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**The financial crisis: How did we get here?**

Thank you. It is a pleasure for me to be here, among friends. And it is a wonderful opportunity for me to share a few thoughts about the present situation which are shaped by the fifty years I have spent as an observer of the global economy.

Let me start by reflecting on the present turmoil in the financial markets. Though it is not completely unprecedented in my experience, it is as scary as anything since the original oil price shock of the early 1970s, and it is still very uncertain as to its outcome. In my view, it has its roots in the powerful forces which have completely transformed the financial landscape in recent decades – forces that have transformed the financial system into a giant lottery.

It is worth glancing back to see how these forces originated, and how they interacted to create the toxic mix we have today, because there may be lessons.

I would single out three: financial innovation, deregulation of the finance industry, and monetary policy. I mention them in that order because that is the order in which they occurred.

Taking financial innovation first, I am talking here about innovation in two senses: the invention of new ways of doing business, and the globalisation of financial markets. These trends essentially began back in the 1960s with the development of the Euromarkets, a process with which I was personally and intimately involved. The phenomenon of “stateless” money – mainly dollars which had left the US or avoided to be deposited in US banks – created a resource which opened up international financial trading on a completely new scale, and which allowed virtually any bank with international ambitions to participate.

These markets evolved in essentially two forms: securities and loans. The eurobond market was the first to emerge, in the early 1960s, as a means for international companies to tap new sources of capital at a time when national barriers were coming down. But though they were very inventive, these markets were rapidly overtaken in size by the syndicated loan market which emerged a few years later, in the late 1960s/early 70s. That, I am proud to say,

was my contribution. Within five years of the first Euroloans that Manufacturers Hanover Ltd arranged for Iran and later Italy, deals were running at the rate of hundreds of billions of dollars a year.

This process was made easier by the willingness of the monetary authorities of the day to allow these developments. Or, more accurately perhaps, I should say their inability to do anything about them because we must remember that the US (under Presidents Kennedy and Nixon) introduced tough capital controls to prevent the outflow of dollars. But generally “willingness” is the more accurate term because these new markets took pressure off hard-pressed domestic capital markets, and opened up important new sources of capital for business and sovereign borrowers alike, which was good. The process was also facilitated by the invention, of an interest rate formula known as LIBOR, which enabled large groups of banks, several dozen, to put together very large loans. Again, this is an area where I was directly involved.

While I am proud of my contribution, I must accept that the history of the Euromarkets is not entirely positive, though at the time it helped countries to finance balance of payments deficits arising from the sudden increase in oil

prices. As we know, these markets soon exhibited the sort of “irrational exuberance” which we have come to associate with almost all large scale financial developments. They got carried away with their success. By the end of the 1970s, the international syndicated loan market, in particular, had become enormously competitive, and was churning out loans at the rate of over a hundred billion dollars a year. Loans were literally being forced on ill-qualified borrowers, many of them unsophisticated Third World countries, and when they couldn’t repay, they were given more loans to keep them current. By this time, I was no longer directly involved in the loan business, and I am on record as warning about “the monster” I had helped create. But, rather like Dr Frankenstein’s own monster, it had become unstoppable.

The crunch came in the early 1980s, with the Third World debt crisis and the collapse of the syndicated loan market. From a peak of \$135bn in 1982, the market crashed to a mere \$19bn in 1985 – that is to only 15 per cent of its size - a shock which plunged the world economy into crisis, and left bankers, governments, borrowers and international agencies desperately scrambling for a solution. What increases the parallel with today, of course, is that this was also taking place against the

background of an oil crisis. Despite innovation, in finance, nothing is ever completely new.

How did we get out of that mess? Again, there may be lessons for today.

Although many people, including myself, were proposing solutions to the global debt crisis, it essentially came down to a judgement as to whether the international banking system could face up to the true value of the hundreds of billions of dollars, in face value, of loans it had made, or whether some way should be found to sustain that value through refinancing and rescheduling. There were, of course, endless negotiations to extend and refinance loans which became very tedious. But in the end the banks started to write the loans down. J.P. Morgan led the way in 1986 – and though much criticised – it was soon followed by the others, starting with Citibank.

By 1990 the banks had recovered and the whole episode had become financial history. I should add that the Euroloan market also recovered. New loan volumes crossed the \$1 trillion a year mark in 1996 and the \$2 trillion mark in 2004, and today the market that I and a few friends created in London thirty-odd years ago is by far the

largest capital market in the world. So we should never lose hope.

But even while the crisis was at its worst, other important financial developments were occurring, particularly in Chicago, where clever commodity traders were perfecting financial derivatives – new instruments which permitted leveraged forward trading in interest rates, currencies, bond values and so forth. By the early 1980s, these were becoming firmly established, and by the mid-1980s, they were actually leading the cash markets, rather than taking their cue from them. An important evolution was the invention of the swaps market in the mid-1980s, which greatly expanded the liquidity of the secondary markets and provided the basis for the complex deals which were soon to follow.

Invention piled on invention, until about five years ago we began to read about instruments called collateralised debt obligations, essentially mortgages which had been securitised, repackaged and hedged to create a tradable commodity with an attractive yield. But once again, “irrational exuberance” took over, and hundreds of billions of dollars of these securities were created and traded, mispriced by the rating agencies, and ended up on the

books of banks who were desperate for assets. Many of those banks didn't understand just what they had bought, and grossly underestimated the risk.

Though innovation was the prime driver for these new markets, there were other forces at work as well.

One was the shift – regrettable in my view – in the banks' attitude to new business. When I was a banker, it was a relationship business, and these relationships could last a lifetime. Today's banking world is one driven by volume targets, by a business model which originates and distributes financial products, which does not retain an interest in, or responsibility for, the quality of assets it creates. No wonder we get into trouble if banks lose interest in credit quality and even in profit, so long as deals meet short term solvency requirements. This is precisely what happened in the Third World debt market 30 years ago.

The other problem was the quest for yield. If the low interest rate environment of the last 15 years has done one thing, it is to give a tremendous boost to innovation in the area of financial returns: derivatives, hedge funds, private equity – these all owe their existence (at least in

part) to eager minds seeking out new ways of obtaining higher-than-market returns. Sometimes, that search is successful; but, all too often, it is not. I'll say a bit more about this in a moment.

I said that another of the big drivers behind the present crisis was deregulation.

The history here also goes back some way, but I'll just mention a few key moments. May Day in the US in 1975 and Big Bang in London in 1986 were key events because they liberalised the securities markets and led to a tremendous increase in activity, particularly on the equities side. Big Bang was particularly important because it also opened up these markets to commercial banks - a development which did not take place in the US until a few years later with the abolition of the Glass-Steagall Act in 1999.

The removal of these barriers allowed the evolution of "universal" banks combining commercial and investment activities. They are the giants of today's markets, but also among their biggest victims. UBS, Citigroup, JPMorgan, Royal Bank of Scotland – these are just a few of the top names which have been severely bruised by the credit

crunch. True, some pure investment banks have suffered also: Merrill Lynch, Bear Stearns. But I venture to say that the crisis would not have reached the proportions it has unless the big banking groups, with their tremendous capital resources and hungry business practices, had not been around to drive it.

I was among the first people, back in the 1980s, to propose universal banking combinations – including also insurance. But I think that one of the big questions that arises from our present crisis is whether financial groups on this scale are a healthy development. There are undoubtedly benefits to be gained from universal groups: benefits of scale, of cross-fertilization and cross-selling, of international reach. But commercial and investment banking remain very different businesses, with contrasting cultures, attitudes to risk, profit cycles, clientele and so forth. I am not proposing that we try and stuff deregulation back into the bottle, that would be impossible. But perhaps we need a broader debate about the sort of banking structures that can make markets stronger and also safer. Commercial banks are, in many ways, like a public utility – and they need to be run in a prudent and cautious way consistent with that role. They are banks, not casinos.

The third driver is monetary policy.

It has been fascinating to watch the debate about the Greenspan legacy. Was he a good central banker or a bad one?

Given the mess we are in I suppose you have to say he was a bad central banker, but things are not, of course, that simple.

On the positive side, Greenspan shepherded the US economy through some very difficult times, particularly the dotcom crash in 2000, when his sudden relaxation of monetary policy helped the markets recover. And we shouldn't forget that many people at the time thought that he was the best Fed chairman we had ever had (personally, I would put my money on Paul Volcker).

But in handling the crash as he did, he also created the famous "Greenspan put", which essentially sent a message to the banks that they could do as they liked because the Fed would always use monetary policy to bail them out at the end of the day. Dr Bernanke, with his own variant on Greenspan's monetary policy, may have reinforced this tendency.

The Greenspan years also sowed the seeds of the present crisis in other ways. One was by focusing monetary policy on consumer prices, and ignoring the bubble in asset prices, particularly housing, which eventually detonated the credit bomb. The other was by creating a low yield environment, which turned out to have complex consequences. For the broad economy, it was good because it boosted economic activity and made credit cheap. But it also generated new stresses. With credit so plentiful, lenders were bound to start edging down the quality scale in search of business - and pretty soon they found the sub-prime market. It only took a bit of financial engineering – coupled with rating agencies that had deep conflicts of interest and inadequate risk models – to transform low quality housing loans into allegedly Triple A paper.

As I have already mentioned, the low yield environment also did wonders for ordinary people's risk appetite – and for the risk appetite of the banks. Both were willing to take on unfamiliar risks – consciously or not – in order to raise their returns. This is somewhat ironical: a low yield environment should imply that an economy is in good health, with inflation under control and adequate credit available. But in our present high octane environment, it

provided the fuel for leverage and risk-taking on an unprecedented scale.

So I suppose we have to conclude that Greenspan is partially to blame - though he would say that the central bank is only one player in the market, albeit a powerful one, and that banks knew or should have known what they were doing.

One issue does come out of this though: that is, whether central banks face a conflict of interest when they are given responsibility for both monetary policy and banking stability – as the Fed is. Was Greenspan’s manipulation of interest rates dictated more by concern for the health of the US banking system than for the promotion of economic growth and full employment - which is the Fed’s prime mandate? Was the ‘Greenspan put’ real? It is interesting that, as we speak, the United Kingdom is debating whether to give the Bank of England a greater role in the management of banking stability. It probably will be given that role, but where will that leave its monetary role?

I said earlier that, in finance, nothing is completely new: changes occur, new mechanisms are invented, creativity

gets overtaken by excess and destruction. This is Joseph Schumpeter's theory of "creative destruction" - the price paid for innovation - though he did think that we come out ahead at the end of the day. But though history can teach us lessons, each event seems new at the time because it involves new techniques and new complexities which we are slow to understand. At least, we can be sure that the present crisis is part of an ongoing cycle of highs and lows from which we will ultimately recover, rather than the end of the world as we know it. In the meantime, however, I fear that there is probably quite a lot of bad news still to come.

Thank you all.