Greenspan Brookings Paper

Causes

Global bubble generated by market liberalization generated by the end of the Cold War. Global savings glut led to decline in l t interest rates generating global home price bubble

delinking of monetary policy from l t i exaggerated by heavy use of debt for leverage + securitization

"Great moderation" reduced global risk aversion to historically unsustainable levels" 47

"likely to be judged the most virulent global financial crisis ever" p3

"virtual withdrawal... of private short-term credit" p3

failure of private counterparty credit surveillance and global regulatory system

" financial intermediaries tried to function on too thin a layer of capital, owing to a misreading of the degree of risk" p3

Fall of Berlin Wall

S/Y in developing world 24% '99, 34% '07

global ex post S-I Y only modestly ↑

weakening of global I

classic euphoric bubble

"Almost all market participants of my acquaintance were aware of the growing risks, but also cognizant that risk had often remained underpriced for years" p 8

irrational exuberance speech in 96, continued until 2000

"financial firms were fearful that should they retrench too soon, they would almost surely lose market share, perhaps irretrievably" p 8

bubble - a protracted period of falling risk aversion that translates into falling capitalization rates that decline measurably below their long-term trendline averages ... [and] propel one or more asset prices to unsustainable levels" pp 9-10

"Mathematical models that define risk ... are surely superior guides to risk management than the 'rule of thumb' judgments of a half century ago" p 11

"The depth of financial crisis is properly measured by the degree of collapse in the availability of short-term credit" p18

"the evaporation of the global supply of short-term credits within hours or days of the Lehman failure is.... without historical precedent" p18

Greenspan unweighted ave 5 yr CDS
on 6 major US banks

early 07	9-15-08	10-10	10-14 (Tarp)	12-31-09
17 bp	170 bp	400+	↓ 200	≈ 100

9-09 Libor/OIS had returned to pre crisis

History of Regulatory capital

Pre civil war	late 19th	pre crisis	2012
50%	30%	10%	13-14%

net income to equity relatively stable at 5-10%
Fannie + Freddie taken over 9-7-08
crisis emerged Aug 2007

Greenspan

TBTF ⇒ "too interconnected to be liquidated quickly"

can't identify risk "in a sufficiently timely manner to enable the the liquidation of a large failing bank with minimum loss" p 33

Best chance of reducing moral hazard

contingent capital bonds - require all banks + possibly all fin intermediaries to hold

special bankruptcy facility - regulator access to public funds for "debtor-in-possession financing" panel of expert judges

principles for haircuts for creditors before restructuring - split into smaller units

"Regulations embodying a forecast fail with regularity"

"Regulators can readily identify underpriced risk and the existence of bubbles, but.. they cannot... effectively time the onset of crisis" 34-5

fin crisis - an abrupt and sharp decline in the price of income producing assets..." 35 - risk often remains underpriced for years

"current environment for complexity" 35

beefing up banks counter party risk surveillance - "first line of defense ... Regrettably [it] failed" p 36

Corr Fed funds + 30 yr mortgage rate
63 - 02 = .83 02-05 .17

little correlation between product and asset prices

Taylor argues global savings rate not high in 02 to 04

Greenspan criticizes using ex post data for ex ante analysis

incremental tightening won't defuse a bubble - effort in early '94 failed

He doubts that bubbles can't be prevented without central planning