A top-level warning of heightened global financial risks

Nick Beams
3 December 2025

The Bank for International Settlements, the umbrella organisation of the world's central banks, is warning that the rise in government debt and changes in the way it is being financed are creating heightened risks for the stability of the global financial system.

The warning was delivered in a major address by BIS General Manager Pablo Hernández de Cos at the London School of Economics last week.

Commenting on the speech, *Financial Times* columnist Martin Wolf recalled that prior to the financial crisis of 2007-09, the BIS had made warnings about the risks created by accommodative monetary policies, excessive debt and lack of transparency.

"These warnings were ignored," he wrote, and the result was a "calamitous financial crisis." Now the BIS is again sounding the alarm.

The focus of the lecture, de Cos said, was on "the combination of high government debt levels and the growing presence of non-bank financial institutions (NBFIs) in sovereign bond markets," which posed "new financial stability challenges" both domestically and internationally.

Two major changes had taken place since the global financial crisis (GFC) of 2008. There had been a shift towards the financing of government debt and the NBFI footprint in this funding had grown considerably, "facilitated by short-term funding markets that enable the build-up of leverage in the financial system."

Sovereign debt levels had reached post-war highs in many advanced economies and were projected to rise even further to around 120 percent of GDP in advanced economies by 2030, according to projections by the International Monetary Fund.

When the fiscal pressures due to pension and medical costs were taken into account as well as increased spending on energy transition and rising defence spending, "the public debt outlook appears even more concerning."

Interest costs were another factor as they "may not return to the very low levels observed in the pre-pandemic decade," and already current interest rates were "putting pressure on fiscal accounts." Among OECD countries with relatively high interest payments, the average outlay had risen from 3 percent of GDP in 2021 to 4 percent in 2024.

One of the most significant changes in the financial landscape since the GFC has been the shift away from banks as a source of financing to NBFIs.

"In the aftermath of the GFC and the COVID-19 pandemic, central bank quantitative easing absorbed a large share of the increase in government debt, helping to ease pressure on yields [the interest rate on government bonds]. However, the subsequent quantitative tightening, combined with the decline in official reserve managers' sovereign debt appetite, increased the amount of government debt that had to be absorbed by the private sector," de Cos said.

He noted that NBFIs were a diverse group and included what he called "real money" or long-term private investor NBFIs, such as pension funds and insurance companies, and "highly leveraged NBFIs," in particular hedge funds.

Investment in government bonds is an international operation carried out in several currencies. Consequently, there is a need for hedging operations to take account of shifts in currency values, with the result that the foreign exchange (FX) swap market grew rapidly after the GFC and is now "very large," with outstanding FX swap contracts reaching $130 trillion in 2023.

While long-term private investors had increased their presence in government bond markets, they have not been able to fully absorb all the increase in government debt issuance.

"This has been, at least in part, driven by rising concerns about the sustainability of fiscal trajectories and deteriorating creditworthiness of some AE [advanced economy] sovereigns," de Cos said.

The implications of this statement, written in financial language, are truly far-reaching when it is translated.

What is being said is that investments in government debt are being held back because there is concern that so-called advanced economies, pillars of the global economy and its financial system, may not be able to pay them off.

No countries were named but the US is certain to be one of them, as its government debt has reached a record $38 trillion and is set to go even higher, with the interest bill reaching $1 trillion a year and rapidly becoming the biggest item in government spending.

According to de Cos, the gap between the increasing supply of government debt and the demand from banks and "real money" NBFIs has been filled by leveraged NBFIs and hedge funds.

Increasingly, they do so by using what are termed relative trading strategies, which exploit the very small price differences between the price of a government security and its price in the futures market. Because the difference is tiny, the only way to make a profit is by borrowing heavily in the short-term repo, or repurchase, market to leverage the operation.

As a result, the relative value strategies of hedge funds are "highly vulnerable to adverse shocks in funding, cash or derivatives markets."

This was seen in the market turmoil of March 2020—the so-called "dash for cash"—when "margin calls in Treasury futures markets triggered an unwinding of the trade … contributing to destabilising deleveraging spirals."

The global interconnectedness of all financial markets means that a crisis in one area can be rapidly transmitted to another. De Cos noted that stress in the repo market could rapidly spread to the FX market and vice versa, and this could lead to a "global scramble for dollars" as was seen in March 2020.

But those events are only a dramatic expression of the inherent instability of the entire system, which continually threatens to erupt to the surface.

A case in point is what happened on Monday when the governor of the Bank of Japan, Kazuo Ueda, signalled the bank might raise interest rates later this month. In what one analyst described as a "butterfly effect," the prices of speculative assets, above all bitcoin, fell sharply.

The immediate fear was that an increase in Japanese interest rates would affect the carry trade in which investors borrow Japanese yen at low rates to invest in higher yielding assets in the US and elsewhere.

And there are longer-term concerns as well, because Japan is the leading international investor in US debt.

As Michael Metcalfe, head of macro strategy at State Street Markets, told the *Financial Times*, "The more it becomes clear that Japanese rates … are normalising, the higher the probability that Japanese investors begin to repatriate funds from foreign bond markets, or at the very least buy fewer foreign bonds, removing a key source of international finance at a time when sovereign issuance is surging."

As is the case with all such studies of the increasingly complex global financial system, and the destabilising role of highly leveraged hedge funds and private credit within it, de Cos called for greater oversight and regulation by financial authorities.

Apart from the fact that, like all market systems under capitalism, financial markets are inherently anarchic and not subject to conscious control because of private ownership, he then raised one of the immediate problems with even a limited reformist perspective.

"To properly oversee, regulate and supervise NBFIs, policymakers need to have high-quality data. Unfortunately, there is considerable opacity in many of the key markets in which NBFIs are active, thereby preventing a consolidated global view of these markets and the key exposures." In other words, would-be regulators have great difficulty in determining what is going on.

One is reminded of the famous passage in the *Communist Manifesto* where Marx likens capitalist society to the sorcerer "who is no longer able to control the powers of the nether world whom he has called up by his spells."