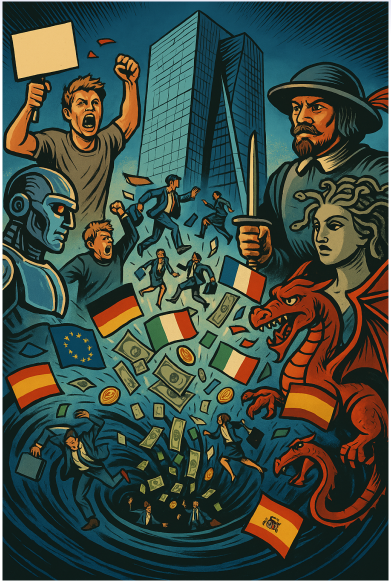

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Is Europe prepared for extreme events? Risks - resilience - policy responses

ESM – SUERF – Bruegel

Extreme events — Systemic financial events

- Cost trillions of euros
- Can have internal causes
  - 2008, 1866, ...
- Or originate externally and then impact the financial system with systemic consequences
  - Like Covid, but it did not quite meet the systemic bar

“Is Europe Prepared for Extreme Events?”

Are we fighting the last war (GFC 2008) while
neglecting new external threats to systemic stability?

Crises are all about debt

- Sovereign and real estate debt
- But safeguards usually keep things in check — No need to worry
- Need a catalyst that viciously interacts with debt
- Hemingway (1926): "How did you go bankrupt? Two ways. Gradually, then suddenly."
- Many catalysts have been mooted
  - Shadow banking, private credit, asset bubbles, weak oversight, financial innovation, technological disruptions, climate change, (de)globalisation, ...
- But they don't meet the systemic bar. Instead ...

1. Populism, credibility and political capital

- Central bank credibility essential for containing systemic risk
- But the ultimate backstop – "whatever it takes" – is a double-edged sword
  - Contained the European sovereign debt crisis
  - But also (Fed version) allowed SVB
  - And encourages the excess taking of risk
- Central banks have finite political capital
- Populism erodes that capital
- As does giving central banks non-systemic objectives like climate
- By using up much of our fiscal and monetary space, credibility goes away

2. Debt death spirals and "fiscal heart attacks"

- Vicious cycle: borrow to service debt and provide public services
- Ending with a "fiscal heart attack"
- Europe is at risk
- Italy a likely trigger

3. Manufactured tensions

- Governments often manufacture tensions to deflect problems at home
  - Falkland Islands in 1982, Spanish-American War (1898), Russia (2014), ...
- China faces considerable domestic challenges
- Particularly difficult when state legitimacy rests on performance
- Conflict with Taiwan a way out

4. Artificial intelligence — "rational maximising agent"

A shock arrives

	Run	Stay
Crisis	✓Right decision	✗Wrong decision
No Crisis	✗Wrong decision	✓Right decision

- If it opts to run, then wants to be the first
- AI speeds up bank crisis reaction
- Crises that used to take days or weeks now minutes or hours
- If private sector AI conclude the central bank is not prepared, an AI-induced systemic crisis becomes more likely

5. Geopolitics

- Geopolitical events frequently trigger systemic crises
  - 1914 shutdown of the cross border payment system, 6-month exchange closing
  - Great Depression — Trade war, global trade down by over 2/3
- Global order since then eroding

These five external threats to systemic stability are more important than preventing a repeat of the 2008 GFC

How can the financial authorities respond?

Economic growth and resiliency

Shift the focus of macroprudential policy away from preventing the 2008 GFC

- Controlling micro risks and have high capital and liquidity buffers
- Fallacy of composition: Not true that if we make the all part of system prudent, system is safe

Towards

1. Deregulation
2. System diversification/heterogeneity
3. Financial stability leads on AI, AI-to-AI API links, triggered facilities

Since economic growth reduces systemic risk

Deregulation and system diversification are macroprudential tools