

## **Where's the next Lehman?**

### ***The Economist, September 7 2013, Page 11***

**Five years after the maelstrom of September 2008, global finance is safer. But still not safe enough.**

The bankruptcy of Lehman Brothers, an American investment bank, in 2008 turned a nasty credit crunch into the worst financial crisis in 80 years. Massive bail-outs from governments and central banks staved off a second depression, but failed to prevent a deep recession from which many rich economies have yet fully to recover. Five years after that calamity, two big questions need to be answered. Is global finance safer? And are more crises on the horizon?

The quick answers are yes, and yes. Global finance looks less vulnerable because reforms to the financial industry have made it more resilient, and because America, the country at the heart of the Lehman mess, has got rid of much of the excess debt and righted many of the imbalances in its economy. Today's danger zones are elsewhere. They are unlikely to spawn a collapse on the scale of 2008. But they could produce enough turmoil to hit growth hard.

#### **The three harbingers of the apocalypse**

The disaster of September 2008 had many causes, as the first our series of "school briefs" on pages 64-65 makes clear. But, put crudely, Lehman's demise spawned catastrophe because it combined three separate vulnerabilities. The underlying one was a surge in debt, particularly in the financial sector, brought on by a housing bubble. The ensuing bust was made more dangerous because of the second weakness: the complex interconnections of securitized finance meant that no one understood what assets were worth or who owed what. Lehman's failure added a third devastating dimension: confusion about whether government could, or would, step in as finance failed. A rule of thumb for spotting future disaster is how those weaknesses --- a debt surge, ill-understood interconnections and uncertainty about a safety net --- are repeated.

The overhaul of financial regulation since 2008 has made most progress

on the first two. Under the new Basel capital standards banks are being compelled to hold more, and better, capital relative to their assets; the biggest “systemic” banks even more than others. Another strand of reforms, such as pushing derivatives trading onto clearing-houses, has tried to improve transparency. Least progress has been made on what to do when big banks fail --- though new efforts to write global rules that would force banks to issue bonds that can be “bailed in” in the event of failure is a promising step.

American finance has become safer. The country’s big banks have raised more capital and written off more dud assets than most others. At around 13%, their risk-weighted capital ratio is far above the new global norms and some 60% higher than before the crisis. American property prices have adjusted and households have cut their debts. Government debt has risen, but most of that rise is the sensible mirror-image of efforts by households to reduce theirs. Now that the economy is recovering, the biggest deficit is tumbling. You can find bubblieness in bits of American finance, including the corporate-bond market, and some nasty off-balance-sheet liabilities like student loans and public-sector pensions, but America does not look like a source of imminent trouble.

Britain and Japan have changed less. Abenomics has improved Japan’s prospects, but government debt is still close to 250% of GDP. In Britain the combination of budget cuts and weak private investment has produced a recovery that is built on the same ingredients --- particularly rising house prices --- that caused the last bust. Britain is not about to fell the world economy, but growth that was based more on investment, both public and private, would be an awful lot safer.

What about emerging economics, many of which have seen a big run-up in debt? China is often dubbed a Lehman-in-the-making. Since 2008 credit growth in the Middle Kingdom, now the world’s second-largest economy, has exploded, and by some estimates is over 200% of GDP. China’s financial system has few international connections. But, as in America in 2008, there is uncertainty about the true size of its debts and how much of them will be repaid. The danger China poses depends on the third ingredient of the Lehman conflagration: how the government behaves when trouble strikes. The country is a big net saver, the banking

system is still largely deposit-funded and the government has the fiscal capacity to underwrite troubled loans. Provided it does so, the odds of a sudden collapse with global ramifications are low.

From Brazil to Thailand, many of the other emerging economies are now wobbling have also seen credit booms. The difference with China is their vulnerability to global financial flows. Today's drought in foreign capital is pushing down currencies like India's rupee and making current-account deficits harder to finance. In the 1990s that dynamic caused crises. But this time round most countries' defenses are more powerful. Exchange rates float, far more debt is denominated in domestic currency and reserves are fatter. Some places may be overwhelmed: our index of vulnerability has Turkey flashing reddest (see page 60). Most are likely to suffer slower growth.

### **The shadow over Europe**

If there is one part of the world that could still bring about another global meltdown, it is the EURO area. Though less Lehman-like than a year ago, it remains a worry. Its debt problems are growing, not shrinking: European banks have thinner equity buffers than their American counterparts, and have written down far fewer debts. In the troubled economies on Europe's periphery recession has made it harder to reduce debt burdens of all sorts. Too much austerity has proved counterproductive. A destabilizing political backlash remains a danger, given Europe's sky-high jobless rates. Its sleepwalking leaders cannot agree on how to complete necessary reforms, such as a proper banking union, while the European Central Bank's ability to live up to its brave pledge to "do whatever it takes" to save the EURO remains untested.

There may be no new Lehman-sized catastrophes on the near horizon. But plenty of smaller crises-in-the-making dot the landscape --- and a potentially big one continuing to threaten Europe. Five years on, global finance is a long way from safe.

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