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?

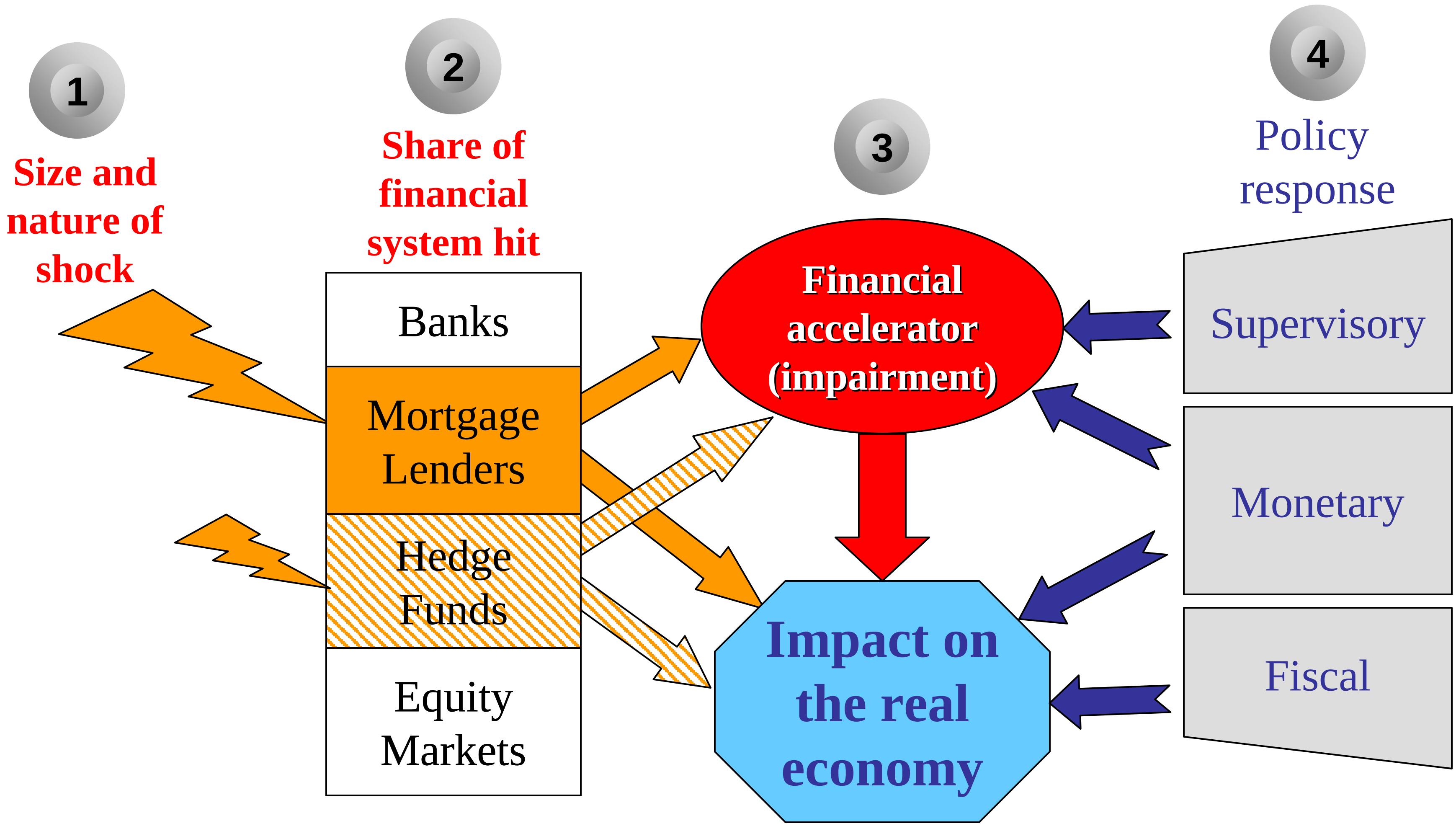
International currency risk:

- 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



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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

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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

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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