

INTERVIEWING Greenspan

Capital Leaders' Forum

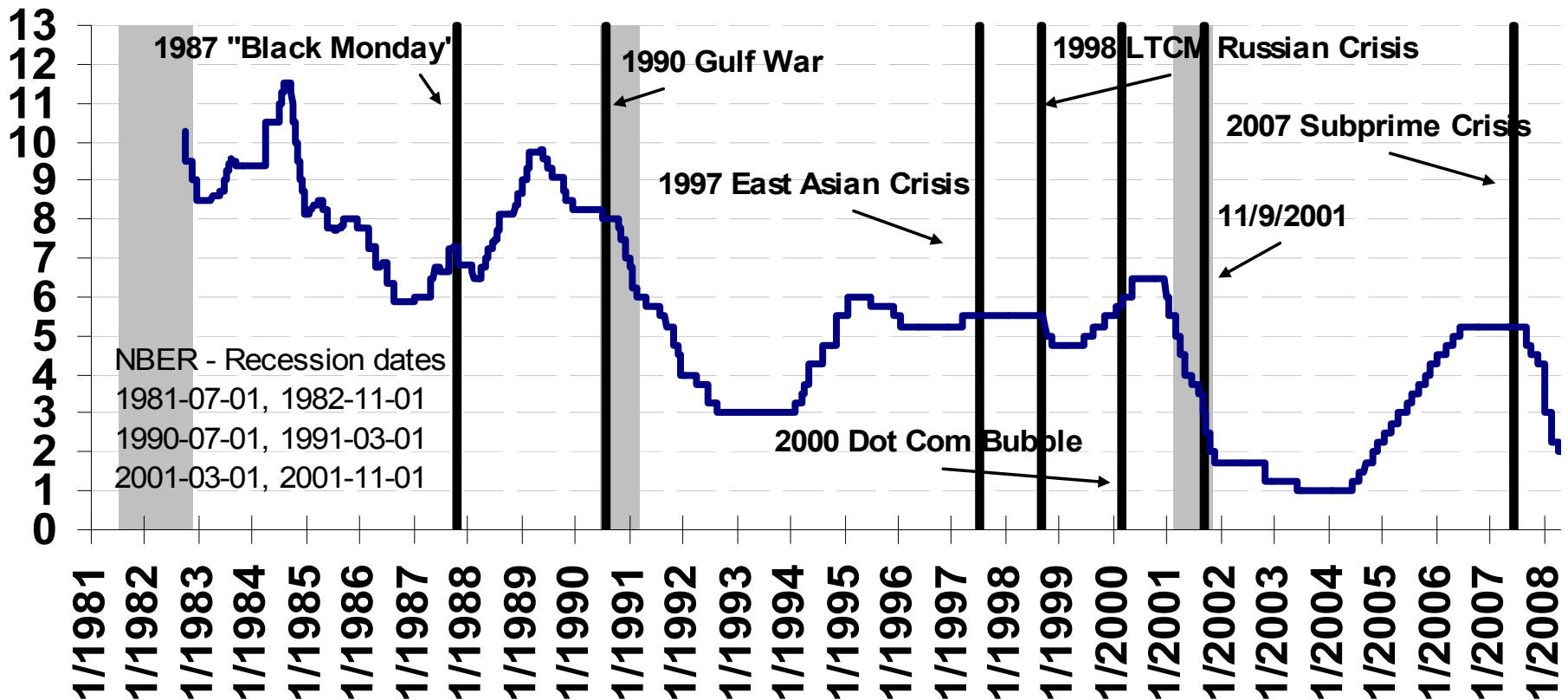
20/5/2008

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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](https://www.amazon.com/dp/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*

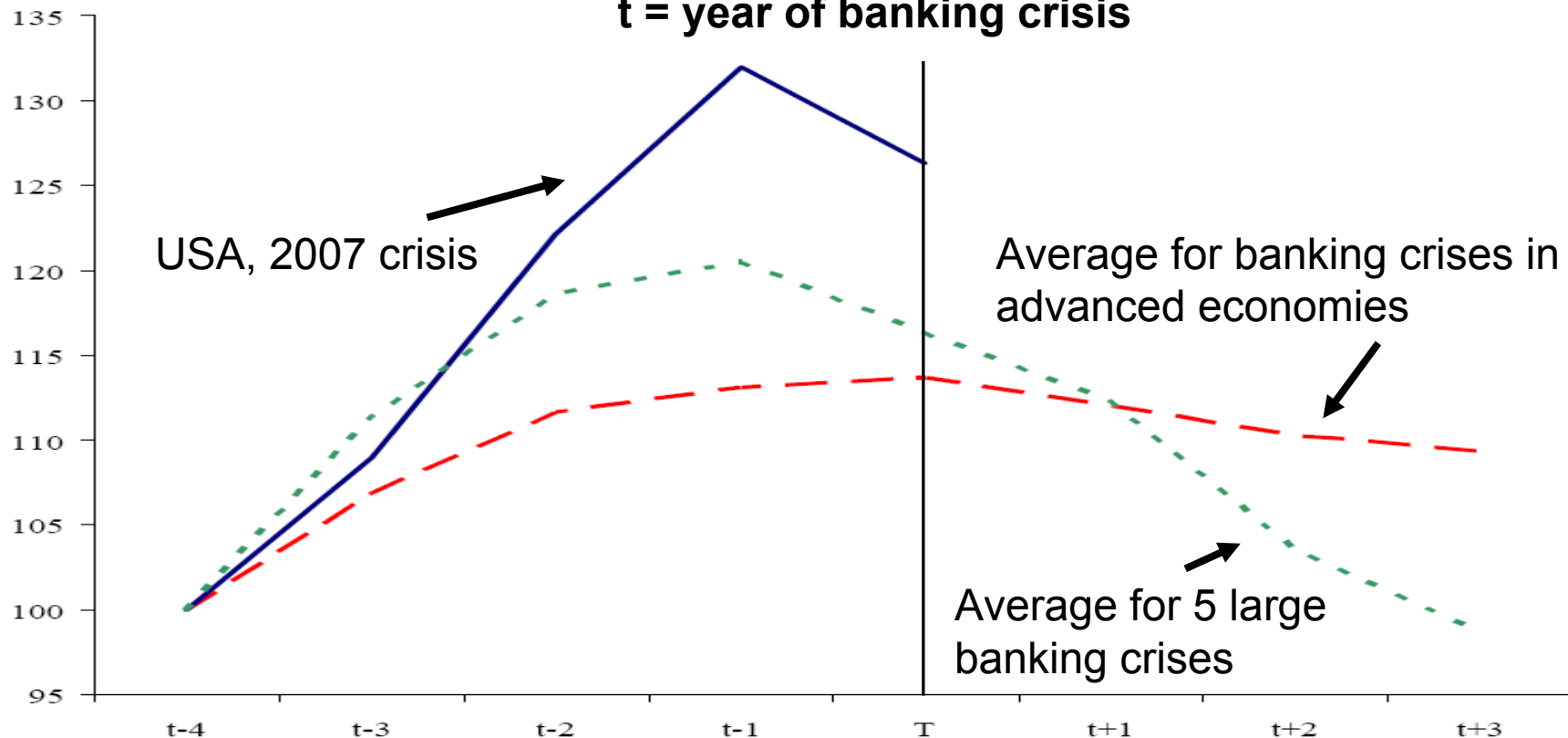
Note: Greenspan is careful not to call the rise in house prices a “bubble”

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

Real house prices 4 years before until 3 years after the crisis
 $t = \text{year of banking crisis}$



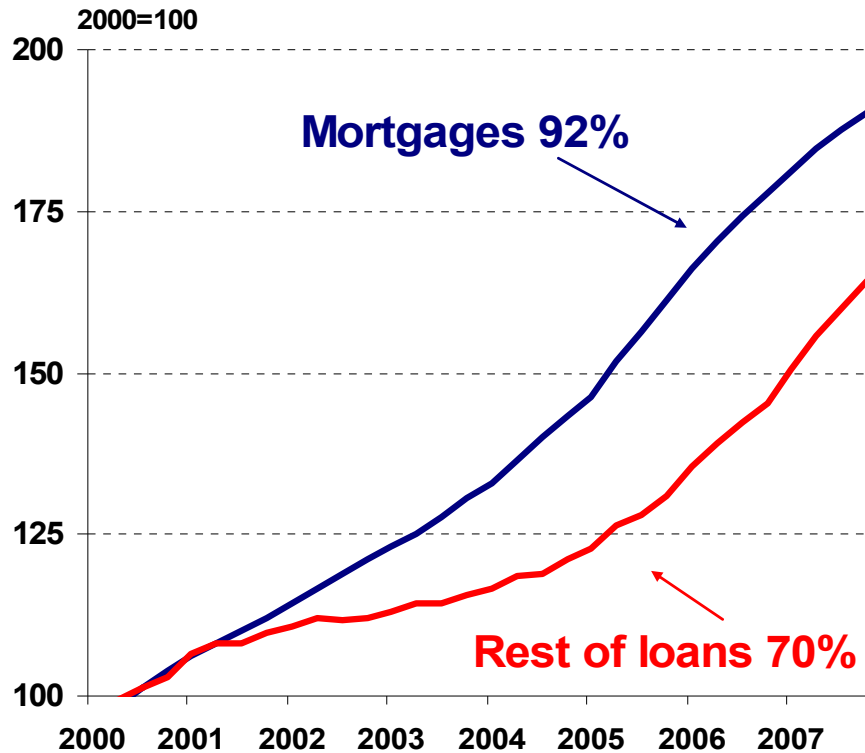
Source: Reinhart & Rogoff (2008)

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).

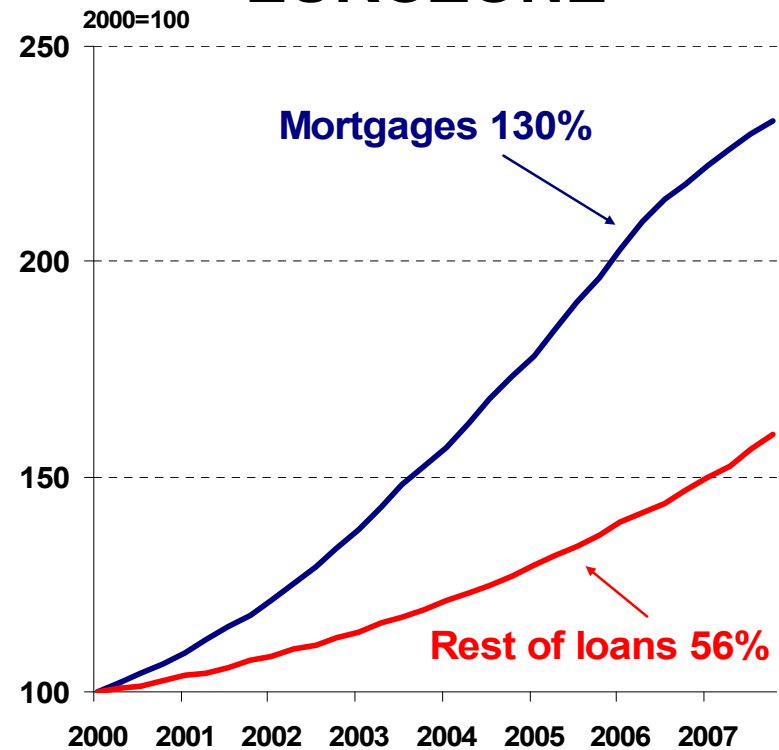
... with a rise in credit expansion

USA



Source: ECB

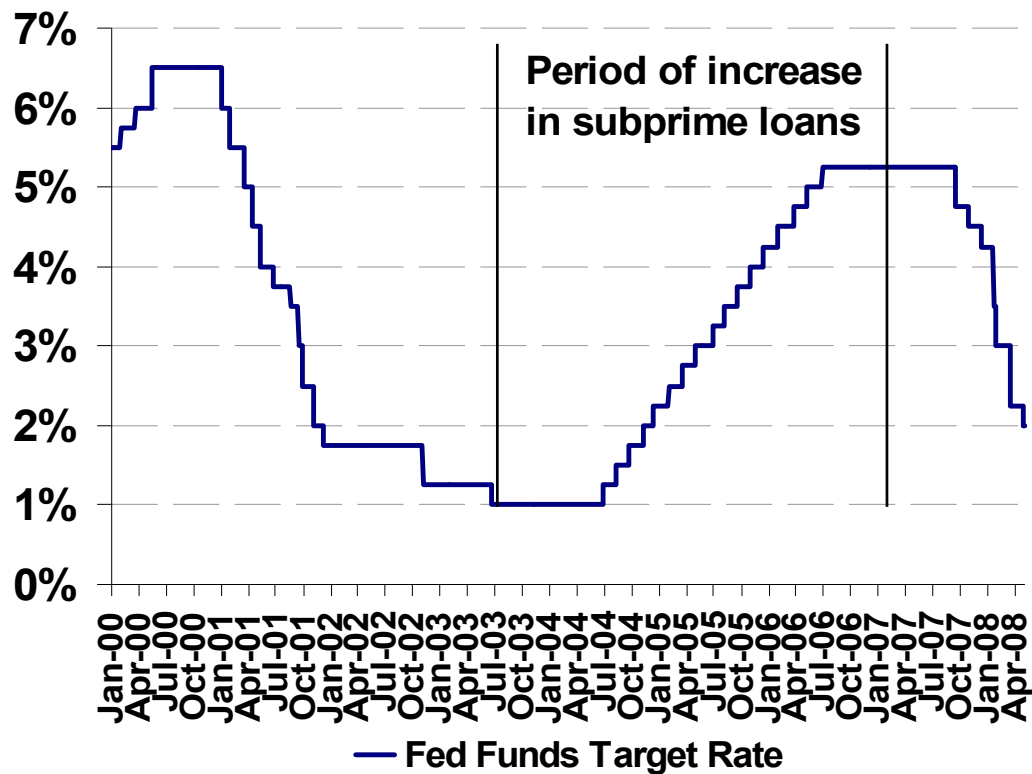
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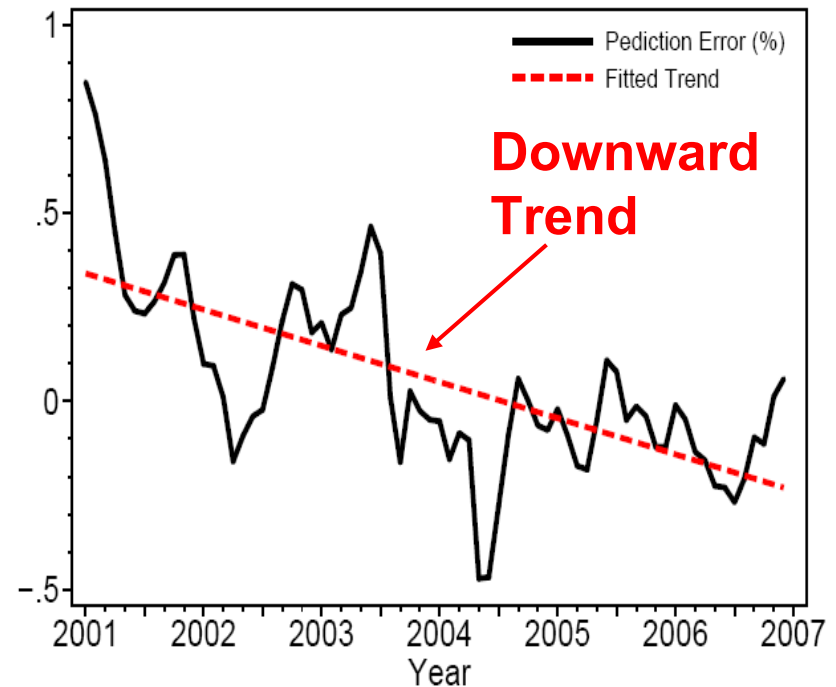
Source: Federal Reserve

... 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



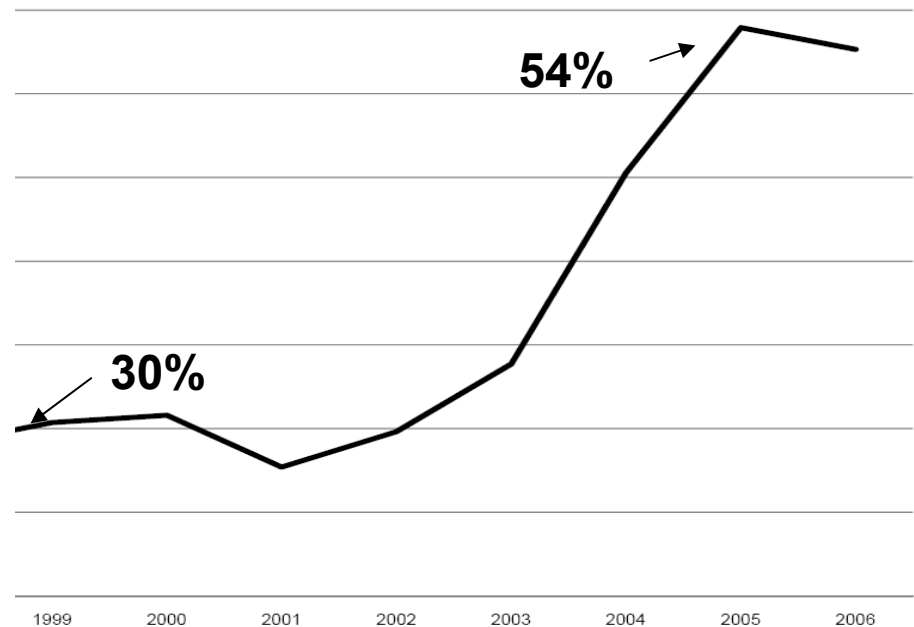
Source: Demyanyk & Van Hemert (2007)

... 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, FHLM, 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

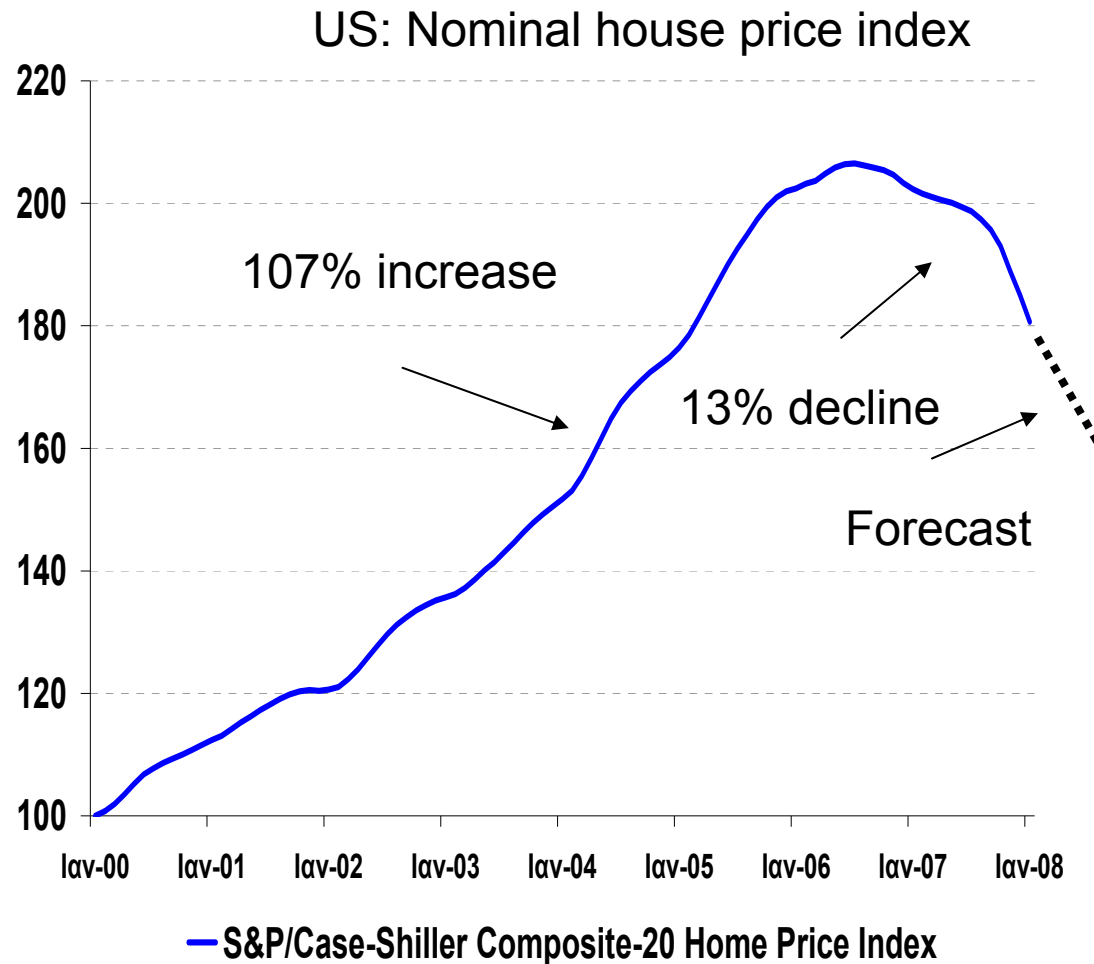


1999 Source: Mian & Soufi (2008) 2006

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

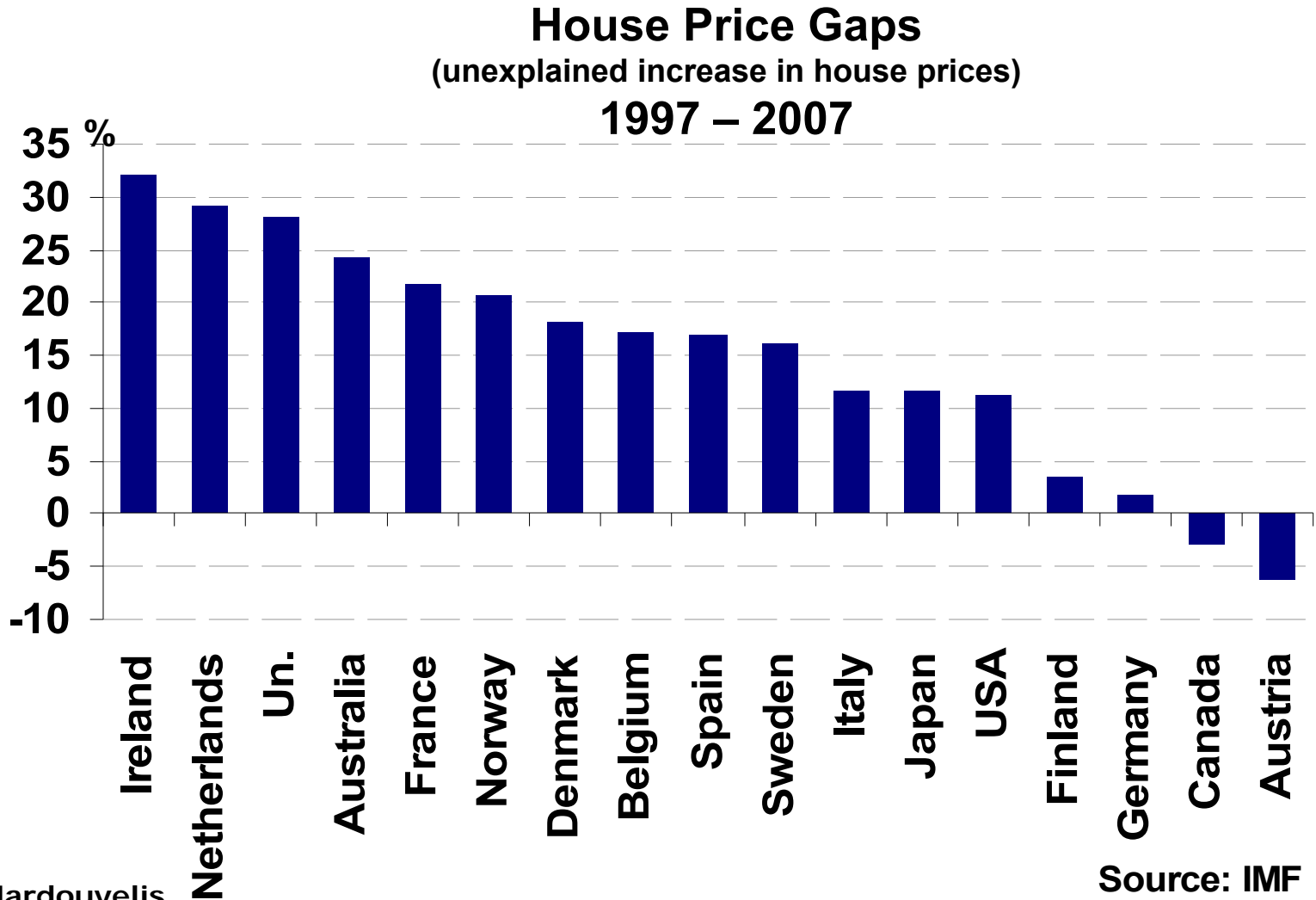
The fall in home prices continues in the US ...

- 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 ...



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>



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Gikas Hardouvelis



A quarterly analysis of the countries of New Europe

Μηνιαία έκδοση με θέματα για την ελληνική και παγκόσμια οικονομία

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