EXECUTIVE SUMMARY

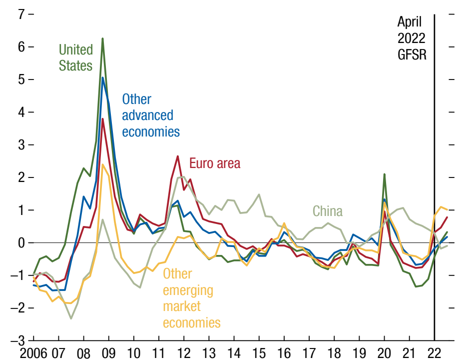
The world economy is experiencing stubbornly high inflation, a challenge it has not faced for decades. Following the global financial crisis, with inflationary pressures muted, interest rates were extremely low for years and investors became accustomed to low volatility. The resulting easing of financial conditions supported economic growth, but it also contributed to a buildup of financial vulnerabilities. Now, with inflation at multidecade highs, monetary authorities in advanced economies are accelerating the pace of policy normalization. Policymakers in emerging markets have continued to tighten policy against a backdrop of rising inflation and currency pressures, albeit with notable differences across regions. Global financial conditions have tightened notably this year, leading to capital outflows from many emerging and frontier market economies with weaker macroeconomic fundamentals. Amid heightened economic and geopolitical uncertainties, investors have aggressively pulled back from risk-taking in September. With conditions worsening in recent weeks, key gauges of systemic risk, such as higher dollar funding costs and counterparty credit spreads, have risen. There is a risk of a disorderly tightening of financial conditions that may be amplified by vulnerabilities built over the years. The report will focus on the risks to global financial stability in the current macro-financial environment—an environment that is new to many policymakers and market participants.

The global economic outlook has deteriorated materially since the April 2022 *Global Financial Stability Report* (GFSR). A number of downside risks have crystallized, including higher-than-anticipated inflationary pressures, a worse-than-expected slowdown in China on the back of COVID-19 outbreaks and lockdowns, and additional spillovers from Russia's invasion of Ukraine. As a result, the slowdown of the global economy has intensified.

Amid extraordinary uncertainty about the outlook and stubbornly high inflation, central banks have continued to normalize policy to restore price stability. Global financial conditions have tightened in most regions since the April 2022 GFSR (Figure 1)—partly an intended consequence of tighter monetary policy and partly due to rising uncertainty about the outlook since April. By contrast, conditions in China have eased somewhat, as policymakers have provided additional support to offset a deterioration in the economic outlook and strains in the real estate sector.

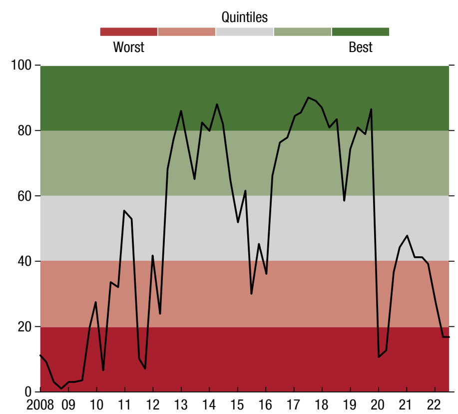
Global financial stability risks have increased since the April 2022 GFSR, and the balance of risks is significantly skewed to the downside. The range of adverse GDP growth outcomes based

Figure 1. Global Financial Conditions in Selected Regions
(Standard deviations from the mean)



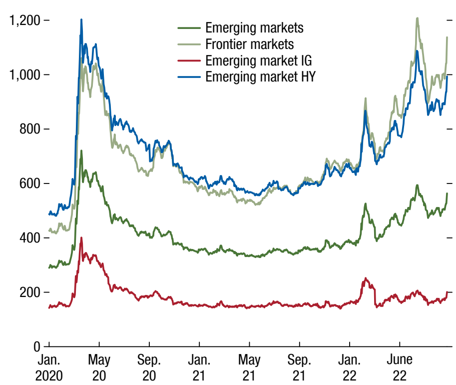
Source: IMF staff calculations.
Note: GFSR = *Global Financial Stability Report.*

Figure 2. Near-Term Growth-at-Risk Forecast
(Percentile)



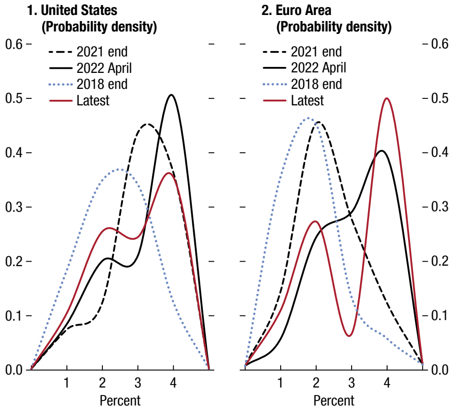
Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: The black line traces the evolution of the 5th percentile threshold (the growth-at-risk metric) of near-term growth forecast densities.

Figure 3. Emerging Market Hard Currency Sovereign Spreads
(Basis points)



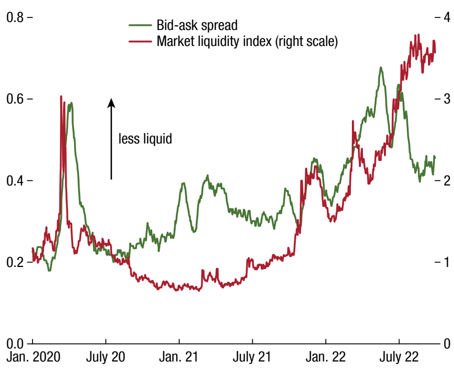
Sources: Bloomberg L.P.; and IMF staff calculations.
Note: HY = high yield; IG = investment grade.

Figure 4. Market-Implied Probability Distributions of Inflation Outcomes



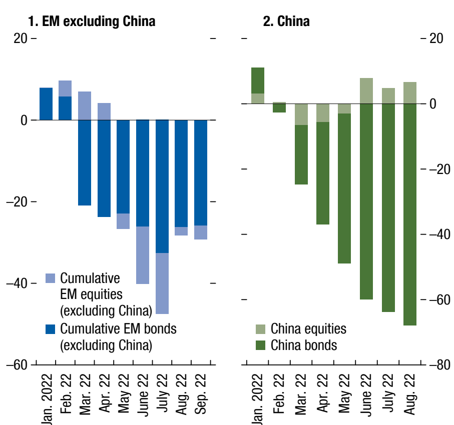
Sources: Bloomberg L.P.; and IMF staff calculations.

Figure 5. US Treasury Bid-Ask Spread and Market Liquidity Index
(Basis points)



Sources: Bloomberg Finance L.P.; JPMorgan Chase & Co.; and IMF staff calculations.
Note: The market liquidity index is the average of Bloomberg US Government Securities Liquidity index and the JP Morgan US Treasury total root mean square error (RMSE) index.

Figure 6. Emerging Market Local Currency Bond and Equity Flows
(Cumulative, billions of US dollars)



Sources: Bloomberg Finance L.P.; national sources; and IMF staff calculations.
Note: EM = emerging market.

on the probability distribution of future GDP growth is in the worst 20th percentile of the last four decades (Figure 2). Financial vulnerabilities are elevated in the sovereign and nonbank financial institution sectors, while market liquidity has deteriorated across some key asset classes.

Interest rates and prices of risk assets have been extremely volatile since April, reflecting heightened uncertainty about the economic and policy outlook. Risk assets sold off sharply through June on fears that central banks would have to step up the pace of policy rate hikes to fight high inflation. Emerging market assets suffered large losses, and sovereign spreads of high-yield emerging markets rose nearly to levels last seen in March 2020 (Figure 3). Crypto markets also experienced extreme volatility leading to the collapse of some of the riskiest segments and the unwinding of some crypto funds.

In the middle of the year, as recession fears grew, risk assets rallied on hopes that the monetary policy normalization cycle would end sooner than previously anticipated. These moves, however, have been unwound and risk assets have experienced further losses, as major central banks have strongly reaffirmed their resolve to fight inflation and meet their price stability mandates.

Disagreement among investors around the most likely inflation outcomes appears to have become more notable. In the euro area, there are significant odds of both low- and high-inflation outcomes, likely reflecting heightened concerns about a slowdown in aggregate growth (Figure 4). There is a risk, however, that a rapid, disorderly repricing of risk in coming months could interact with, and be amplified by, preexisting vulnerabilities and poor market liquidity.

Market liquidity metrics have worsened across asset classes, including in markets that are generally highly liquid and among standardized and exchange-traded products. US Treasury bid-ask spreads have widened significantly, market depth has declined sharply, and liquidity premiums have increased (Figure 5).

European financial markets have shown strains since the April 2022 GFSR. Asset prices have sold off on the back of growing recession fears amid natural gas shortages and the reemergence of fragmentation risks in the euro area. However, spreads of southern European government bond yield over German yields tightened after the European Central Bank's announcement of a new tool to fight fragmentation in the euro area, the Transmission Protection Instrument. In the UK, investor concerns about the fiscal and inflation outlook following the announcement of large debt-financed tax cuts and fiscal measures to deal with high energy prices weighed heavily on market sentiment. The British pound depreciated abruptly, and sovereign bond prices dropped sharply. To prevent dysfunction in the gilt market from posing a material risk to UK financial stability, the Bank of England, in line with its financial stability mandate, announced on September 28 temporary and targeted purchases of long-dated UK government bonds.

Central banks in emerging and frontier markets have also continued to tighten monetary policy. But regional differences remain stark, with some countries hiking policy rates earlier and more aggressively in response to inflationary pressures. Conditions in local currency bond markets have worsened materially, reflecting concerns about the macroeconomic outlook and rising debt levels. Sovereign bond term premiums have increased sharply, especially for central and eastern Europe.

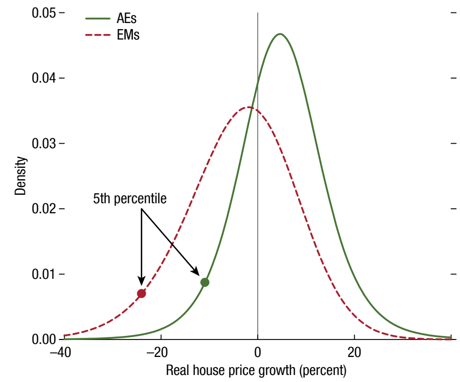
Emerging markets face a multitude of risks stemming from high external borrowing costs, stubbornly high inflation, volatile commodity markets, heightened uncertainty about the global economic outlook, and pressures from policy tightening in advanced economies. Pressures are particularly acute in frontier markets, where challenges are driven by a combination of tightening financial conditions, deteriorating fundamentals, and high exposure to commodity price volatility. Interest expenses on government debt have continued to rise, increasing immediate liquidity pressures. In an environment of poor fundamentals and lack of investor risk appetite, defaults may follow. However, investors have continued to differentiate across emerging market economies so far, and many of the largest emerging markets seem to be more resilient to external vulnerabilities. Nonresident portfolio flows remain weak despite some signs of stabilization after sizable outflows in the first half of the year (Figure 6). Issuance of sovereign hard currency bonds has deteriorated sharply. Without an improvement in market access, many frontier market issuers will have to seek alternative funding sources and/or debt reprofiling and restructurings.

The challenging macroeconomic environment is also pressuring the global corporate sector. Credit spreads have widened substantially across sectors since April. Large firms have reported a contraction in profit margins due to higher costs, while downward revisions to global earnings growth forecasts appear to be gaining momentum on concerns about a possible recession. At small firms, bankruptcies have already started to increase in major advanced economies because these firms are more affected by rising borrowing costs and declining fiscal support. Companies that rely on leveraged finance markets are facing tighter lending terms and standards against a challenging growth backdrop. The credit quality of these assets may be tested during an economic downturn, with potential spillovers to the broader macroeconomy.

As central banks aggressively tighten monetary policy, soaring borrowing costs and tighter lending standards, coupled with stretched valuations after years of rising prices, could adversely affect housing markets. In a worst-case scenario, real house price declines could be significant, driven by affordability pressures and deteriorating economic prospects (Figure 7).

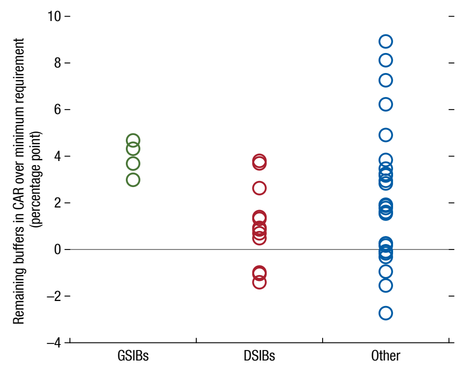
In China, the property sector downturn has deepened as a sharp decline in home sales during COVID-19 lockdowns has

Figure 7. House Prices at Risk: Advanced Economies and Emerging Markets Three Years Ahead
(Density; cumulative growth in percent)



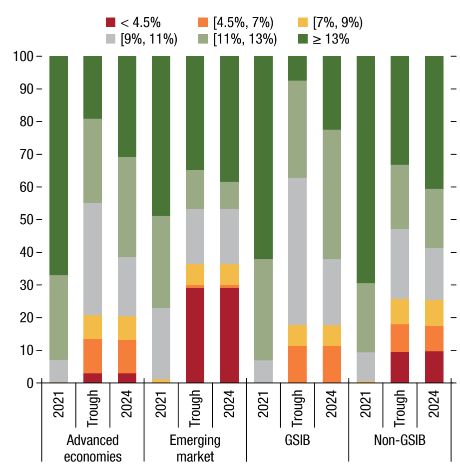
Sources: Bank for International Settlements; Bloomberg L.P.; Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.
Note: AEs = advanced economies; EMs = emerging markets.

Figure 8. Potential Credit Losses for Chinese Banks Related to Real Estate Exposure
(Percent of total risk-weighted assets)



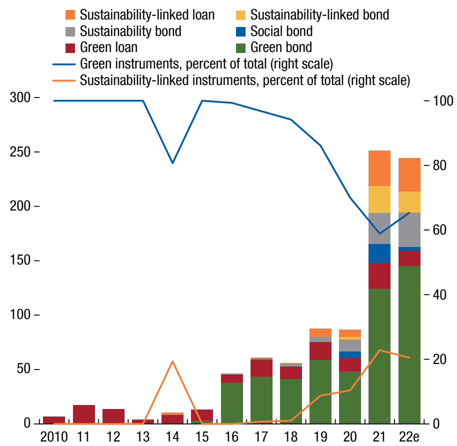
Sources: Bloomberg Finance L.P.; CEIC; S&P Capital IQ; and IMF staff calculations.
Note: CAR = capital adequacy ratio; DSIBs = domestic systemically important banks; GSIBs = global systemically important banks.

Figure 9. Distribution of Banks by Capital Adequacy in an Adverse Scenario
(Percent of assets)



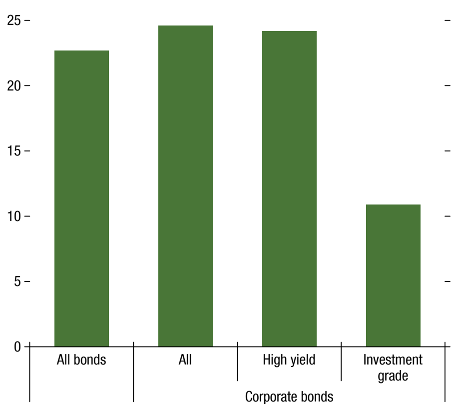
Sources: Fitch Connect; and IMF staff calculations.
Note: The figure shows the composition of common equity Tier 1 (CET1). GSIB = global systemically important bank.

Figure 10. Sustainable Debt Issuance in EMDEs Grew Strongly in 2021, with a Notable Rise in Sustainability-Linked Instruments
(Billions of US dollars; percent)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.
Note: Share of green instruments and sustainability linked instruments is shown as a percent of total emerging market sustainable instrument issuance.
22e = annualized estimate for 2022; EMDEs = emerging market and developing economies.

Figure 11. Effect of Open-End Investment Fund Vulnerabilities on Bond Return Volatility
(Percent of median volatility)



Sources: FactSet; Morningstar; Refinitiv Datastream; and IMF staff calculations.

exacerbated the liquidity stress of property developers, raising concerns about broader solvency risks. Property developer failures could spill over into the banking sector, affecting some vulnerable small banks and domestic systemically important banks, given their lower capital buffers and higher property-related concentration risk (Figure 8).

High levels of capital and ample liquidity buffers have bolstered the resilience of the global banking sector. However, the IMF's Global Bank Stress Test shows that, in a scenario with an abrupt and sharp tightening of financial conditions that would send the global economy into recession in 2023 amid high inflation, up to 29 percent of emerging market banks (by assets) would breach capital requirements, while most advanced economy banks would remain resilient. To rebuild buffers and the capital shortfall would require over $200 billion (Figure 9).

As outlined in Chapter 2, emerging market and developing economies will need significant climate financing in coming years to reduce their greenhouse gas emissions and to adapt to the physical effects of climate change. Sustainable finance has grown rapidly but emerging market and developing economies continue to be at a disadvantage. Decisively scaling up private climate finance faces significant challenges, including the lack of supportive climate policies (such as effective carbon pricing) and a still-weak climate information architecture (Figure 10).

Open-end investment funds are playing an increasingly important role in financial markets. However, the liquidity mismatch between their assets and liabilities raises financial stability concerns. Chapter 3 looks at how open-end funds holding illiquid assets while offering daily redemptions can be a key driver of fragility in asset prices by raising the likelihood of investor runs and asset fire sales (Figure 11). The vulnerabilities of open-end funds can also have cross-border spillover effects and lead to a tightening of overall domestic financial conditions, generating potential risks to macrofinancial stability.

Policy Recommendations

Central banks must act resolutely to bring inflation back to target, keeping inflationary pressures from becoming entrenched and avoiding de-anchoring of inflation expectations that would damage credibility. The high uncertainty clouding the outlook hampers the ability of policymakers to provide explicit and precise guidance about the future path of monetary policy. But clear communication about their policy reaction functions, their unwavering commitment to achieve their mandated objectives, and the need to further normalize policy is crucial to preserve credibility and avoid unwarranted market volatility.

According to the IMF's Integrated Policy Framework, where appropriate, some emerging market economies managing the global tightening cycle could consider using some combination of targeted foreign exchange interventions, capital flow measures, and/or other actions to help smooth exchange rate adjustments to reduce financial stability risks and maintain appropriate monetary policy transmission.

Sovereign borrowers in developing economies and frontier markets should enhance efforts to contain risks associated with their high debt vulnerabilities, including through early contact with their creditors, multilateral cooperation, and support from the international community. Enacting credible medium-term fiscal consolidation plans following the recent shocks could help contain borrowing and refinancing costs and alleviate debt sustainability concerns.

Policymakers should contain further buildup of financial vulnerabilities. While considering country-specific circumstances and the near-term economic challenges, they should adjust selected macroprudential tools as needed to tackle pockets of elevated vulnerabilities. Striking a balance between containing the buildup of vulnerabilities and avoiding procyclicality and a disorderly tightening of financial conditions is important given heightened economic uncertainty and the ongoing policy normalization process.

Implementation of policies to mitigate market liquidity risks is paramount to avoid possible amplification of shocks. Supervisory authorities should monitor the robustness of trading infrastructures and support transparency in markets. In addition, improving the availability of data at the trade level would help with timely assessment of liquidity risks. Given the increasing importance of nonbank financial institutions, counterparties should carefully monitor intraday activity and leverage exposures, strengthen their liquidity risk management practices, and enhance transparency and data availability.

Scaling up private climate finance will require new finance instruments and the involvement of multilateral development banks to attract private investors, leveraging private investment and strengthening risk absorption capacity. A larger share of equity financing and additional resources for climate finance from multilateral development banks would help countries achieve these objectives. The IMF can help its members address climate change challenges by undertaking financial stability risk assessments, lending through its new Resilience and Sustainability Trust, and advocating for closing data gaps and disclosures.

Policy action is warranted to mitigate vulnerabilities and risks associated with open-end investment funds. Price-based liquidity management tools such as swing pricing can be effective in lowering asset price fragilities but policymakers should provide further guidance on their implementation. Additional tools could include linking the frequency of redemptions to the liquidity of funds' portfolios. Policymakers should also consider tighter monitoring of funds' liquidity risk management practices, additional disclosures by open-end funds to better assess vulnerabilities, and measures to bolster the provision of liquidity.