FOREWORD

The global environment is fragile with storm clouds on the horizon. Inflation is now at multi-decade highs and broadly spread across countries. The economic outlook continues to deteriorate in many countries. At the same time, geopolitical risks persist. With these developments, the global financial stability outlook has deteriorated since the April 2022 *Global Financial Stability Report* (GFSR).

Confronting the specter of stubbornly high inflation, central banks in advanced economies and many emerging markets have had to move to an accelerated path of monetary policy normalization to prevent inflationary pressures from becoming entrenched. As an intended consequence of monetary tightening, global financial conditions have tightened in most regions.

Global financial markets have shown strains. Asset prices have sold off on the back of continued energy market pressures, emerging stress in cross-currency funding, and stress in certain nonbank financial institution segments. At the same time, market liquidity has deteriorated across key asset classes. There is a heightened risk of rapid, disorderly repricing which could interact with—and be amplified by—pre-existing vulnerabilities and poor market liquidity.

Rising uncertainty has additionally contributed to tighter financial conditions. Financial stability risks have increased, and the balance of risks is tilted to the downside. Financial vulnerabilities are elevated in the sovereign and nonbank financial institution sectors, where rising interest rates have brought on additional stress. A bright light comes from our global bank stress tests which show relative resilience for advanced economy banks.

The challenging macroeconomic and policy environment is also putting pressure on the global corporate sector. Large firms have reported a contraction in profit margins due to higher costs. Among small firms, bankruptcies have started to increase because of higher borrowing costs and declining fiscal support.

Many advanced economies and emerging markets may face housing-market-related risks as mortgage rates rise and lending standards tighten, squeezing potential borrowers out of the market.

Emerging markets are confronted with a multitude of risks from the strength of the US dollar, 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. However, investors have continued to differentiate across emerging market economies, and many of the largest emerging markets seem to be more resilient to external vulnerabilities. Having said that, our updated global bank stress test shows that, in a severely adverse scenario, up to 29 percent of emerging market banks would breach capital requirements.

Pressures are particularly severe in frontier markets—generally smaller developing economies—where challenges are driven by a combination of tightening financial conditions, deteriorating fundamentals, and high exposure to commodity price volatility.

Navigating the uncharted waters of high inflation and tighter financial conditions requires a delicate balance by policymakers. Central banks must act resolutely to bring inflation back to target and avoid a de-anchoring of inflation expectations. Clear communication about their policy decisions, their commitment to their price-stability objectives, and the need to further normalize policy will be crucial to preserve credibility and avoid market volatility. At the same time, the tightening of financial conditions needs to be calibrated carefully, to aim at avoiding disorderly market conditions that could put financial stability unduly at risk.

The IMF's Integrated Policy Framework for emerging markets suggests a carefully calibrated mix of tools including interest rate policy, macroprudential actions, foreign exchange intervention, and capital flow measures. In the current environment, for many emerging markets, managing the global tightening cycle could involve a mix of tools to help mitigate stark monetary policy trade-offs and reduce financial stability risks.

Policymakers will also need to continue to scale up private climate finance, particularly in emerging market and developing economies. This includes efforts to require new financing instruments for

climate-related investments in infrastructure, as well as the involvement of multilateral development banks to attract private investors, leveraging private investment and strengthening risk absorption capacity. The IMF will continue to help address climate change challenges through its financial stability risk assessments, lending through its new Resilience and Sustainability Trust, and advocating for improvements in the climate information architecture.

In addition, reform efforts for nonbank financial institutions have to continue. The role of open-ended funds featured prominently in the 2020 dash-for-cash episode, yet reforms have been lacking so far. Liquidity management tools, including swing pricing, should be considered seriously by policymakers.

Policymakers face an unusually challenging financial stability environment. If further adverse shocks were to realize, tighter financial conditions may trigger market illiquidity, disorderly sell-offs, or distress. Economic and financial market surveillance to act in a timely and well-informed manner and communicate clearly is crucial under such circumstances. I hope that this GFSR contributes to such timely and insightful surveillance.

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