Ανακρίνατε τον Greenspan

Capital Leaders' Forum

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Αρχείο 21
Οικονομία

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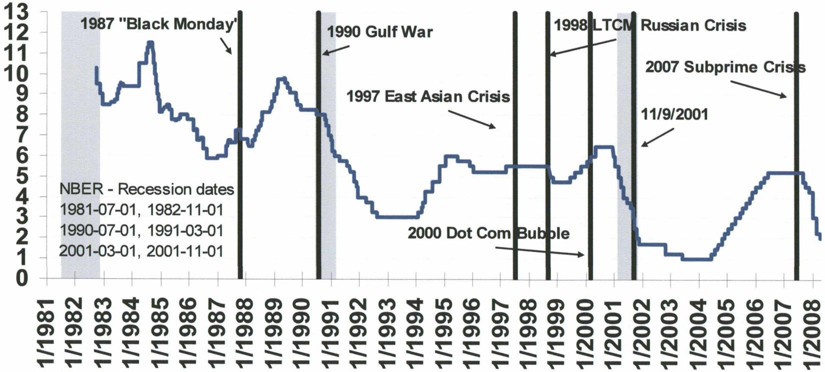
A brief history of the Greenspan Fed

Eurobank EFG

$18^{1/2}$ years & 4 presidential administrations
11/8/1987 – 31/1/2006

USA Fed Funds Target Rate



His recent book: The Age of Turbulence: Adventures in a New World (ISBN 1594201315)

Questions in the post-Greenspan era:

- How long will the financial crisis last? Any surprises in the horizon?
- Is global inflation getting out of control? Will global hunger persist? Are we going to see a quick reversal in US monetary policy once the crisis is over?
- Will stock market euphoria come back soon?
- Will the dollar strengthen in 2009?
- How much stricter will the regulatory framework be in the future: Will it affect bank profitability?
- Will emerging economies follow the US fate, or have they decoupled?
- Are we in a world of increasing inequalities?
- Should we worry about supply constraints and the environment?
- Can the US manage to keep its leadership in global economic policy making?

The Financial Crisis began post-Greenspan ...

... because of the simultaneous development of three factors:

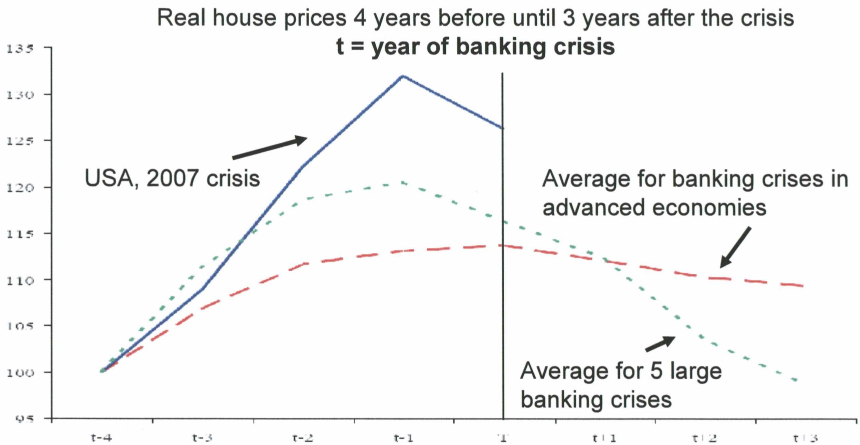
1) ***An earlier bubble in house prices in the US***
2) ***The rapid expansion of subprime mortgages***
3) ***The transfer of risk from the banks' balance sheets to third party investors through securitization***

Note: Greenspan is careful not to call the rise in house prices a "bubble"

Crisis is problematic because it began

- in the US, which produces 25% of 2007 world GDP
- in the financial sector, which is highly levered

The house price bubble is larger than before

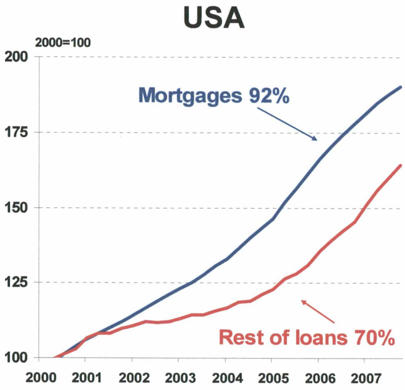


Source: Reinhart & Rogoff (2008)

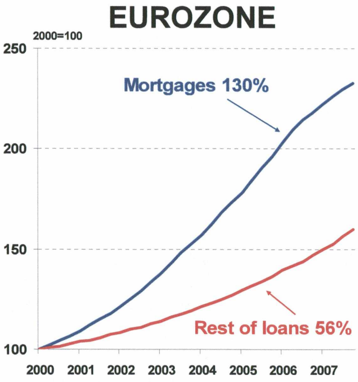
Categorization of banking crises according to Reinhart-Rogoff:

- 5 «big» banking crises: Spain (1977), Norway (1987), Finland (1991), Sweden (1991), Japan (1992).
- Smaller banking crises in developing economies: Australia (1989), Canada (1983), Denmark (1987), France (1994), Germany (1977), Greece (1991), Iceland (1985), Italy (1990), N. Zealand (1987), Un. Kingdom (1974, 1991, 1995) και USA (1984).

… with a rise in credit expansion



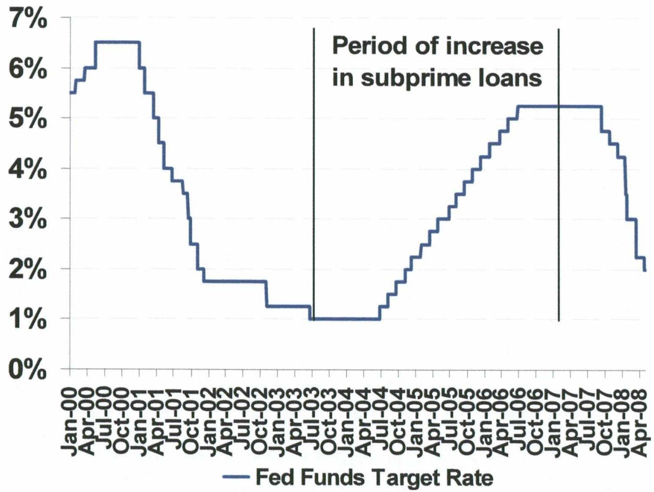
Source: ECB



Source: Federal Reserve

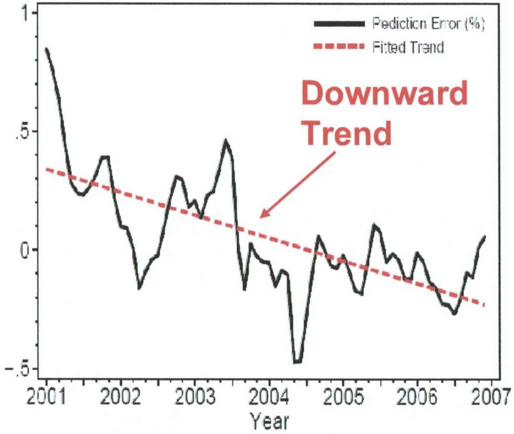
... especially in subprime loans in the US

Subprime: **From 9% of total mortgages in 2003 to 24% by mid-2007 (subprime & Alt-A)**



Subprime-Prime spread

after controlling for loan characteristics



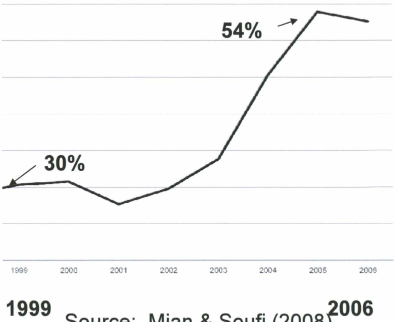
Source: Demyanyk & Van Hemert (2007)

... due to the cannibalization of a useful market innovation: Securitization

Banks have three options:

1) Keep the loans on their balance sheets
2) Sell the loans to state controlled agencies (FNMA, FHLA, etc.), which in turn securitize them, a practice since 1939. So banks acquire the necessary liquidity in order to give new loans.
3) Sell the loans to private agents, which also securitize them.

Share of mortgages securitized by non state agents

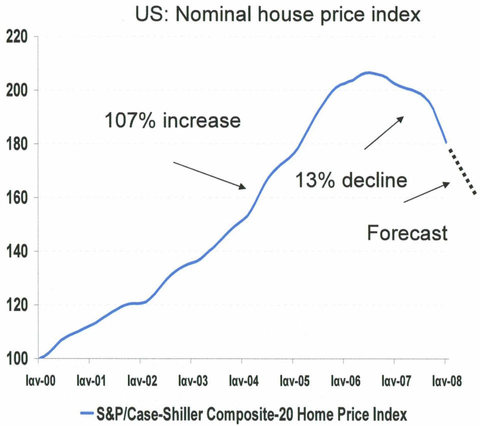


Source: Mian & Soufi (2008)

➢ **77% of new subprime loans were securitized**

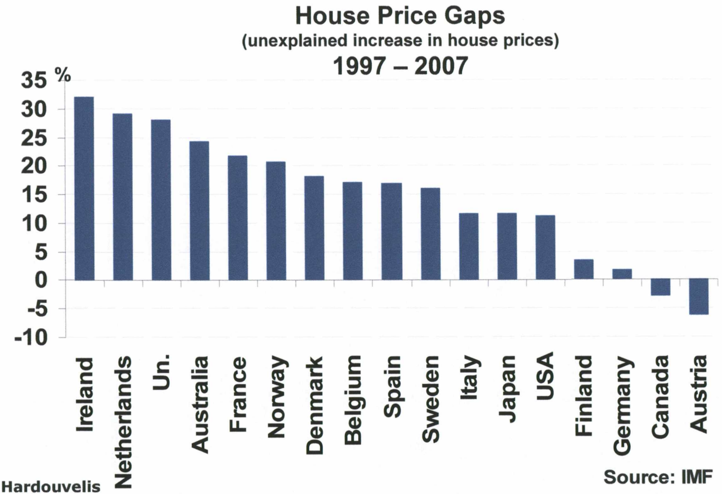
The fall in home prices continues in the US …

- The largest fall in the history of the indices, in some areas as large as 40%
- They are expected to fall by an equal percentage in the future



… and follows around the globe

- Europe will probably follow USA experience, with most of the effect to come in the future …



Source: IMF

The crisis spread as …

1. **Structured products** are present **everywhere**
   - in portfolios across the entire financial system, in US, European and Asian banks, funds, insurance companies, etc.
2. **Counterparty risk increased** (lack of transparency & complexity)
   - Interbank market – liquidity problems
3. **High leverage** of hedge funds, investment banks:
   - Increased the need for liquidity & pressures for selling
   - (Near) defaults of Investment Banks, Insurers, Hedge funds
4. **Supply of credit insurance by single entities**
   - Credit Default Swaps (a $62 trill. market), Monoline Insurers
5. **Securitization had expanded into non-mortgage loans**
   - Asset Backed Commercial Paper
6. **Rating agencies became more strict**
   - Further write-downs
7. **International Accounting Standards:** Mark-to-Market
   - Banks are forced to show PV losses
   - Increased pressure for selling assets → fire sales → lower prices

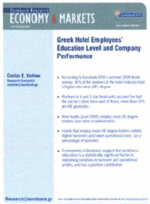
THANK YOU FOR YOUR ATTENTION!!

My thanks to the research department of Eurobank EFG for able research assistance and support

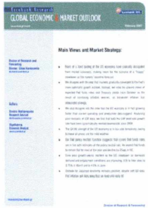
For more info, please consult the Eurobank website:

http://www.eurobank.gr/research


New Europe


ECONOMY & MARKETS

Greek Hotel Employees' Education Level and Company Performance


GLOBAL ECONOMIC & MARKET OUTLOOK

Main Views and Market Strategy

New Europe: A quarterly analysis of the countries of New Europe

Οικονομία & Αγορές: Μηνιαία έκδοση με θέματα για την ελληνική και παγκόσμια οικονομία

Global Economic & Market Outlook: A quarterly in-depth analysis of major market and economic trends across the globe with our detailed forecasts

Mr. Chairman,

INFLATION

i. Has the Fed lost control of inflation? **Are we seeing a repetition of the inflation of the 1970s?** In the 1970s, oil prices were a problem, agricultural prices too. Now, the predictions of economists are for a continuation of the increase in commodity & agricultural prices and a stabilization of oil prices at these higher levels.

ii. **Will the Fed,** in its effort to fight future inflation, **increase interest rates equally fast in 2009**, as it decreased them during the last 8 months? Would such a delayed response by the Fed end up being a lot more aggressive - more restrictive - in order to be effective in the future, risking another future recession?

iii. Should the Fed adopt an inflation target, as Bernanke & Mishkin – in their previous academic work – seemed to espouse? **Should the Fed adopt another explicit anchor?**

TAYLOR RULE & FED POLICY

i. Our models at Eurobank show that the 1% low level of the intervention interest rate, the federal funds rate, in the period from June 2003 to June 2004 was the correct level, despite the ex-post criticism you receive now. This is because our Taylor-rule, responds to INFLATION & Unemployment Stress (a product of unemployment with unemployment duration), instead of Inflation and the unobservable output gap. That same rule that justifies the Greenspan policy of low interest rates, now shows that today's interest rates by

Ben Bernanke should have been 4%, not 2%. **Isn't this current level of interest rates at 2% extremely inflationary?**

THE CONUNDRUM

i. Long term interest rates were unusually low in the past. You, yourself called the phenomenon a "conundrum." Do you foresee in the future another period of low long term interest rates? Will the global disequilibria in savings and investment wash away after the US recession is over and the US current account normalizes a bit more?

BUBBLES

i. Mr. Chairman, you have been quoted to say that Monetary policy should not be responding to bubbles, as bubbles are hard to identify while they unfold. Ben Bernanke seems to hold a similar view. Nevertheless, he has left a window open. The window is regulation. **Can regulatory intervention be used to counteract bubbles?** In my own research, for example, I have found that, if margin requirements decline following a large decline in stock prices and, much later, are normalized back to their average level, then **this countercyclical regulatory (margin) policy decreases average volatility in the stock market. Should the Fed use <u>additional instruments</u> to counteract unusual changes in asset prices?**

ii. How far more of a **decline in US housing prices** do you predict?

GLOBALIZATION & INCOME DISTRIBUTION

i. In the last decade, **financial globalization** across the globe is a major driving force. Another characteristic is **rising wage inequality**. The share of wages in aggregate output declined and the share of profits increased. **Are the two phenomena related in your opinion?** Is perfect competition losing out to oligopolistic structures across the globe that drive up prices above marginal cost and result in huge corporate profits? What is the cause of all this? The academics do not seem to agree on this and are very emotional about it. **What should be done about it?** Should we restrict free capital movements, as some economists argue? Should we restrict transnational oligopolies? Should we establish a transfer mechanism to help the underprivileged?

THE DOLLAR

i. **Should the Fed act to place a bottom under the dollar?**

FISCAL POLICY & US ECONOMY

iii. Do you think the tax package of President Busch will do the trick and take the US economy quickly out of the recession?

iv. Will the growth slowdown in the US last into 2009?

THE FINANCIAL CRISIS

i. **Do you think the worst of the financial crisis is over?** Judging form the narrowing of credit swap spreads, the market seems to think so, especially after the rescue of Bear Stearns in Mid March. Yet, the latest total number of write-downs and credit losses sum up to only $330 billion, when the IMF in its recent Financial Stability Report, claims the losses will be over $900 billion. Are losses being hidden? Should we be afraid of blow ups in hedge funds or in insurance companies and other financial intermediaries some time soon?

ii. Will credit losses by European Financial intermediaries increase with time, as they seem to be revealed gradually? **Do you foresee a worse case for the European financial sector and the European economy in 2009?**

REGULATION

i. Some Greek bankers expect the worst in terms of new stricter regulation in Europe and the world. Greek banking was among the first sectors to be liberalized in Greece in the late 1980s and has prospered, expanding into New Europe. **Do you think the entrepreneurial spirit would be suffocated in the years to come in the financial sector?**

ii. **What is your view on the appropriate new regulation?** For example, Paul Vocker, your predecessor, borrowing some proposals from Nouriel Roubini, was quoted in the FT recently, posting 7 principles, the seven "c" s of the new regulation:

1) Full regulatory **coverage** to avoid regulatory arbitrage
2) Greater **cushion** in terms of capital requirements
3) **Commitment**, meaning that originators of loans should hold equity portions of securitized loans
4) **Cyclicality**: Current rules are pro-cyclical, so he proposes that there is a target rate of capital adequacy above the minimum level, in the spirit of initial and maintenance margin requirements in the stock market.
5) **Clarity** of information and the role of rating agencies.
6) **Complexity**: All derivatives should be traded in exchanges
7) **Compensation**, in the name of aligning incentives of managers and stock owners, the compensation scheme rewards the upside, without penalizing the downside.
8) Martin Wolf of the FT added the 8th c: Keyne's **Casino** capitalism: Should it be restrained?

iii. Should the regulatory system in the US become simpler with a single regulator? In addition, **should monetary policy and regulatory policy be administered by a single entity, i.e. the Fed?** Or should there be managed separately by at least two separate regulators?