FOREWORD

Sentiments in financial markets are quite different now compared to April when we last published the *Global Financial Stability Report*. Concerns about the spread of stress in the banking sector gave way to optimism about brisk disinflation and a soft landing of the global economy. But such optimism can unravel in the face of adverse shocks—like upside surprises to inflation, financial stability concerns in China, and renewed concerns about debt sustainability—resulting in a sharp repricing of assets. Rapid rises in global bond yields in recent weeks provide a glimpse of the abruptness at which financial conditions can tighten. Moreover, though acute strains in the global banking sector have subsided, there are now indications of trouble elsewhere as higher interest rates are beginning to bite, for example, by squeezing the repayment capacity of corporate and household borrowers. Financial stability risks therefore remain elevated, as was the case in April.

Policymakers can take steps to prevent bad outcomes. What are the chief policy priorities to maintain financial stability and enable the financial sector to continue supporting economic growth?

The main priority continues to be returning inflation to target. Global core inflation has slowed so far this year but remains elevated. As sustainable growth requires both price and financial stability, a restrictive stance is needed in economies with still-elevated and persistent inflation until there is tangible evidence that inflation is sustainably moving toward targets. That said, divergence in inflation developments between advanced economies and some emerging market economies has surfaced in recent months, so country-specific circumstances are imperative in monetary policy decision making.

High global interest rates are also affecting the cost of financing in emerging market and developing economies. Most major emerging markets have been resilient so far in 2023. However, a significant number of frontier and low-income sovereign issuers will likely continue to face financing challenges. Sovereigns should focus on structural reforms that foster growth and enhance efforts to manage risks associated with high debt vulnerabilities. Where feasible, refinancing or liability management operations should be executed to rebuild buffers. Moreover, countries nearing debt distress should establish early contact with creditors and find ways to coordinate preemptive and orderly restructuring to avoid costly defaults and prolonged loss of market access. Policymakers should also promote the development of local currency markets and cultivate a stable and diversified investor base that helps to insulate domestic financial conditions from external developments.

The prospect of higher-for-longer rates also impacts the residential and commercial real estate sectors. In certain countries, especially those with a significant share of variable rate mortgages, home prices have registered double-digit declines since their peak. Additionally, vulnerabilities in the commercial real estate sector pose a significant risk to the financial sector, and it has become more apparent over the course of this year that the sector will face a funding pullback by lenders in the coming years. Authorities should conduct stringent stress tests to assess the potential effects of rising interest rates on borrowers' ability to repay loans and the consequences of a sharp fall in real estate prices for households, corporations, and, ultimately, financial institutions. There is also an urgent need to address systemic risks related to commercial real estate stemming from nonbank financial institutions. This can be achieved by broadening the reach of macroprudential tools and enhancing data collection.

Although the acute stress in the global banking system observed last March has subsided, a deeper look reveals that a sizable tail of weak banks remains (see Chapter 2 of the *Global Financial Stability Report*). Supervisors should ensure that banks have corporate governance and risk management processes commensurate with their risk profiles and pay specific attention to bank asset classification and provisions, as well as exposures to interest rate and liquidity risks. Timely, intrusive, and conclusive banking supervision is, therefore, crucial and rests upon safeguarding the operational independence of supervisors by providing them clear safety and soundness mandates, adequate resources, and legal protection. Countries should also continue to build buffers as necessary to help guard against future losses and to support the provision of credit through periods of stress.

As the dust settles after the bank failures in March and April, the international community can derive lessons to improve the effectiveness of reforms implemented since the global financial crisis. Authorities should evaluate whether the Basel III liquidity standards performed as intended and explore potential improvements in international standards for interest rate risk. Policymakers should also consider expanding the scope of their regulations and resolution regimes to encompass a broader range of banks, as even relatively small banks have proven to be systemic at times of wider stress. Furthermore, addressing obstacles—be they legal, regulatory, or operational—to cross-border funding in resolution, including the ability to mobilize collateral across borders, is essential.

Nonbank financial intermediation (NBFI) has become increasingly important in the global financial system over the past decade, making comprehensive systemic risk assessments of NBFI a financial stability policy priority. Closing data gaps by strengthening disclosures and regulatory reporting is critical to characterizing and identifying systemic risk from NBFI. This will also facilitate the increased supervisory effort required to rein in excessive liquidity mismatches and leverage. These efforts should be the first line of defense. Should central bank liquidity be needed to stem systemic crises involving NBFIs, this would require clear communication about the pertinent financial stability objectives and the parameters of the program, including the time frame for exit.

Finally, addressing climate financing needs in emerging market and developing economies requires a comprehensive set of policies (see Chapter 3 of the *Global Financial Stability Report*). While carbon pricing can be highly effective in directing capital flows toward low-carbon investments, it may take time to be phased in because of political resistance. Policymakers should complement carbon pricing with a mix of fiscal, structural, climate, and financial sector policies. Strengthening the climate information architecture—data, disclosures, and alignment approaches (including taxonomies)—is an important part of the policy mix. Transition taxonomies can help institutions identify activities that may reduce greenhouse gas emissions over time, including in the most carbon-intensive sectors. Disclosures and labels for sustainable investment funds should enhance market transparency, market integrity, and alignment with climate impact–oriented outcomes. Through its convening power, the IMF has a crucial role to play in mobilizing private climate finance, in particular in lower-income countries. The Resilience and Sustainability Facility can be a catalyst for private finance through its policy conditionality, supporting reforms that can help attract private capital.

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