Financial market risks: Too many fault- lines?

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What can / should central banks do?

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The next crisis: are we prepared for a perfect storm?

- *The next crisis is unlikely to resemble any scenario we design in advance"* (P Montagner, SSM).
- "*If market dysfunction threatens financial stability or monetary transmission, central banks **need to intervene**… [But in practice] it is a difficult balancing act to separate price movements caused by fundamentals from those driven by market dysfunction"*(P de Cos, BIS)
- The warning raised in this seminar is that the probability of a **"perfect storm**" whereby many bad things happen at the same time is elevated in the **near term**. Are we prepared for a Murphy's law situation?
- The ESRB has launched a project to develop a desktop-based **system-wide** stress test by **2028**. It considers that *"This is a major step towards translating the existing analytical framework into a practical Eur exercise"*.
- **Systemic vulnerabilities** are relatively well **identified**, but policy recommendations largely remain an impressive **"to-do" list**, and more worisome unsettled policy options.
- It is an open question to what extent successful backstop interventions of central banks (and other authorities) **encourage greater risk-taking.** Perceptions of entry and exit conditions of central banks matter a lot.
- The lessons of successful **private** sector interventions in idiosyncratic events are not sufficiently commented (Situational Awareness). Risk of self-confidence bias.

The global financial landscape: a new configuration of risks

- Macro environment: multiple **headwinds** (“zero sum” geopolitics, energy shocks, etc…) and one major **tailwind** (AI related productivity expectations). Extreme scenario of a “sudden stop” in the AI narrative.
- Worrisome **public debt dynamics**. Stretched public finances limit fiscal capacity in crisis. Growing potential for sovereign-market stress, financial repression and the risk of central banks being buyers of last resort.
- Financial system **rapid transformation**: growing NBFI intermediation, leverage, liquidity mismatches, opaque risk transfer and risk transformation. **Widespread regulatory arbitrage**. High **sectoral concentration** risk (AI). High **information gaps**.
- The **critical role of the dollar** in the global financial system underpinned by a limited number of **systemic dealer banks** supplying **repo based funding** (with Treasuries as prime collateral) and **forex swaps** ($) to the **international** community.
- Rapidly adaptive financial ecosystem currently driven by the **tension** between **limited balance-sheet capacity of dealer banks** (regulation) and the ever **increasing supply** of US **Treasuries** (see Geneva Report).

Central bank reaction function in crises: when and how to intervene? How to limit the risks of financial dominance and fiscal dominance ?

- **The challenge:** Designing a time-consistent backstop framework that is credible in a crisis but does not exante undermine market discipline. Bagehot's principles remain relevant, but are harder to apply in a financial ecosystem dominated by interconnected banks, NBFIs and markets.
- **A solid backstop framework necessitates cooperation with other authorities for the preventive part, for crisis management and for the exit** conditions**.**
- In the **Euro crisis**, the too slow restructuring of the banking sector and the collapsing of money supply in some jurisdictions led the ECB to use non conventional measures for an extended period. Downward price pressures enabled lasting expansionary mp, but creating a number of negative side effects.
- In the **UK** where inflationary pressures were present, the BoE could successfully launch a "stability QE" in the LDI crisis ("separation principle"): the change in fiscal policy made the exit possible**.**
- In the current **French** episode of spread widening of OATs, it is concerning that the market participants conversation (and probably also of politicians) is about which tool the ECB will create to intervene.
- In financial crises **trustful** cooperation and coordinated responses are of critical importance. To what extent will the US continue to play its leadership role, ensuring orderly dollar liquidity conditions at the global level (dollar swaps).

Lender of last resort and/ or market maker of last resort

- Opportunity for interventions, timing, choice of tools depend on specific circumstances. Currently, concerns of **financial** and **fiscal dominance** are high, having perhaps an impact on **“setting the bar” for interventions.**
- **Which tool**? Liquidity facilities to **qualified** counterparties (LOLR), **specific** asset purchases (MMLR), **general** market interventions for financial stability, not for policy stance reason (“stability QE”).
- ESRB “**attributes** for an effective enhanced LOLR and MMLR”: include supporting only financial markets that are deemed essential; lending only to regulated institutions to ensure solvency; developing an ongoing capacity to price securities accepted as collateral in a lending operation or purchased outright; offering pricing that is unattractive in normal times to reduce moral hazard; and once market liquidity has been restored, exiting quickly and in a manner that minimises the impact on market prices.