Risks

Global financial stability risks are elevated. The global financial system is confronting the ongoing war in the Middle East, potential inflationary pressures, rising risks of further tightening in financial conditions, and several channels through which market turmoil could escalate into financial instability.

Markets have corrected in an orderly manner so far, but risks are asymmetric. The longer the conflict continues, the greater the risk that global financial conditions—which had been very accommodative before the war—could tighten further and more abruptly. Since February, global equity prices have declined by 8 percent, after being boosted by strong corporate profits in the months before (Figure ES.1). Global sovereign bond yields have risen sharply, driven by market expectations of higher inflation. Emerging market assets have been strongly impacted amid a strengthening dollar and rising energy prices, especially in commodity-importing and more vulnerable countries. The financial system’s resilience could be tested

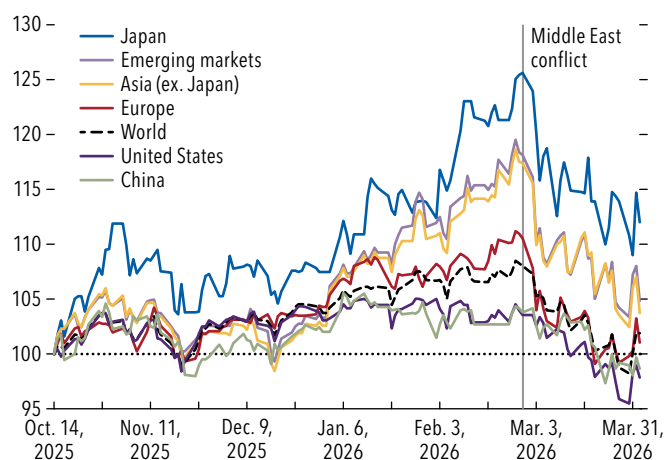
as several channels could amplify such tightening, leading to financial stability risks.

First, rising debt-to-GDP levels, combined with an increased presence of price-sensitive investors, has led to larger bond yield gyrations on auction days (Figure ES.2). Greater bond market volatility could tighten funding markets, which has been a locus of past financial turmoil. More concentrated issuance of shorter-term securities has made core sovereign bond markets more vulnerable to rollover risks—particularly in periods of rising inflation—which could accelerate the rise in bond yields, beyond what would be warranted by rising inflation expectations alone. These pressures could also revive concerns about the sovereign–bank nexus, as sharp sovereign bonds losses may weaken bank balance sheets just as government face constraints in supporting troubled banks.

Second, emerging markets may face currency and capital outflow pressures as carry trades unwind and terms of trade worsen. Asset valuations in emerging markets had reached their highest level in more than a decade before the conflict, but capital flows have taken on a K-shaped pattern, heavily skewed toward

Figure ES.1. Equities Sold Off amid the Conflict in the Middle East

(Index, October 14, 2025 = 100)

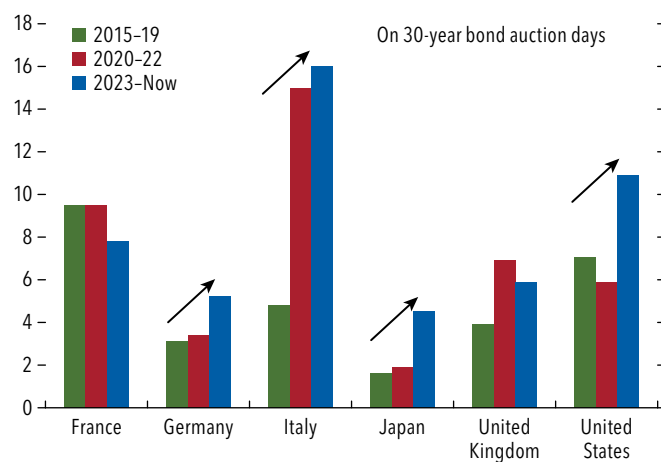


Sources: Bloomberg Finance L.P.; and IMF staff calculations.

Note: ex. = excluding.

Figure ES.2. Bond Yields React More to Bond Auctions

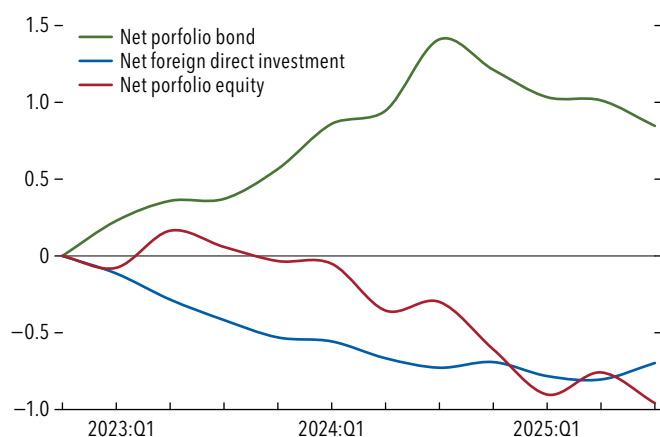
(Basis point change on auction days, 90th percentile within indicated periods)



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

Note: The figure shows the 90th percentiles of daily 10-year bond yield changes on 30-year bond auction days within the indicated periods.

Figure ES.3. K-Shaped Emerging Market Net Capital Flows Favoring Bonds (Not Foreign Direct Investment or Equities)
(Trailing four quarters as a percentage of GDP, change from 2022:Q4 levels)



Source: IMF staff calculations.

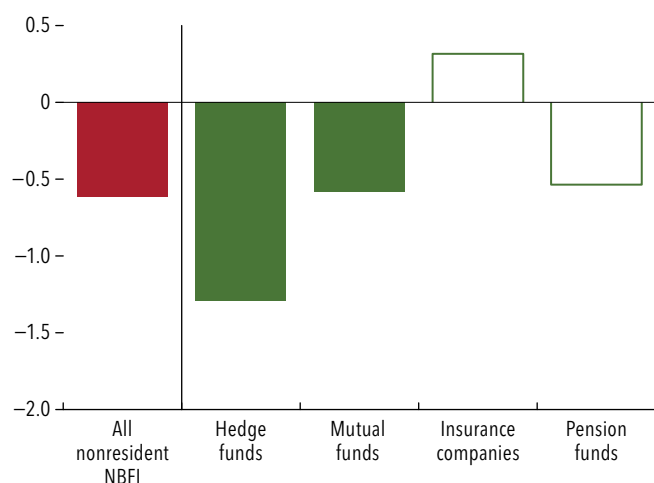
Note: Net flows are calculated as the difference between net nonresident inflows and net resident outflows.

debt inflows and carry trades rather than more stable foreign direct investment (Figure ES.3). Frontier economies that have issued sizable amounts of debt since the beginning of 2025 could face heightened debt sustainability challenges. More broadly, the growing role of nonresident nonbank financial investors in emerging markets, while offering important benefits, has increased sensitivity to shifts in global risk sentiment (Figure ES.4).

Third, an abrupt tightening of financial conditions can lead to forced selling by hedge funds, option sellers, leveraged exchange-traded funds, and other nonbank financial intermediaries (NBFIs) that have expanded through leverage. In equity markets, exuberant options selling by premium-seeking investors has suppressed volatility but could amplify price swings if such investors reverse course during stress. The growing use of leveraged exchange-traded funds to speculate on equity prices could also result in outsized losses and heavy selling. In bond markets, hedge funds have increased the use of leverage to boost returns on relative-value trades, the unwinding of which could magnify yield gyrations and spill over to other markets (Figure ES.5).

Fourth, signs of more borrower defaults in private credit could cascade into broader concerns about corporate credit, particularly for highly leveraged borrowers subject to the artificial intelligence (AI) disruption.

Figure ES.4. Nonresident Nonbank Financial Investors in Emerging Markets More Sensitive to Global Risk than Residents
(Percentage points, relative to residents)

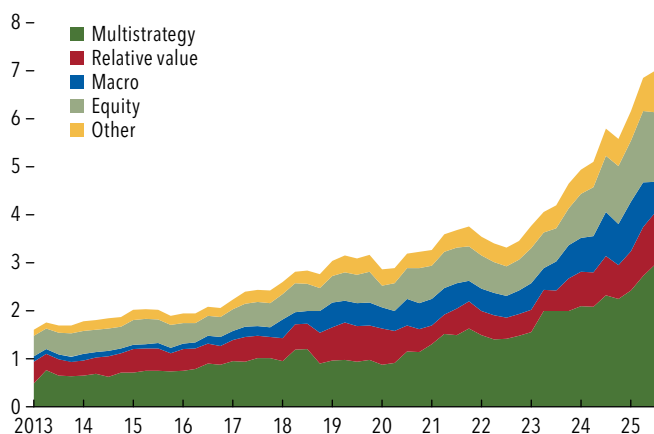


Sources: FactSet; Lipper; and IMF staff calculations.

Note: The figure shows regression estimates of the valuation-adjusted change in the growth of nonresident NBFIs holdings of emerging market securities to a one-standard-deviation increase in the Chicago Board Options Exchange Volatility Index (VIX). Solid bars indicate statistical significance at 10 percent or lower. NBFIs = nonbank financial intermediary.

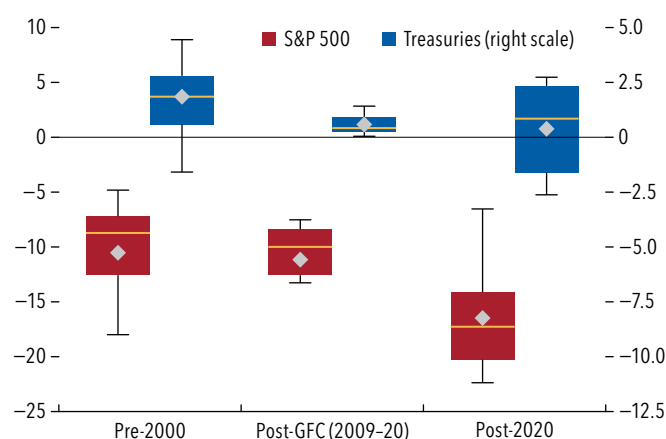
Although liquidity mismatches in private credit appear limited to semiliquid structures, suggesting contained systemic impact, investors have accelerated the pace of redeeming investments, wary of worsening borrower credit quality.

Figure ES.5. Rising Hedge Fund Leverage, by Fund Strategy
(Trillions of dollars)



Sources: Office of Financial Research; Securities and Exchange Commission; and IMF staff calculations.

Figure ES.6. S&P 500 and Treasury Bond Returns during Bear Markets
(Percentage of S&P 500, left scale; percentage of US Treasuries, right scale)



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

Note: A “bear market episode” was defined using the methodology of Bry and Boschan (1971). GFC = global financial crisis.

Fifth, booming investments in AI may slow significantly if the conflict in the Middle East were to persist. This could weigh on the enterprise value of firms along the AI value chain that have increasingly relied on circular financing arrangements, with *hyperscalers* in the center, although its impact on financial stability appear modest currently.

Finally, simultaneous and larger sell-offs of equities and bonds occur during market downturns, reflecting more frequent supply shocks in recent years (Figure ES.6). Further shocks raises the risk of forced deleveraging in both asset classes.

This report also assesses medium-term vulnerabilities, including those in the banking sector, such as the growing cross-border interconnectedness with

nonbanks—given their systemic importance—as well as challenges faced by frontier markets, where limited buffers heighten exposure to adverse external shocks.

Policy Recommendations

Amid the conflict in the Middle East, policymakers should act decisively to bolster resilience. They should be prepared for market dysfunction by ensuring that liquidity and funding facilities are accessible and operationally ready. Monetary policy should preserve price stability and be attuned to spillovers from actual inflation to inflation expectations, while remaining data dependent. Strong governance frameworks for central banks and financial sector supervisors are vital to ensuring operational independence and accountability. Emerging market authorities should continue to strengthen policy frameworks. The shock absorption capacity of exchange rates should be complemented with tools within the IMF’s Integrated Policy Framework.

Fiscal stances should shift toward appropriately tight settings to place public debt on a stable path, with new spending focused on protecting vulnerable groups from the inflation shock. The potential for strains in short-term funding markets call for strengthening market infrastructure, for example by central clearing repo transactions. Completing the Basel framework implementation is essential, alongside avoiding regulatory arbitrage and weakening prudential standards.

As NBFIs grow more leveraged and more connected to banks, closing data gaps, improving cross-jurisdictional data sharing, and enhancing oversight are critical. Stress tests or scenario analyses should be applied to banks and, where possible, to NBFIs, to assess the impacts of a potential rise in illiquidity and corporate credit distress.