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Remarks for a Panel Discussion of the Global Outlook and Risks

Eric S. Rosengren
President & Chief Executive Officer
Federal Reserve Bank of Boston

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I have been asked to briefly discuss the *risks* to the economic and financial outlook.[1] In some sense, this is much easier than the jobs assigned to other panelists tasked with forecasting the outlook for either financial markets or the real economy. At a time when some of the risk scenarios are increasingly seeping into relevance, forecasting the most likely outcome can be quite difficult.

Risks that one year ago were viewed as so-called "tail-risk events" are increasingly being integrated into many peoples' base forecasts. This shift highlights that risks are once again on the rise, and that uncertainty about some of the challenges facing the global economy is already impacting the economic behavior of households and businesses.

[1] *Of course, I would like to note that the views I express today are my own, not necessarily those of my colleagues on the Federal Reserve's Board of Governors or the Federal Open Market Committee (the FOMC).*

Such uncertainty is leading to a degree of risk aversion that becomes apparent when we look at 10-year government bond rates in the U.S., U.K., and Germany (**Figure 1**). In all three countries, 10-year government bond rates are well below the inflation targets of their respective central banks. The fact that 10-year government bonds are trading at well below 2 percent indicates that perceived risks are leaving investors willing to purchase an asset that would provide a negative real return for 10 years (assuming that central banks are successful in hitting their inflation targets). For investors to view this pricing as reasonable implies that rising inflation is not a prime concern of financial market participants. It seems investors believe that central banks are more likely to undershoot their inflation targets than overshoot them, and that policymakers need to be particularly attentive to the downside risks of their economic and financial outlooks – and examine how best to mitigate these risks.

Some analysts have focused on direct exposures of financial institutions to a particular geographic location as a measure of current risk exposures. I would say that such measures do not capture the true risks. For example, in 2008 signs of potential disruption in financial intermediation activity and liquidity were a much better gauge of the financial and economic risks building up in the system than were measures of direct exposure to sub-prime U.S. mortgages. While it took many months for sub-prime credit losses to materialize, sources of short-term funding dried up well in advance, providing a timelier indicator of underlying stresses than measures of credit exposure. This episode highlights the risk that remains today to any institution that relies heavily on short-term funding to finance its business, and suggests that monitoring stresses in short-term funding markets may provide better early indications of troubles to come.

In 2008, many financial institutions learned that strategies of capital arbitrage, often in the form of holding assets off-balance sheet to avoid capital charges, were profitable during good times but were recipes for disaster during times of financial stress. Those structures quickly lost the confidence of counterparties who had been funding them, and thus became a significant problem to financial institutions. Fortunately, some of the most egregious structures, like certain structured investment vehicles (SIVs), have been wound down.

Furthermore, many financial institutions have taken measures over the past several years to bolster capital and liquidity. However, we – banks *and* regulators – need to understand better how funding models and investment structures are likely to behave under severe stress. Our best way to learn more about that is through ongoing stress tests. Such tests should focus on undercapitalized structures, or structures that are sufficiently opaque or risky that they are likely to require significant capital or liquidity at a time when they are particularly expensive.

Financial institutions and their regulators must make continued progress in reducing the institutions' sensitivity to rapid changes in risk preferences, and the consequences of such shifts for funding the assets of many institutions. In recent years and recent weeks, such shifts have pulled funders out of many risky investments and into the lowest-risk financial vehicles – most often the sovereign debt of the safest countries. This dynamic lies behind the recent surge in demand for U.S., U.K., and German bonds. The financial system remains quite vulnerable to this rapid shrinkage of funding sources.

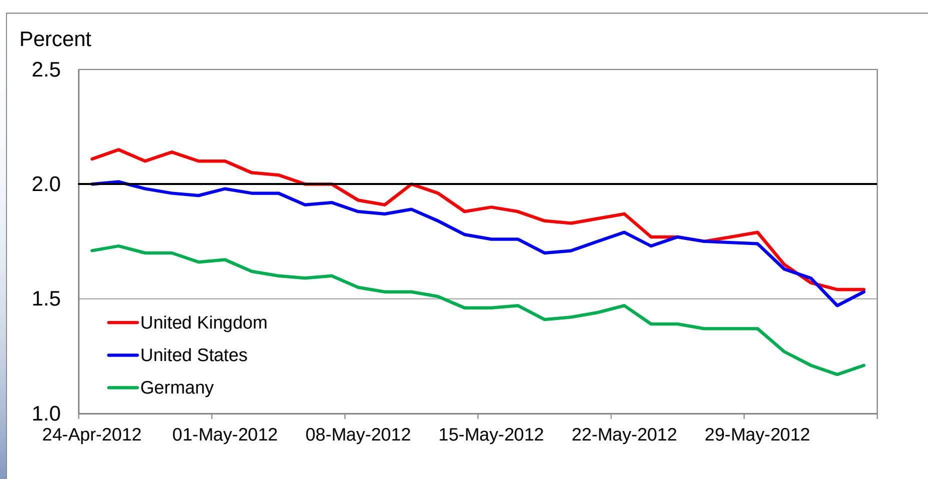
A second significant risk is that a failure to decisively resolve banking problems could cause collateral damage to the global economy. Historically, Japan is probably the leading example of how the failure to aggressively address banking problems can yield serious collateral damage. A protracted period of deleveraging of bank balance sheets, coupled with a persistent pattern of allocating capital to defer the realization of unavoidable losses, can cause an extended period of significantly misallocated resources. Such misallocation hoards scarce funds in inefficient investments and siphons them away from profitable and productive new investment opportunities. The combination of a banking system in denial, with business and households that are constrained by deleveraging and risk-avoidance, helps explain why recessions that are accompanied by financial crises are often deeper and slower to recover.

The global economy remains at risk. The longer the risks I have highlighted remain unaddressed, the more that investors, financial institutions, households, and businesses will shift what they considered tail risks into their expected outcomes. In this way, concerns about the possibility of *future* problems cause a substantial reduction in *current* economic growth. Policymakers and financial institutions need to continue to improve the robustness of the financial system in order to minimize the impact of this uncertainty.

Thank you for inviting me to join this panel today.

Figure 1
Ten-Year Government Bond Yields

April 24, 2012 - June 4, 2012



Source: U.S. Treasury, Financial Times / Haver Analytics