The (new?) European economy

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What kind of crises?

First Stage ‘subprime’

- Surprime only tip of iceberg.
- Real problem is combination of two factors:

1. Global real estate boom
2. Explosion of financial activity – most of which designed to shift risk away from banking system (securitisation, credit default insurance, etc.).

What kind of crises? II
The build up

‘Subprime’ perfect expression of the two driving forces:

1. Global real estate boom, made sub prime loans attractive. (As house prices go up forever no need to worry about creditworthiness of borrower.)
2. Explosion of financial activity to get rid of risk: e.g. sub prime loans not originated by banks and immediately securitised.

What kind of crises? III
The bust

1. Real estate boom ends and reverses.
2. Illusion that banks could get risk of all risk evaporates as:

- Originators who had promised to look after delinquent loans go bust.
- RMBS market dries up and banks have to stand by their special purpose vehicles.

An ‘Anglo-Saxon crises?

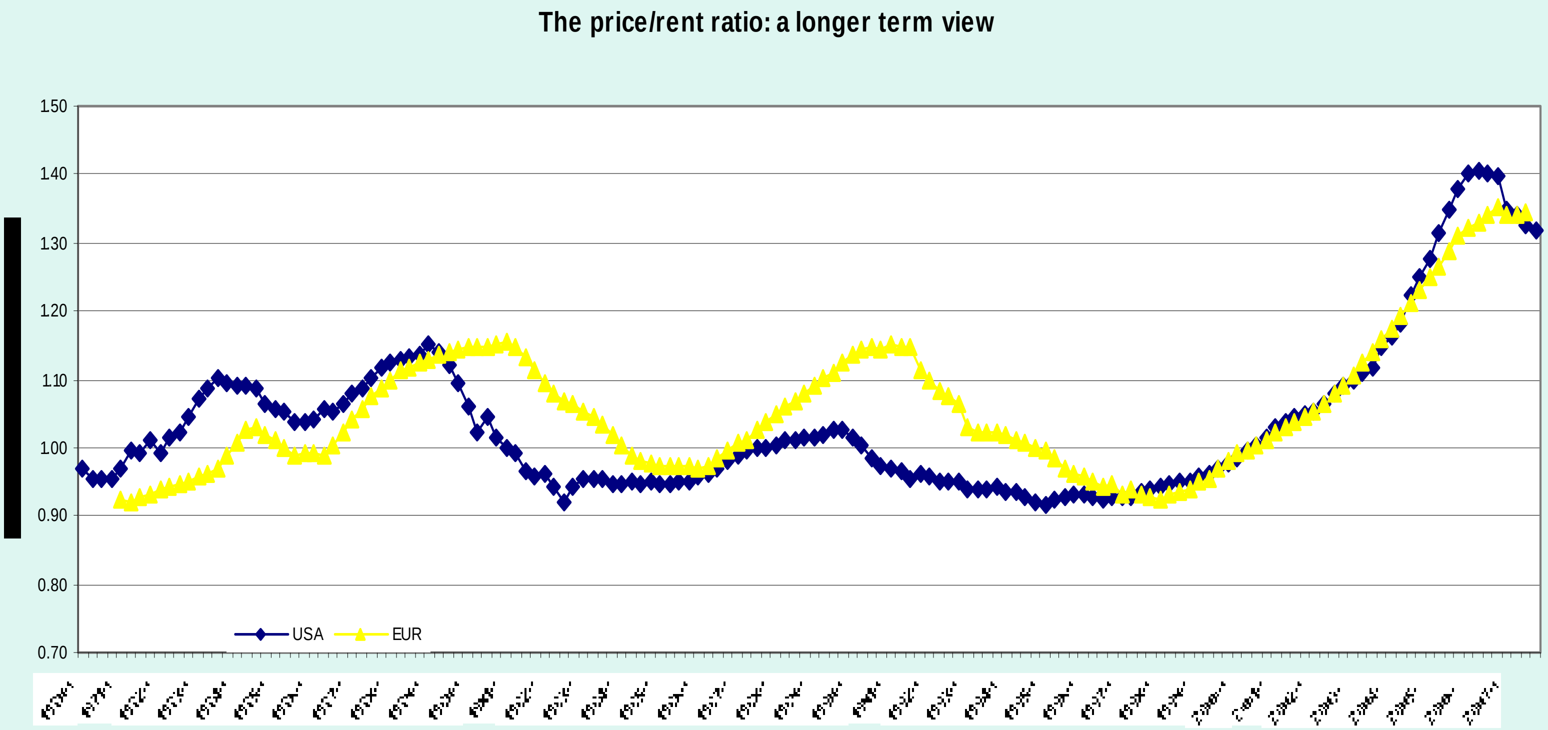
1. Real estate boom not only Anglo Saxon, but global (with two exceptions).
2. Securitisation on industrial scale: mainly an Anglo-Saxon phenomenon plus Spain

From (‘Anglo-Saxon?) ‘sub prime’ to global financial crisis

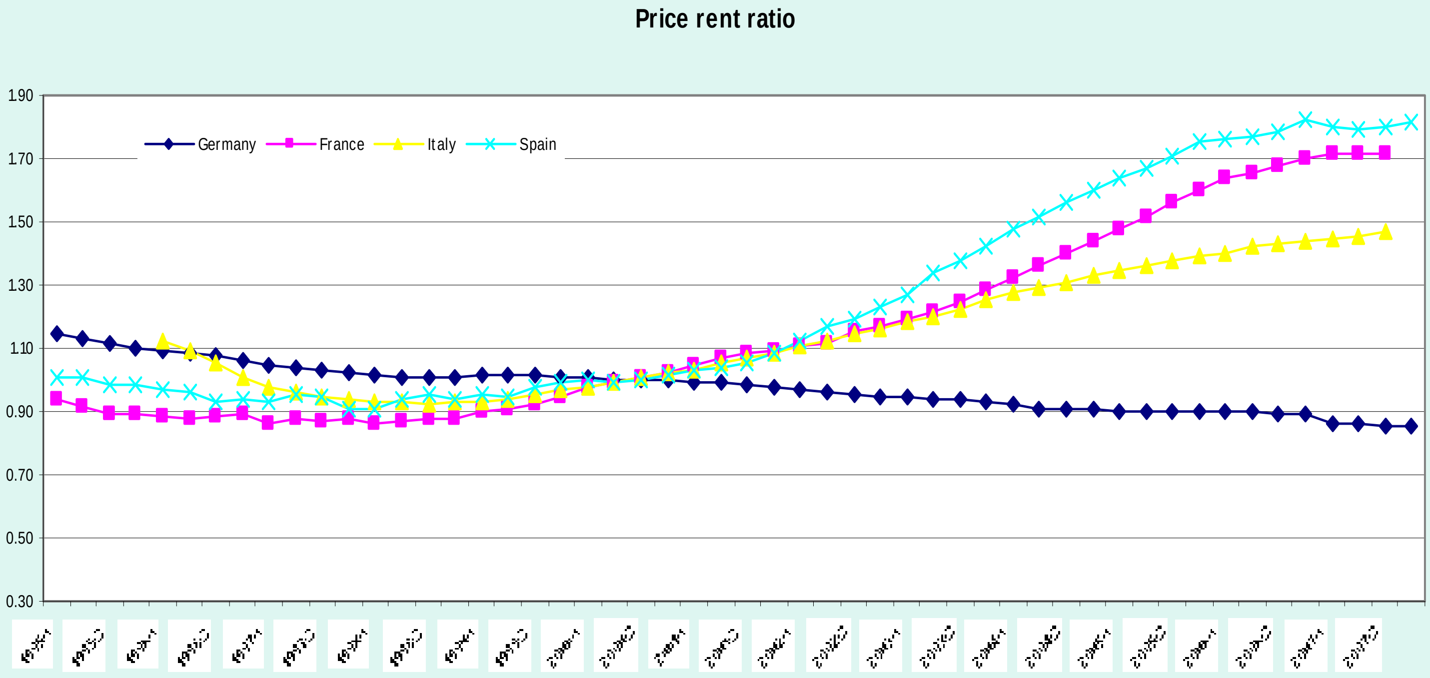
Problems from real estate bust spill over into other financial markets, notably banking system.

Europe’s banking system more exposed (higher leverage) and more important (for financing of economy).

A transatlantic housing boom



But divergence within Europe



Consequences of housing boom(s)

- Stronger consumption
- More investment in construction/housing.
- Less discussed, but more pernicious because housing a very durable asset.
- A housing overhang takes a decade to correct.
- (As opposed to the ‘IT’ overhang created by the Dotcom bubble).

From boom to housing overhang

As *% of GDP*	UK	US	Japan
Construction	1.3	4.6	-30.9
Dwellings	4.9	7.1	-10

Housing overhang Euro area ?

As % of GDP	DE	Spain	FR	Ireland	Italy
Construction	-19.1	30.2	-4	51.8	-5.5
Dwellings	-6.5	24.6	-8.6	44.3	-0.9

How serious will the problems be? A Hit parade

- Spain: largest price bubble plus massive overbuilding.
- US: sizeable bubble modest overbuilding.
- UK: sizeable bubble but no overbuilding.
- France: idem.
- Italy: modest price bubble no overbuilding.
- Germany: out of sync since bubble burst 12 years ago.

A key transatlantic difference

- In US most mortgages are ‘no recourse’: the borrower can just send the keys to the bank.
- In Europe borrower remains liable for remainder should value of house be lower than mortgage: no ‘jingle mail’.
- => in US cost of house price bust is borne by banks, not households.

Can the US banking system survive a jingle bell ‘tsunami’?

- Two sources of losses:

1. RMBS on balance sheets (700 bn. $) originally: TARP should deal with this.
2. Mortgages since 2001 (2000 bn. $): losses up to one half?

- Key: this is not an issue for monetary, but for fiscal policy.

How to save the US banking system?

- Inflation!
- US house prices around 25 % above long term trend (in real terms).
- To get back to trend (and allow some undershooting) real house prices need to fall by around 20-30 %.
- Does not happen instantly: it Germany and Japan it took over a decade.
- Assume US is quicker: full adjustment in 5 years.
- => Real prices need to fall by around 4-6 % p.a. until 2013 or only 0-2 % if inflation = 4 %.

Exposure in the EU's banking system

- **Leverage Ratio (total assets/equity)**
- UBS 63.9
- HSBC Holding 18.4
- Barclays Bank 52.7
- Deutsche Bank 52.5
- BNP Paribas 31.5
- Examples of banks too large too fail and too large to be saved (by one state).

Transatlantic differences

- Europe: banks are exposed (too little capital): Solution recapitalise (a lot!).
- In US markets disappear (lemon problem) because of ‘regime shift’ (invalidates usual signals of creditworthyness) and increase in risk. Solution more difficult? Public sector must put floor on entire market?

Transatlantic similarities

- Financial markets are integrated:
- Increase in risk premium on both sides.
- Negative wealth effect on both sides. As Europeans are “long dollar” (i.e. Europeans hold lots of dollar assets).

How long will « it » last?

- What is « it » ?
- Acute financial market distress: many months (with government intervening when tensions increase).
- Weak banking sector: years.
- Slower growth (mainly US): years.
- Decline of house prices: many years.