

## CHALLENGES TO GLOBAL MONETARY AND FINANCIAL STABILITY

Branka Topić - Pavković<sup>1</sup>

Received 01.03.2024. | Send to review 23.03.2024. | Accepted 04.08.2024.

### Original Article



<sup>1</sup> University of Banja Luka,  
Faculty of Economics, Bosnia  
and Herzegovina

**Corresponding Author:**  
Branka Topić - Pavković

**Email:**  
[branka.topic-pavkovic@ef.unibl.org](mailto:branka.topic-pavkovic@ef.unibl.org)

**JEL Classification:**  
E31, E52, E58, F40, G01, H63

**Doi:**  
10.61432/CPNE0201031t

**UDK:**  
336.711(4-672EU):338.124.4(100)

### ABSTRACT

Central banks have undertaken one of the most significant and synchronized global monetary policy tightening in their recent history. Tightening monetary policy primarily meant raising interest rates, reducing the money supply, and other measures to control inflation and stabilize the economy. While the downward trend in inflation is positive, lower inflation does not mean low inflation. In most countries, inflation remains above central bank targets but is expected to continue to decline. Financial forecasters believe that the central bank's inflation targets will be reached by mid-2025 since monetary policy works with lags. However, the current state of monetary and financial stability is shaped by a complex interplay of factors, including high inflation, geopolitical risks, banking sector vulnerabilities, debt sustainability, and climate-related risks as well as the challenges posed by tighter monetary and financial conditions. Examining challenges to global monetary and financial stability requires a systematic and multidisciplinary approach based on economic, political and international relations. In this paper, the research strategy encompasses a comprehensive literature review to understand the theoretical underpinnings and historical context of global financial stability, monitoring global economic trends, policy development and implementation, investigating geopolitical risks as well as assessment of financial risks from climate change. The research aims to understand the complexity and dynamics of the challenges facing global monetary and financial stability and contribute to the formulation of effective strategies to mitigate these risks.

**Key words:** *central banks, inflation, monetary stability, monetary policy, financial crises, financial stability, sovereign debt*

### 1. INTRODUCTION

Recent geopolitical and economic developments have once again focused on the phenomenon of inflation, which proved to be an inevitable result of market disruptions caused by the pandemic crisis, and subsequent conflict in Ukraine. These circumstances are having a significant impact on the global economy, trade, and finance. Along with these movements, geopolitical shifts are taking place in the form of the strengthening of the economic position of Asian countries, primarily China, reflected in the appreciating value of the Chinese currency, the yuan. The changing monetary landscape, which includes the current global currency system, exchange rate fluctuations,

and macroeconomic trends, is posing new challenges for the development of monetary policies. To navigate this dynamic environment, it is necessary to implement modified monetary policy instruments and closely monitor the functioning of macroeconomic mechanisms.

The financial globalization has been observed to contribute to a heightened frequency of financial crises, thereby presenting a new challenge in the maintenance of financial stability and its impact on overall macroeconomic stability. Financial stability is reflected in the smooth functioning of all segments of the financial system, risk assessment and management, as well as in the system's resistance to sudden shocks. A well-organized financial system plays a pivotal role in directing economic growth and fostering social prosperity through the efficient allocation of financial resources. Geopolitical tensions shape global dynamics, with conflicts and rivalries impacting trade, investment, and regional stability.

Many countries around the world have enacted state policies in response to market shocks, which typically involve a combination of macroeconomic measures such as monetary and fiscal policies to mitigate the repercussions of the crisis. In light of these challenges, central banks in developed nations have implemented a range of unconventional monetary tools to bolster weakening economic conditions. The global financial crisis has prompted the evolution of novel policies and strategies, as well as enhanced communication channels of monetary authorities. However, the widespread adoption of these unconventional measures also presents critical challenges, as their practical implications have not been comprehensively studied thus far.

The unconventional monetary policy measures implemented by major central banks in response to the global pandemic crisis were intended to stimulate the sluggish economy and combat deflationary pressures. Central banks injected substantial amounts of liquidity into financial markets, yet the anticipated economic revitalization did not manifest immediately. This delay in the transmission of monetary policy can be attributed to the complexity of the mechanism, necessitating a prolonged period for the full impact to materialize. Research has underscored concerns that prolonged loose monetary policy could potentially sow the seeds of financial instability.

A concerted effort comprising both fiscal and monetary stimulus measures was orchestrated to revive the global economy, prompting apprehensions regarding the inflationary consequences of unprecedented money supply expansion. The current increase in inflation, which is thought to be temporary, has been attributed to various factors including intense consumer demand, disruptions in the supply chain, rising energy costs, and increased prices of manufactured goods. However, lingering uncertainties persisted as to whether the inflation surge stemmed from short-term imbalances or prolonged monetary excess. Global policy interventions, primarily involving monetary and fiscal measures, have led to the expected inflationary path commonly seen during post-crisis recovery periods, promoting a stronger economic rebound. Inflationary pressures, unfolding gradually in the aftermath of the crisis, acquired a new dimension amidst geopolitical tensions between Ukraine and Russia. The escalating inflationary environment prompted analysis of Keynesian theories regarding inflation mechanisms, such as the cost-push and supply shock theories. The inflation developments observed in the aftermath of the crisis highlighted the significance of increased input costs in driving inflationary pressures ([Dastgerdi, 2020](#)).

The intersection of elevated inflation rates and geopolitical turmoil has resulted in un-

anticipated economic outcomes, necessitating central banks to implement corrective strategies in the immediate term. This has entailed the escalation of benchmark interest rates to their peak levels in the preceding 25 years, intending to curb inflation and return it to the desired range of around 2%. The principal aim of these efforts is to uphold monetary stability and instill trust in the currency, marking the onset of a new phase of complexities and vulnerabilities for the worldwide financial framework.

The shifts in monetary policy have the potential to introduce uncertainty and heightened volatility in financial markets, impacting investment decisions and creating unstable market conditions. These factors can exert pressure on government budgets and debt levels, increase the risk of loan defaults, elevate the likelihood of a recession, raise unemployment rates, and facilitate global spillovers. The current landscape of monetary and financial stability is influenced by a multitude of factors, encompassing high inflation, geopolitical uncertainties, vulnerabilities within the banking sector, sustainability of debt levels, climate-related risks, and the challenges of tighter monetary and financial conditions. Political uncertainties and growing structural obstacles for banks have implications for the entire financial system. The strategy of this research includes a comprehensive literature review to understand the theoretical foundations and historical context of global financial stability, monitoring of global economic trends, policy development and implementation, research on geopolitical risks, as well as assessment of financial risks from climate change. The goal of the research is to understand the complexity and dynamics of the challenges facing global monetary and financial stability and to contribute to the formulation of effective strategies to mitigate these risks.

## **2. METHODOLOGY**

The study of challenges to global monetary and financial stability requires a systematic and interdisciplinary approach drawing from the fields of economics, politics and international relations. The research strategy of this article includes a thorough literature review of theoretical foundations and historical context of global financial stability, monitoring global economic trends, policy development and implementation, examining geopolitical risks, and assessing financial risks from climate change. The results of this study will contribute to a better understanding of the complex dynamics affecting global monetary and financial stability.

### **2.1. THEORETICAL REVIEW OF MONETARY AND FINANCIAL STABILITY**

Theoretical and empirical research on financial system stability is focused on identifying measures and instruments that can maintain the stability of the entire financial system. This research primarily encompasses the examination of non-traditional monetary policy instruments, whose efficacy has been demonstrated in addressing market and banking imbalances. The stability and growth of the national economy are heavily reliant on the solvency, liquidity, and crisis management capabilities of the financial sector (Topić - Pavković et al., 2023). Key measures such as low inflation and macroprudential supervision of the banking sector play a crucial role in mitigating financial imbalances and systemic risk, thus underscoring the significant impact of monetary and financial stability on overall macroeconomic stability. With the growing complexity of financial systems, there is a greater interconnectedness between monetary and financial stability. The maintenance of monetary stability, which is achieved through the effective implementation of monetary policy, plays a crucial role in reducing the likelihood of financial instability. At the same time, financial stability contributes to

macroeconomic stability, thus enabling the efficient execution of monetary policy. The correlation between these factors highlights the significance of upholding both monetary and financial stability in safeguarding overall economic stability.

In the traditional sense, monetary stability is characterized by low, stable, and predictable inflation rates, as well as confidence in the local currency. Financial stability, on the other hand, denotes a robust financial system where banks and other financial institutions operate efficiently and responsibly manage their clients' funds. In periods of steady economic growth devoid of market disturbances, monetary policy serves as an effective tool for macroeconomic stabilization, while fiscal policy focuses on addressing medium-term growth and efficiency issues. The primary objective of most central banks is to uphold price stability, typically manifested through the maintenance of low and stable inflation levels using standard monetary policy instruments. Common tools utilized for this purpose include open market operations and the management of short-term interest rates. Academic researchers, including Ayuso and Repullo (2003), Bindseil and Nyborg (2008), Blanchard et al. (2014), Sellin and Sommar (2014), Mastilo et al., (2021) have emphasized the significance of utilizing these strategies to reach liquidity and inflation control goals.

Research conducted during the COVID-19 crisis has revealed that central banks have adopted varying measures to navigate the evolving market conditions, with the distribution of liquidity by financial institutions resulting in heightened competition and increased costs for accessing liquidity. A key inquiry in the realm of monetary and financial stability research pertains to the potential risks associated with prolonged loose monetary policies, which some scholars and policymakers attribute to exacerbating financial fragility and precipitating financial crises.

Unlike conventional monetary policy approaches, unconventional measures have been devised to target long-term risk-free rates, liquidity provision, and credit spreads to reinforce the effectiveness of the monetary policy transmission mechanism and promote financial stability. Strategies adopted by central banks in response to the global financial crisis encompassed the introduction of innovative policy instruments and adjustments to existing monetary policy frameworks, including the implementation of credit operations, negative interest rate policies, forward guidance, and asset purchase programs. Quantitative easing is the most obvious unconventional instrument of monetary policy. This measure became widely used in response to the mitigation of the 2008 crisis. In contrast to conventional monetary policy, unconventional measures were aimed at something other than short-term interest rates, which included: reduction deadlines (or, equivalently, long-term risk-free rates); liquidity spreads and credits (or, equivalently, interest rates on various risk-free instruments); financial stability to support the monetary policy transmission mechanism (Bindseil, 2016). The tightening of monetary policy in one country, especially a major economy like the United States, can have global repercussions. It can lead to capital outflows and financial market volatility in emerging markets and other economies. This is often due to the increased attractiveness of higher-yielding assets in the country implementing the tightening.

The global financial crisis highlighted the crucial importance of financial stability, placing it as a top priority above other instruments and objectives of economic policy. Financial crises, often originating from banking crises, are deemed controllable and subject to regulation by central banks. In contrast, monetary policy can play a crucial role during crises by bolstering liquidity through actions such as granting bank loans, reducing reserve requirements, and lowering reference interest rates. These measures

can enhance public confidence and significantly contribute to the fortification of macroeconomic stability (Topić - Pavković, 2015).

According to Gjedrem (2005), financial stability is achieved when households and businesses can make optimal decisions between consumption and investment within a well-operating financial system. This system acts as an intermediary between lenders and borrowers, effectively redistributing risks and optimizing the allocation of economic resources over time. A stable financial system facilitates the efficient allocation of economic resources, determines prices, and manages financial risks. It is adept at fulfilling these functions even in the face of external shocks and imbalances (Schinasi, 2006). Contrarily, Ferguson (2003) proposes that it is more feasible to define financial instability rather than stability.

The stability of the banking system is particularly crucial in periods of steady economic growth and is even more vital for transitioning economies. The relationship between the banking sector and broader macroeconomic stability is commonly utilized by researchers to define banking stability, given the sector's substantial impact on the overall economy. Banks play a critical role as financial intermediaries, resulting in other sectors being highly dependent on the banking system, thus highlighting its significance to the economy. A stable and healthy banking sector, in conjunction with the balance of public finances, can contribute to the stability and growth of the entire economic system. The stability of the banking i.e. financial sector contrasts with the banks' expansionary credit policy. The capitalization ratio is an indicator that provides information on the ratio of capital to bank assets. The higher the capital-to-assets ratio, the more restrictive the banking system is in lending. In this way, capital regulation plays an important role in increasing the stability of the financial system (Craig & Koepke, 2012). There has been a notable amount of research in the literature on the correlation between financial stability of the banking system and the relationship between capital, bank assets, and performance in the real economy (Bloom, 1999; Diamond & Rajan, 2002; Kopecky & VanHoose, 2006; Hakenes & Schnabel, 2011; Fratzscher et al, 2016; Gorton & Winton, 2017; Agenor & Pereira da Silva, 2021).

Two distinct models of financial systems are identified in developed market economies based on who plays the main role in financing firms: market-based and bank-based financial systems. This classification approach is known as the classical dichotomy (Veysov & Stolbov, 2012). In the early stages of economic development, banks are believed to hold an advantage over the securities market when the institutional environment lacks the efficiency to support securities market activities (Grbić & Jovanović, 2020).

In their empirical study, Grimm et al. (2023) examine the impact of excessively loose monetary policy on financial instability. They are investigating potential mechanisms through which accommodative monetary policy leads to increased financial fragility, with a focus on the credit market and asset prices. The results indicate that loose monetary policy has significant implications for medium-term financial instability. Using instrumental variables, results show, that a 1 percentage point reduction in policy over 5 years is associated with a 5.5 percentage point increase in the probability of a financial crisis in the next 5 to 7 years and a 15.5 percentage point increase in the next 7 to 9 years. Given the unconditional probability of experiencing a crisis within 3 years at 10.5%, these effects are significant. Additionally, the results remain consistent across alternative measures of stance and definitions of financial stability. The study highlights a connection between monetary policy conduct, financial fragility, and real eco-

conomic activity, supporting the existing literature on growth risks (Adrian et al., 2019; Adrian et al., 2022). This suggests that an overly accommodative monetary policy stance contributes to financial instability in the medium term.

The preservation of financial stability is a crucial economic objective due to the well-documented macroeconomic disruptions and significant economic and social costs associated with financial crises. The growing importance and highlighted role of financial stability as the primary focus of monetary policy in the contemporary global economic scene is evident in a multitude of recent studies. Notably, the approach to financial stability entails a thorough analysis by monetary policymakers to identify and mitigate any factors that may jeopardize financial stability. This approach typically encompasses two dimensions: a micro dimension, which assesses risks at the level of individual financial institutions, and a macro dimension, which evaluates risks from the perspective of the entire financial system (Grubišić & Galić, 2011). The objective of this two-dimensional approach is to accurately evaluate systemic risk, defined as the risk that issues of illiquidity or insolvency within a single institution propagate throughout the entire system (Fabris and Galić, 2009).

There is an ongoing debate regarding the potential consequences of tightening monetary policy, with some arguing that moderation or cessation of such measures may be necessary to avoid a recession and mitigate increases in unemployment. Central banks primarily rely on creating economic slack, particularly in labor markets, to curb inflationary pressures. However, given the current high level of uncertainty, the prospect of effectively fine-tuning monetary policy to reduce inflation without triggering a recession is deemed unrealistic. The European Central Bank (ECB) acknowledges the challenges associated with this dilemma (Lane, 2023; Schnabel, 2023), suggesting that policies aimed at reducing demand pressure could complement monetary efforts to restore price stability. This approach would lessen the extent of monetary tightening required and minimize the risks to financial stability posed by abrupt shifts in monetary stance (Gern et al., 2023).

Tightening monetary and financial conditions typically occur in response to inflation management, currency stabilization, or addressing economic imbalances. Heightened interest rates raise the cost of borrowing, potentially leading businesses to scale back investment in essential areas such as infrastructure, technology, and expansion initiatives. Consequently, reduced investment could impede economic growth, as consumers may also curtail spending. Excessive or rapid tightening of monetary policy has the potential to significantly dampen economic activity, possibly resulting in a recession - especially if the economy is already fragile or facing multiple simultaneous shocks. Rising capital costs and weakened demand may prompt businesses to reduce hiring or implement layoffs to maintain profitability, contributing to elevated unemployment rates and broader societal and economic repercussions. Furthermore, escalating interest rates can squeeze the profit margins of banks and other financial institutions, particularly those heavily invested in fixed-income assets whose value diminishes as interest rates climb. Additionally, higher interest rates increase the burden of servicing government debt, potentially pushing countries with substantial debt levels toward higher fiscal deficits. This may require reductions in public spending or increases in taxes, potentially exacerbating the downturn in economic activity.

The rise in servicing costs for debt has the potential to pose challenges for both individuals and businesses in meeting their loan obligations. This situation could result in an upsurge in default rates, thereby exposing financial institutions to risks and potentially

jeopardizing the stability of the financial system. Consequent to tighter monetary conditions, there could be a decline in asset values, encompassing stocks and real estate, as investors adjust their expectations for growth and returns. This devaluation of assets could lead to a reduction in household wealth, a decrease in consumer confidence, and a hindrance to consumer spending. Emerging markets, in particular, are vulnerable to the effects of tight financial conditions in major economies such as the United States. Increased interest rates in developed countries may cause capital to flow out of emerging markets as investors seek higher returns, leading to currency devaluation and inflation in these regions (Topić - Pavković and Šoja, 2023).

## **2.2. INSIGHT INTO GLOBAL GEOPOLITICAL AND ECONOMIC TRENDS**

Geopolitical tensions and turbulence are currently unprecedented, with problematic political, war, and economic hotspots emerging worldwide. This situation has a detrimental impact on economic growth, leading to increased uncertainty that manifests in financial market instability, disrupted supply chains, fluctuating oil prices, and rising costs of various products. The global pandemic, the conflict in Ukraine, the turmoil in the Middle East, sporadic terrorist attacks, and uncertain global forecasts have heightened global geopolitical risks. This has raised concerns among investors, market participants, and policymakers that conflicts and adverse geopolitical events could hinder global economic growth and exacerbate inflation.

In a study by Caldara and Iacoviello (2022) and Caldara et al. (2023) based on a unique dataset of historical macroeconomic data spanning back to 1900 for 44 economies, it was found that geopolitical risks are strongly associated with high inflation. The impact of these risks on inflation varied across countries and historical periods. The rise in inflation was accompanied by reduced economic activity, increased military spending, higher public debt, money growth, supply disruptions, and a decline in international trade. Geopolitical risks were also linked to heightened uncertainty surrounding inflation and the potential for a significant increase in inflation. These studies revealed that increased commodity prices and currency depreciation have a greater influence on inflation compared to the deflationary effects caused by reduced consumer sentiment and tighter financial conditions. This underscores the complex interplay between geopolitical risks and economic outcomes, highlighting the need for policymakers to consider these factors when making decisions related to inflation and economic stability.

In the shaping of international economic conditions, uncertain geopolitical events play an increasingly important role, often acting as triggers for substantial fluctuations in markets and economies on a worldwide scale. Given the complex interplay of supply, demand, and policy forces that can influence inflation in various directions, geopolitics have the potential to disrupt international trade, flows of goods and capital, global supply chains, and prompt spikes in commodity prices - factors that could contribute to inflationary pressures. Discussing the demand side, unpredictable geopolitical events have the potential to restrict financial conditions, undermine the confidence of investors and consumers, and lead to inflationary pressures too. Geopolitical crises play a significant role in influencing the decision-making of central banks regarding monetary policy adjustments. Depending on the prevailing economic conditions and policy objectives, central banks may opt to either tighten or ease monetary policy in response to geopolitical crises. This can result in increased government debt as a consequence of heightened spending and targeted fiscal support measures.

Current geopolitical and global economic trends are continuously changing, influenced

by a range of factors such as political choices, economic progress, technological innovations, and societal shifts. Understanding these trends requires ongoing analysis and adaptation to navigate the complexities of the global economic and geopolitical landscape. In order to respond to these changes, governments, businesses, and international organizations are required to adjust through strategic planning, policy development, and collaboration at the international level.

Many countries are currently grappling with escalated levels of inflation as a result of a combination of supply chain bottlenecks, escalating energy costs, and a surge in demand driven by economic recovery efforts. This situation has placed central banks in a position of scrutiny as they are tasked with determining whether the inflationary pressures being experienced are short-term in nature or have deeper, long-lasting roots, thereby impacting global monetary policy decisions. The International Monetary Fund is projecting a moderate global economic growth rate of around 3.1% for 2024. However, inflation continues to be a significant concern, with global inflation expected to decrease to 5.8% in 2024, although there are significant regional variations (IMF, 2024). In emerging markets, inflation is significantly high, contributing to economic challenges in those areas. Geopolitical crises may prompt central banks to modify their monetary policy in response to current economic conditions and goals, such as tightening or loosening it. Moreover, research appraisals of global risks have indicated a discernible likelihood of global GDP growth trailing below parity due to the advent of tighter monetary policies (Bremmer and Kupchan, 2024). Additionally, these crises can result in elevated government debt as a consequence of increased spending and specific fiscal aid efforts.

The increase in global debt levels has become a prominent trend in recent years, driven by various factors and carrying significant implications for economic stability and policy development. In response to crises such as the 2008 financial crisis and the COVID-19 pandemic, governments around the world have implemented substantial increases in spending to support their economies. This has often involved significant borrowing to finance stimulus packages, leading to a notable rise in public debt levels. The prolonged period of historically low interest rates, instituted by central banks to encourage economic growth, has made borrowing more attractive for both governments and private businesses. This favorable environment has contributed to the escalation of debt levels by reducing the costs of servicing debt. However, higher levels of debt leave economies vulnerable to financial, economic, and geopolitical shocks. An increase in interest rates could have a significant impact on heavily indebted entities, potentially triggering defaults and financial crises. For companies, a higher debt burden can restrict investment in expansion due to increased interest payments, hindering overall economic growth. Elevated debt levels also pose risks to the financial system, as financial institutions and banks face greater risks of loan defaults, particularly in times of economic downturn. This could lead to tighter credit conditions, reduced lending activity, and potential banking crises.

Simultaneously, there are concerns about the reliability of supply chains, as seen in recent disruptions caused by events like the COVID-19 pandemic and geopolitical conflicts. These disruptions, which stem from logistical challenges, labor shortages, and intermittent lockdowns, have impacted production processes and led to price increases for a wide range of goods. Additionally, the trend toward nationalism and protectionism, which was already apparent before the pandemic, continues to influence global trade dynamics. Countries are reevaluating their trade relationships and supply chain



dependencies, especially in crucial sectors like technology and pharmaceuticals. This reassessment reflects a broader shift toward trade practices and highlights the changing nature of the global economy.

The growing significance of emerging markets in shaping global economic and political dynamics is a subject of increasing scholarly interest. Countries like India, Brazil, and select regions in Africa are gaining prominence, owing to factors such as demographic shifts including a youthful population and an expanding middle class. These regions are expected to play pivotal roles in shaping future economic trends.

The geopolitical rivalry, particularly between major powers like the USA and China, is a crucial issue that spans across various aspects such as military, technology, economy, and diplomacy. This rivalry affects the strategic choices of other countries and international organizations. The tense relationship between the United States and China - characterized by ongoing disagreements on trade, technology, and security - continues to impact global geopolitical trends and influence the foreign and economic strategies of other nations. Following Brexit, the European Union (EU) faces both internal and external challenges, with a focus on areas like migration, regulatory standards, and the establishment of a unified foreign policy. The EU is also actively addressing digital regulations and climate change, demonstrating its dedication to addressing pressing global issues.

The importance of climate change policy and the global energy transition is increasing significantly. International focus on environmental policies and efforts to achieve carbon neutrality are growing, with agreements like the Paris Accord and national strategies being key in addressing climate challenges. As the impacts of climate change become more apparent, there is a greater need for global cooperation to tackle these issues. The shift from fossil fuels to renewable energy sources is progressing, but it brings about geopolitical complexities, especially for countries heavily reliant on oil and gas exports. The move towards a low-carbon economy is reshaping the energy sector, emphasizing renewable energy sources, electric vehicles, and sustainable infrastructure. Geopolitical dynamics are evolving as nations aim to reduce their reliance on fossil fuels and address climate risks.

The current economic and geopolitical landscape is undergoing a period of transformation, presenting both challenges and opportunities on a global scale. The possibility of an economic downturn has slightly increased due to factors such as monetary tightening, financial instability, and rising energy costs linked to heightened geopolitical tensions. Leaders and policymakers worldwide need to take into account these ongoing trends when making strategic decisions to adapt to this evolving reality effectively.

### **2.3. ASSESSMENT OF FINANCIAL RISKS FROM CLIMATE CHANGE**

The primary focus of modern countries is the transition to an economy that efficiently utilizes resources while protecting people from the adverse impacts of environmental change. Various reforms and policies are being implemented to enhance environmental protection mechanisms and strategies. A key consideration is how to achieve environmental and fiscal sustainability simultaneously, particularly in light of competing priorities resulting from post-crisis economic policies.

The urgency of addressing accelerated climate change risks has been somewhat overshadowed by the impact of the COVID-19 pandemic and the conflict in Ukraine. Despite 2020 being recorded as the hottest year to date, it received limited attention. Amid the pandemic, the European Union set a target of achieving zero greenhouse gas

emissions by 2050, which has become a pivotal aspect of the EU's fiscal policy. This is particularly significant as the national debt of the Eurozone has exceeded 95 percent of GDP. Concerns have emerged regarding the potential implications of climate change on a global scale and the increased allocation of public funds for its mitigation, which may jeopardize countries' ability to manage debt obligations in the aftermath of recent crises ([Dibley et al., 2021](#)).

The assessment of financial stability risks stemming from climate change is increasingly important as the economic impacts of environmental changes become more pronounced. Climate change presents numerous risks to financial stability, both directly and indirectly. Prioritizing the protection and enhancement of the environment has become a focal point for contemporary businesses with an eye toward long-term sustainability. To attain sustainable development that aligns with environmental needs and limitations, it is essential to forge links between economic and environmental policies to yield positive financial outcomes and enhance consumer satisfaction. To this end, there has been a heightened push for raising awareness about climate change, elucidating the detrimental impacts of certain activities and products on health, and advocating for responsible and sustainable governance by both the government and the private sector. This has prompted a shift toward social responsibility and the integration of ecological criteria in capital investments.

The impact of global warming on the frequency and severity of natural disasters has led to a growing interest among both public and private investors in promoting environmental sustainability within their businesses. Adapting to and mitigating the effects of climate change has become a priority to prevent further damage to local and global climates.

Recent assessments by the [European Environment Agency \(2023\)](#), have highlighted the significant economic consequences of weather and climate events on public costs in various countries. From 1980 to 2020, the EEA member countries experienced economic losses totaling €450-510 billion, with a reported number of deaths ranging from 85,000 to 143,000. Despite only 3% of events accounting for 60% of economic losses, it is crucial to consider the impacts of smaller-scale events to fully understand the challenges posed by climate change. A noteworthy finding from the analysis is that a majority of deaths (more than 85%) over the past four decades were attributed to heat waves. In light of these findings, it is essential to evaluate the potential financial stability risks posed by climate change, including how climate-related events could destabilize financial systems, institutions, and markets. This assessment involves examining various indicators to understand the risks involved, as well as the tools and methodologies used for evaluation and the broader implications for the financial sector. Furthermore, the influence of climate change on macroeconomic variables such as growth, inflation, and employment underscores the need for proactive measures to address the broader financial implications of climate change.

By examining the effects of climate change on monetary policy, fiscal stability, and overall economic health, decision-makers and stakeholders can collaborate to develop more robust financial systems to address persistent climate-related challenges. Commonly utilized tools in these evaluations include Scenario Analysis and Stress Testing, alongside comprehensive reporting and careful risk management.

The utilization of tools for simulating various climate scenarios plays a crucial role in assessing the potential impacts of climate change. These tools enable the evaluation of

factors such as gradual increases in global temperatures, sudden policy shifts towards decarbonization, and frequent severe weather events. Stress testing is an essential tool for helping institutions identify vulnerabilities and develop resilience strategies in the face of climate-related challenges. Major frameworks like the Task Force on Climate-related Financial Disclosures (TCFD) recommend that businesses disclose climate-related financial risks to stakeholders including investors and regulators. These disclosures are crucial for enhancing understanding of the risks associated with climate change and promoting informed decision-making. Financial institutions are increasingly required to integrate climate risks into their risk management strategies by adjusting credit risk models, asset valuations, and investment approaches. This underscores the importance of addressing climate-related risks in the financial sector to ensure sustainable and resilient investment practices.

The integrated structure of the financial system means that shocks arising from climate change can spread through different channels and cause serious problems. Therefore, understanding and mitigating systemic risks is critical to maintaining financial stability in the face of climate-related risks.

### **3. RESULTS AND DISCUSSION**

The recent comprehensive analysis highlights the challenges facing the global economy in the aftermath of the COVID-19 pandemic, the ongoing conflict between Russia and Ukraine, geopolitical tensions in the Middle East, announcements of recession, and the implications of prolonged high inflation. These developments have presented the world economic scene with new obstacles and realities.

In addition to the aforementioned challenges, the world is also grappling with environmental issues, arguably the most significant challenge of all. Recent climate-related disasters, such as record-high temperatures, devastating floods, storms, extreme colds, and wildfires, underscore the urgent need for lifestyle changes, heightened awareness, and concrete action by accountable parties. The widespread occurrence of natural disasters has significant impacts on various aspects including the economy, society, and natural resources. One area of current concern is the interconnection between monetary and financial stability, public finances, and measures to combat climate change. Global monetary and financial stability plays a critical role in ensuring the efficient functioning of international markets and the global economy. However, numerous challenges such as macroeconomic conditions, technological advancements, and geopolitical uncertainties pose a threat to this stability.

The primary economic goal of any country is to achieve macroeconomic stability, which includes maintaining stable prices, a strong employment rate, and a balanced external economy, all while ensuring consistent economic growth. However, due to the changing market conditions and the effects of the recent crisis, financial stability has become the top priority among other economic policy objectives. During periods of financial stability, monetary policy typically focuses on maintaining price stability and ensuring predictable inflation levels. However, in times of crisis or instability, issues related to liquidity and financial instability become paramount. In such situations, a combination of traditional and innovative monetary policy tools may be required, along with adjustments to the primary goals of economic policy.

The economic downturn triggered by the pandemic has underscored the importance of sound financial management. Countries have grappled with reduced economic activity, escalating unemployment, and declining incomes. In such circumstances, ef-

fective management of public policies and monetary measures is essential to restore economic recovery.

The existing macroeconomic framework emphasizes important principles such as the free movement of goods and capital, rule-based fiscal policy, independent central banks focusing on controlling inflation, public institutions prioritizing financial stability, and international oversight bodies promoting cooperation between nations. While abandoning this framework may not be wise due to the significant benefits it has brought to the global economy through a private sector-centric approach, incremental reforms are seen as necessary to address geopolitical risks, market fragmentation, and climate challenges. These reforms could involve adjusting central bank mandates and fiscal rules to enhance flexibility in responding to economic shocks, as well as revising international institutions like the WTO's dispute settlement mechanism to improve consensus-building processes.

Global challenges in policy demand swift action in the realms of monetary policy, fiscal policy, and regulatory measures. Governments must create plans to boost economic growth without worsening public debt levels. This could involve prioritizing spending, enhancing tax collection methods, and gradually decreasing the deficit. The mounting levels of global debt present a major threat to financial stability worldwide, necessitating coordinated policy measures to effectively handle default risks and financial contagion while establishing a strong foundation for sustainable economic progress. To tackle these obstacles, governments may have to enforce fiscal discipline to prevent inflationary forces from spiraling out of control, particularly in economies burdened with high public debt. Collaboration among policymakers, regulators, and financial institutions is vital to navigate the intricate dynamics of current debt levels and thoroughly mitigate related risks.

Central banks face the challenging task of adjusting the pace of interest rate hikes to control inflation without overly burdening borrowers. This delicate balance is essential for maintaining economic stability and ensuring the credibility of financial markets. If interest rates are adjusted too quickly or too slowly, there is a risk of causing instability in financial markets. The emergence of inflationary pressures, particularly in the aftermath of the COVID-19 pandemic, has become a significant obstacle to global monetary and financial stability. These pressures stem from various sources and have complex effects on economies and financial systems worldwide. Central banks must navigate this complexity by adapting their monetary policy to find the right balance between combating inflation and promoting economic growth.

The conventional goal of monetary policy - to uphold price stability - has been reconsidered in light of lessons learned from the global financial crisis. This crisis highlighted the importance of addressing both monetary and financial instability, as they present similar risks to the financial system. While economies can endure inflationary conditions, financial instability can lead to a breakdown in real and financial flows. Additionally, dealing with financial instability requires more resources and time than addressing inflationary pressures.

Fiscal policy serves as a crucial supplementary factor. Through consolidation, it can alleviate pressure on currency demands, diminish the risk of financial instability, and allow for more leeway in addressing payment management issues when necessary. Reflecting upon the insights gained from this journey, the long-term query revolves around the sustainability of monetary and fiscal policies within a harmonious environ-

ment. This has implications for businesses and institutions (Borio, 2023).

Regulation of financial institutions is crucial for maintaining stability in the global financial system. Banks and other lenders need to uphold strong capital reserves and efficient risk management strategies to reduce the risk of defaults and fluctuations in asset values. However, with the financial system becoming more interconnected and complex, regulatory frameworks are struggling to keep up. There is a pressing need for greater international cooperation to tackle cross-border financial risks and establish uniform global regulations that can prevent regulatory gaps and support fair competition.

The Global Financial Stability Report (2024) highlights the risks posed by entities heavily involved in private credit markets, including insurers affiliated with private equity firms and certain pension funds. The significant growth of assets in less liquid investments by private equity-controlled insurers presents challenges in evaluating the overall risk to financial stability due to data limitations. The potential for systemic risks within the private credit industry is a concern if this asset class continues to expand without proper oversight. To mitigate these risks, regulators are advised to take a proactive regulatory and supervisory approach towards private credit funds, their institutional investors, and leverage providers.

Regulators are increasingly mandating financial institutions to actively manage and disclose climate-related risks. Non-compliance with these requirements may result in regulatory penalties, loss of investor confidence, and financial instability. Financial institutions must incorporate climate risks into their regulatory framework. This includes maintaining sufficient capital buffers and implementing risk management strategies that consider environmental and climate-related risks. Given the complexity of environmental and climate-related financial risks, globally coordinated efforts are necessary. The financial sector must continuously adapt its practices to effectively understand, measure, and mitigate these risks. By doing so, not only will financial stability be safeguarded, but it will also contribute to sustainable economic development. Continuous monitoring of regulatory frameworks, proactive identification of systemic risks, and active international collaboration are crucial for maintaining global financial stability. The constant changes in the global financial landscape emphasize the necessity of adopting policies and strategies to mitigate potential threats to financial stability.

## REFERENCES

- Agenor, P.R., and Pereira da Silva, L. A. (2021). Capital requirements, risk-taking and welfare in a growing economy. *Journal of Regulatory Economics*, 60, 167-192.  
<https://doi.org/10.1007/s11149-021-09438-z>
- Ambec, S., and De Donder, P. (2022). Environmental policy with green consumerism. *Journal of Environmental Economics and Management*, 111, 102584.  
<https://doi.org/10.1016/j.jeem.2021.102584>
- Anayi, L., Bloom, N., Bunn, P., Mizen, P., Thwaites, G., and Yotzov, I. (2022). Firming up price inflation. *NBER working paper*.  
[https://www.nber.org/system/files/working\\_papers/w30505/w30505.pdf](https://www.nber.org/system/files/working_papers/w30505/w30505.pdf)
- Ayuso, J., and Repullo, R. (2003). A Model of the Open Market Operations of the ECB. *Economic Journal*, 113 (490), 883-902.  
<https://econpapers.repec.org/scripts/showcites.pf?h=repec:ecj:econjl:v:113:y:2003:i:490:p:883-902>

- Bindseil, U., and Nyborg, K. (2008). Monetary policy implementation. Discussion Paper Series of the *Norwegian School of Economics and Business Administration*.  
<https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1052.pdf>
- Bindseil, U. (2016). Evaluating Monetary Policy Operational Frameworks. Paper prepared for the Federal Reserve Bank of Kansas City's Jackson Hole Conference.  
[https://www.kansascityfed.org/documents/7036/BindseilPaper\\_JH2016.pdf](https://www.kansascityfed.org/documents/7036/BindseilPaper_JH2016.pdf)
- Blanchard, O., Ariccia, G., and Mauro, P. (2014). Rethinking Monetary Policy. IMF Staff Position Note, SBP/10/03. <https://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf>
- Borio, C. (2023). Monetary and fiscal policy: safeguarding stability and trust. Speech by Claudio Borio Head of the Monetary and Economic Department, Bank for International Settlements on the occasion of the Bank's Annual General Meeting in Basel on 25 June 2023. <https://www.bis.org/speeches/sp230625a.pdf>
- Bremmer, I., and Kupchan, C. (2024). Eurasia group's top risks for 2024.  
<https://www.eurasiagroup.net/issues/top-risks-2024>
- Caldara, D., and Iacoviello, M. (2022). Measuring geopolitical risk. *American Economic Review*, 112(4), 1194-1225. <https://www.aeaweb.org/articles?id=10.1257/aer.20191823>
- Caldara, D., Conlisk, S., Iacoviello, M., and Penn, M. (2023). Do Geopolitical Risks Raise or Lower Inflation. *Federal Reserve Board of Governors Occasional Paper*.  
[https://www.matteoiacoviello.com/research\\_files/GPR\\_INFLATION\\_PAPER.pdf](https://www.matteoiacoviello.com/research_files/GPR_INFLATION_PAPER.pdf)
- Craig, B. R., and Koepke, M. (2012). Bank Capitalization. Retrieved July 28, 2022, from Federal Reserve Bank of Cleveland.  
[https://fraser.stlouisfed.org/files/docs/historical/frbclev/trends/frbclev\\_econ-trends\\_201205.pdf](https://fraser.stlouisfed.org/files/docs/historical/frbclev/trends/frbclev_econ-trends_201205.pdf)
- Dastgerdi, H. G. (2020). Inflation Theories and Inflation Persistence in Iran. *Zagreb International Review of Economics and Business*, Faculty of Economics and Business, University of Zagreb, vol. 23(2), pages 1-20, November.  
<https://doi.org/10.2478/zireb-2020-0011>
- Diamond, D., and Rajan, R. (2002). A theory of bank capital. *Journal of Finance*, 55, 2431-2465. <https://doi.org/10.1111/0022-1082.00296>
- Dibley, A., Wetzler, T., and Hepburn, C. (2021). National COVID debts: climate change imperils countries' ability to repay. *Nature*. 592. 184-187.  
<https://doi.org/10.1038/d41586-021-00871-w>
- European Central Bank (2022). Economic Bulletin Issue 4, 2022. Frankfurt: ECB.  
<https://www.ecb.europa.eu/pub/economic-bulletin/html/eb202204.en.html>
- European Central Bank (2023). Euro area bank lending survey, January 2023. Frankfurt: ECB. What European business makes of the green-subsidy race.
- European Commission (2023). A Green Deal Industrial Plan for the Net-Zero Age. Report from the Commission to the European Parliament and the Council, COM(2023) 62 final, February.  
[https://www.eumonitor.eu/9353000/1/j4nvke1fm2yd1uo\\_j9vvik7m1c3gyxp/vm09e7qy6fxb/v=s7z/f=/com\(2023\)62\\_en.pdf](https://www.eumonitor.eu/9353000/1/j4nvke1fm2yd1uo_j9vvik7m1c3gyxp/vm09e7qy6fxb/v=s7z/f=/com(2023)62_en.pdf)
- European Environment Agency. (2023). Economic losses and fatalities from weather- and climate-related events in Europe.  
<https://www.eea.europa.eu/highlights/economic-losses-from-weather-and-fatalities-from>
- Fabris, N. i Galić, J. (2009). Ka novoj monetarnoj paradigmi, Ekonomska politika Srbije u 2010. godini - ka novom modelu makroekonomske stabilnosti, Scientific society of econmists, isbn 978-86-403-1048-2, p.p. 349-361, 2009.
- Fratzscher, M., Konig, P. J., & Lambert, C. (2016). Credit provision and banking stability after the great financial crisis: The role of bank regulation and the quality of governance. *Journal of International Money and Finance*, 66, 113-135.  
<https://doi.org/10.1016/j.jimonfin.2016.02.015>
- Gern, K., Janssen, N., and Sonnenberg, N. (2023). Inflation and the effects of monetary tightening in the euro area.
- Gjedrem, S. (2005). The macroprudential approach to financial stability.  
<https://www.bis.org/review/r050517c.pdf>

- Gorton, G., & Winton, A. (2017). Liquidity provision, bank capital, and the macroeconomy. *Journal of Money, Credit and Banking*, 49, 5-27. <https://doi.org/10.1111/jmcb.12367>
- Grbić, M. and Jovanović, D. (2020). Comparative financial systems: Implications for economic growth. *Oditor - casopis za Menadzment, finansije i pravo*, 6, 49-65. <https://scindeks.ceon.rs/Article.aspx?artid=2217-401X2001049G>
- Grimm, M., Jordà Ò., Schularick, M., and Taylor, A. (2023). Loose Monetary Policy and Financial Instability. *NBER Working Paper, Working Paper 30958*. <https://www.nber.org/papers/w30958>
- Grubišić, Z. i Galić, J. (2011). Nove tendencije u monetarnoj politici. Izazovi i perspektive integracija zemalja Jugoistočne Evrope, Ekonomski fakultet Univerziteta u Tuzli.
- Hakenes, H., and Schnabel, I. (2011). Capital regulation, bank competition, and financial stability. *Economics Letters*, 113(3), 256-258. <https://doi.org/10.1016/j.econlet.2011.07.008>
- IMF. (2024). Global Financial Stability Report. Impact of the war in Ukraine on economic uncertainty. Voxeu column, Center for Economic and Policy Research. <https://www.imf.org/en/Publications/GFSR>
- International Monetary Fund. (2024). World Economic Outlook: Moderating inflation and steady growth open path to soft landing. <https://www.imf.org/en/Publications/WEO/Issues/2024/01/30/world-economic-outlook-update-january-2024>
- Kopecky, K. J., and VanHoose, D. (2006). Capital regulation, heterogeneous monitoring costs, and aggregate loan quality. *Journal of Banking and Finance*, 30(8), 2235-2255. <https://doi.org/10.1016/j.jbankfin.2005.07.018>
- Lane, P.R. (2023). The Transmission of Monetary Policy. Presentation at the SUERF, CGE-G|COLUMBIA|SIPA, EIB, SOCIÉTÉ GÉNÉRALE conference on “EU and US Perspectives: New Directions for Economic Policy” at 8. May. <https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp221011~5062b44330.en.html>
- Mastilo, Z., Božović, N. and Mastilo, D. (2021). Central Bank in the Function of Development of National Economy of Bosnia and Herzegovina. *International Letters of Social and Humanistic*. <https://philpapers.org/rec/MASCB1>
- Schinasi, J. (2006). Safeguarding Financial Stability. Washington: International Monetary Fund.
- Schnabel, I. (2022). Finding the right mix: monetary-fiscal interaction at times of high inflation. Keynote speech at the Bank of England Watchers’ conference. <https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp221124~fa733bc432.en.html>
- Schnabel, I. (2023). “Challenges for monetary policy at times of high inflation. Speech at Hessesischer Kreis. 9th May 2023. <https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230509~b449bef8c9.en.pdf?67ab440b1d9361af1e630bec6ca5b130>
- Sellin, P., and Sommar, P. A. (2014). The Riksbank’s operational framework for the implementation of monetary policy-a review. Sveriges Riksbank Report.
- Topić-Pavković, B. (2015). Održavanje makroekonomske stabilnosti kroz jačanje likvidnosti i finansijske stabilnosti. *Financing*, Broj 1 Godina VI/mart 2015. [https://financingscience.org/wp-content/uploads/2019/09/01\\_15.pdf](https://financingscience.org/wp-content/uploads/2019/09/01_15.pdf)
- Topić-Pavković, B. and Šoja, T. (2023). Post-Pandemic Inflation and Currency Board Arrangements in the Balkans. *Journal of Balkan and Near Eastern Studies*, 25:4, 644-670. <https://doi.org/10.1080/19448953.2023.2167165>
- Topić-Pavković, B., Kovačević, S. & Kurušić, D. (2023). The Impact of Innovative Financial and Banking Development on the Economic Growth of Bosnia and Herzegovina. *ECONOMICS - Innovative and Economics Research Journal*, vol. 11(1), pages 251-267, June. <https://intapi.sciendo.com/pdf/10.2478/eoik-2022-0022>