Recent Financial Disturbances and Risks to the Outlook Beyond the United States

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Immediate financial transmission risk:

- How will this shock affect the financial system and aggregate demand in different countries?

International currency risk:

- Could the rise in risk aversion reverse flows of capital from other economies to the US?

Medium-term monetary question:

- Will inflation expectations remain anchored?
How to project the impact of financial shocks

1. Size and nature of shock
2. Share of financial system hit
3. Financial accelerator (impairment)
4. Policy response

- Impact on the real economy
- Banks
- Mortgage Lenders
- Hedge Funds
- Equity Markets
- Supervisory
- Monetary
- Fiscal

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Germany and Italy: Mind the accelerator!

• Both have highly fragmented banking systems, with extensive public-sector ownership, and limited alternative finance for companies and households

• Thus, bank capital impairment is a very real risk
  – Especially when the semi-public banks make bad bets
  – It wasn’t an accident that IKB and Sachsen LB blew up first

• Italy’s supervisory system is more centralized and likely will perform better than Germany’s BaFin
Spain, Ireland, and UK: Beware additional real estate shocks!

- If you think the US had a property bubble...
- While direct property market spillovers are rare across borders, general liquidity reduction for real estate investment could hit these markets
- Spain is at greatest risk and the UK (i.e., London at the least risk), with Ireland closer to Spain
  - A shock of this kind is extremely unlikely to provoke monetary ease from the ECB but could from the BOE
Japan: Taking it in stride (for a change)

- Thanks to Takenaka and foreign investors, the core banking system is well-capitalized
- The financial system is increasingly diversified
  - Though more for corporate than household borrowers
- BOJ and FSA may *want* to be moralistic hazards, but political and economic constraints will prevent them
Will rising risk aversion reverse the flows of capital into the United States?

• So far, even flights to quality have been within dollar-denominated assets

• “Carry trade” is probably overstated, but there is also more fundamental diversification under way
  – Could be a tipping point for yen/dollar if households panic

• Bullish long-term for euro if the financial system is seen to be sound and soundly supervised
  – Recent events and likely fragility, however, may set back deeper integration and liberalization of the Eurozone financial system
Will inflation expectations remain anchored?

- Arguably, the decline in inflation expectations over the last 15 years has been a major source of liquidity and growth
- Central banks are moving back to adaptive sticky expectations (renamed “learning”) models
  - More room for initial flexibility, but more cost to re-anchor
- Exchange rate pass-through and money growth have declined significantly as influences on inflation
- “Moral hazard” concerns are not a major source of inflationary expectations, but productivity declines are
So what will the major central banks do?

• Keep trying to separate the emergency provision of liquidity from macroeconomic decisions

• Talk a good game against “bailouts” but don’t oversell
  – What happened with Northern Rock will be cautionary

• Focus forecast/data gathering on the interbank credit spreads, availability of commercial paper rollovers

• Return to a “tightening bias” sooner than expected
  – Especially as the US productivity growth rate slows
  – BOJ and ECB will have it easier than BOE and FRB
Bottom Line For The Outlook:
Be concerned about European financial risks

• Though the shock originated in the US, the financial and supervisory structure in the Eurozone is more fragile

• The current recovery is not a robust buffer
  – German and Italian recoveries are not sustainable
  – British, Irish, and Spanish real estate bubbles are significant

• The ECB’s willingness and room to act will prevent a persistent downturn from financial troubles, but not some first-round drag or supervisory problems from local real estate