expansionary
contractionary

LOW INT. RATES betw̄ 2000 – 2004 the lifeblood of housing boom

Dot.com bubble bursts

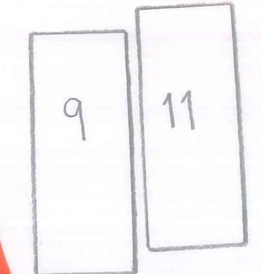
excessive speculation during a period of extreme growth of the internet & tech. stocks

"irrational exuberance" OR F.O.M.O

Mid. 2000

internet & tech. companies underperform expectations & losses lead to panic selling

World Trade Centre Attacks



11 Sept. 2001

U.S. central bank cuts int. rates faster (by end of 2001 at 1.75% – 6.5% two years earlier

despite cuts in int. rate U.S. economy not expanding, coupled w̄ tax cuts (combat recession) and loss of capital gains collections – U.S. federal budget fell into a $150 b. deficit

defn – bubble – when the price of an asset first soars (then plummets over a sustained period of time) at rates that are decoupled from the rate of growth of income that might be reasonably expected to be realized from owning or holding the asset.

expensive military interventions in Iraq & Afghanistan looming (Spending)

2002 – 2003 U.S economy still not recovering adequately despite extreme rate cuts by U.S. central bank

int. rate cut to 1%

for ~1yr.

giant mortgage specialists like Countrywide Financial, big commercial banks like JP Morgan & Citigroup, and big Wall Street investment banks like Lehman Brothers, pushed ever harder to sell the ARMs – a sales culture mentality – w̄ low initial int. rates & no req't of income verification

2004 ARMs boom

Strong growth based on housing boom led Greenspan to raise int. rates in MID-2004 – eventually by more than 4% points

int. rate reached 5.25% by end of 2006 but did not slow the flow of mortgage lending/buying

in 2007, two hedge funds at Bear Stearns went broke and triggered the credit crisis
in 2008 Bear Stearns was saved in a sale to JP Morgan Chase (financed by U.S. gov't)
in 2008 Lehman Brothers collapsed & U.S. gov't initiated a $700 b. bailout of c.&i. banks

a high U.S. dollar coupled w̄ the trade deficit (M > X – net outflow of USD) put even more USD in foreign hands – which foreign investors in turn confidently invested in U.S. securities, providing ample funds for even more mortgages & demand for subprime securities

interest rate increases backfired as they only encouraged Wall Street to take more risks & mortgage brokers to write more bad loans b/c profit margins narrowed

When Greenspan raised int. rates in 2004 (upon which ARMs were based) the clock began to tick – the rates on 100s of b. of dollars of ARMs would reset upward in 2006 – that year default rates on mortgages exploded & home prices fell for first time – confidence was shaken in both real & expectations economy

Many blamed Greenspan's extreme monetary easing for the crisis by making credit too cheap for too long – allowing the financial industry to make decisions we would all come to regret and feel

2008 Greenspan testified he presumed that the self-interest of the financial sector was the best way to protect their own shareholders & equity – the unleashing of unregulated self-interest since the 1980s, Greenspan believed, was a sufficient condition for prosperity – he believed innovation & deregulation went hand in hand w̄ financial stability

Greenspan feared DEFLATION (an overall decline in prices) far more than INFLATION b/c deflation results in acute financial turmoil – debtors don't pay back loans b/c dollars are more valuable b/c each dollar buys more – creditors take large losses

Stimulus, bailouts, low to zero int. rates & QE as MACRO strategies

QE = quantitative easing (in effect, printing money)

Greenspan always believed he could recharge the economy by cutting rates sharply (easy MP) as done ever since rescuing the financial markets in 1987

NOW lower rates alone were not working as the sole macroeconomic policy to recovery / expansion / infationary gap

Greenspan realized to only way out was to push int. rates even lower to ignite a housing bubble

2000 to 2007/8 a highly competitive mortgage market
(A) in particular low-income / poor credit buyers – specifically ARMs (adjustable rate mortgages) where buyers paid low int. rates in first 2 yrs. – then rates rose substantially

(B) middle-income Americans also often took ARMs to buy homes once out of their reach

w̄ rates so low & no federal oversight, mortgage lending practices became widely abusive (FBI warned in 2004 of an "epidemic" of fraud in subprime mortgage writing BUT its resources & focus pre-occupied w̄ counter-terrorism)

the U.S. central bank had the power to investigate but Greenspan chose not to, rather in 2004 Greenspan essentially endorsed the practice of ARMs

Since Wall Street was now the most important source of mortgage money (packaging mortgages into securities made institutional investors, like pension funds & insurance companies, the major providers of funding for mortgages)
↳ 100s of b. of dollars of new money found its way to homeowners each year
↳ when Greenspan raised rates to slow pace/intensity of growth it did not slow the flow b/c Wall Street a bottomless pit of demand for new securitized debt (subprime mortgage-backed securities) from institutional investors, investment managers, & financial institutions worldwide
↳ Greenspan's belief in free market principles led him to approve of securitization as a sound way to spread risk – but did not understand how excessive & risky the borrowing now was (particularly CDOs – a product that packaged risky mortgages for investors willing to make only low-risk investments)
↳ exposed Greenspan's naive & dangerous faith in competitive markets to regulate themselves