

FOREWORD

The backdrop of this *Global Financial Stability Report* is a challenging one. Rising risks to the inflation outlook and rapidly changing views about the likely pace of monetary policy tightening have been dominant themes affecting financial stability. Juxtaposed against financial stability risks is the Russian invasion of Ukraine, which will exert a material drag on the global recovery and pose significant uncertainties to the outlook. The balance of risks to growth has tilted more firmly to the downside as outlined in the April 2022 *World Economic Outlook*. These developments have occurred just as the world is slowly bringing the pandemic under control and as the global economy continues to recover from COVID-19.

The sharp rise in commodity prices—in concert with more prolonged supply disruptions—have exacerbated preexisting inflation pressures and led to a significant rise in inflation expectations. Central banks face heightened challenges in credibly bringing inflation to target while safeguarding economic recovery. They will have to navigate a delicate balancing act between removing accommodation at a pace that prevents an unmooring of inflation expectations while avoiding a disorderly tightening of financial conditions that could interact with financial vulnerabilities and weigh on growth.

Financial stability risks have risen along several dimensions and the resilience of the global financial system may be tested. A sudden repricing of risk from an intensification of the war may expose, and interact with, some of the vulnerabilities built up during the pandemic, and lead to a sharp decline in asset prices. Potential transmission channels of the war in Ukraine on global financial markets include inflation pressure from commodity price shocks, direct and indirect exposures of banks and nonbank financial intermediaries and firms, disruptions in commodity markets, counterparty risk exposures, poor market liquidity and funding strains, and cyberattacks affecting the resilience of financial market utilities and broader market functioning. While the financial system has

proven resilient to recent shocks, future shocks could be more harmful.

Emerging and frontier markets are facing tighter external financial conditions on the back of monetary policy normalization and heightened geopolitical uncertainty, which is increasing downside risks for portfolio flows. Emerging market sovereigns have become more reliant on domestic banks for funding, and bank holdings of domestic sovereign debt have surged to historic highs. Distress in emerging markets could trigger an adverse feedback loop between sovereigns and banks through multiple channels—the sovereign-bank nexus—potentially reducing bank soundness and lending to the economy. In China, the ongoing stress in the real estate sector and the increase in COVID cases has raised concerns about a growth slowdown, with potential feedback effects and possible spillovers to other emerging markets.

Policymakers will need to confront these challenges by taking decisive actions to address financial vulnerabilities and rein in rising inflation. To manage the delicate balance between containing inflation and supporting the recovery from the pandemic, interest rates might have to rise beyond what is currently priced in markets to get inflation back to target in a timely manner. For many countries, this may entail pushing interest rates well above their neutral level.

While taking relevant steps to address energy security concerns, policymakers should intensify their efforts to implement the COP26 roadmap. Although notable progress has been made to strengthen the climate information architecture in terms of disclosure standards and bridging data gaps, focused policies aimed at scaling up private finance in the transition to a greener economy remain a major imperative.

The war in Ukraine has also brought to the fore a number of medium-term structural issues policymakers will need to confront in coming years. The geopolitics of energy security may put climate

transition at risk. Capital markets might become more fragmented, with possible implications for the role of the US dollar. And the fragmentation of payment systems could be associated with the rise of central bank digital currency blocs. In addition, more widespread use of crypto assets in emerging

markets could undermine domestic policy objectives. Multilateral cooperation will remain key to overcome these medium-term challenges.

Tobias Adrian
Financial Counsellor