Economics

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# 10 years after: 10 lessons from the financial crisis

**What went wrong?** In September 2008, the collapse of Lehman Brothers triggered the worst economic crisis in the developed world since the Great Depression. Having first blown up a credit bubble, the US mishandled the failure of Lehman so badly that the bubble burst with devastating consequences instead of deflating more gently. On a smaller scale, the Eurozone added its own policy mistakes during the euro crisis, hesitating for more than a year before stopping the contagion from Greece in mid-2012.

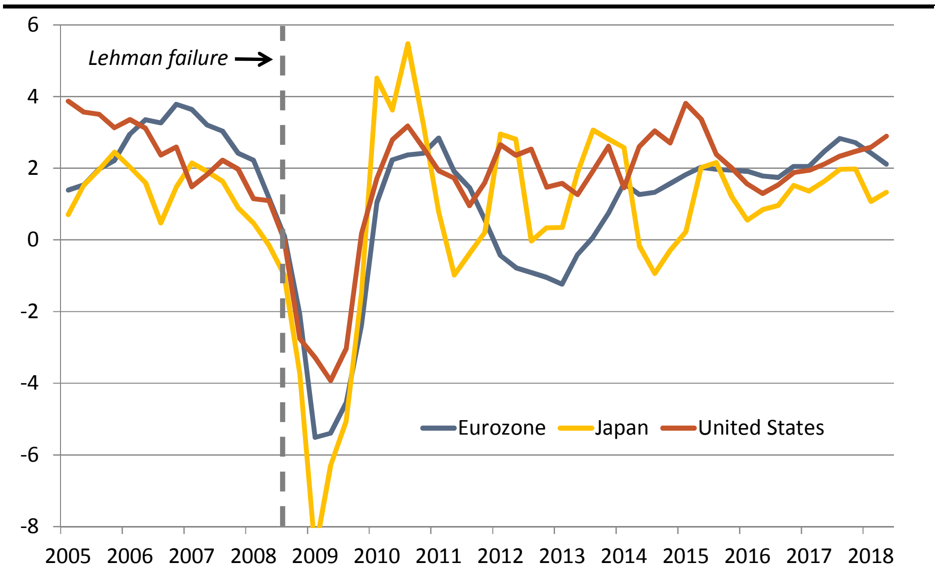
**Can it happen again?** Complacency and herd behaviour are part of human nature. Financial crises will happen again. However, humans rarely make the same mistakes twice in rapid succession. While the next global recession may be due in, say, 2021, it will probably not be brought about by credit excesses in the western world. Western economies have strengthened their defences against a replay of the Lehman crisis.

**In this report, we present 10 lessons from the financial crisis:**

1. Central banks must use their tools to prevent credit and leverage excesses.
2. To prevent contagion, troubled banks must be wound down in an orderly fashion.
3. In case of a panic, central banks must intervene fast and decisively to stop the rot.
4. Only central banks can reliably stop a panic with a credible "whatever it takes".
5. Ditch the dogma. Unconventional times can require unconventional policies.
6. After a financial crisis, countries need to restore the health of their banks fast.
7. Regulators must see to it that financial institutions have adequate shock absorbers.
8. Financial crises unleash deflationary forces. Monetary policy must act accordingly.
9. Pro-growth reforms matter more than austerity for overindebted countries.
10. Do not waste a crisis. If it happens, use it for fundamental pro-growth reforms.

**Protectionism and populism are the risks to watch:** In the 1930s, rampant protectionism exacerbated the crisis. From 2009 to 2015, some additional trade barriers and more polarised political disputes within and among nations remained no more than a faint echo of the 1930s. Over the past two years marked by the Brexit vote and Donald Trump, the protectionist risks have become somewhat more acute, though.

**Chart 1: The shock: change in real GDP, yoy in %**




*Quarterly data. Source: Eurostat, Bureau of Economic Analysis, Cabinet Office of Japan.*

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In September 2008, the collapse of Lehman Brothers triggered the worst economic crisis in the developed world since the Great Depression. Within two quarters, real GDP contracted by 3.3% in the US, by 4.7% in the Eurozone and by 7.2% in Japan (see Chart 1 on the cover). The rebound in markets and real economies started over the course of Q2 2009 after the US Fed had signalled its readiness to buy massive amounts of bonds in March 2009. Beyond the widespread misery which the crisis caused, for instance, for those people who lost their job, it turned out to be very expensive. From the end of 2007 to the end of 2013, the ratio of public debt to GDP surged by 41ppt in the US, 44ppt in the UK and 29ppt in the Eurozone (see chart 2).

*The worst crisis since the Great Depression*

What lessons can we learn from the dreadful experience – and could it happen again?

## What went wrong? Two big mistakes

Two US policy mistakes caused the catastrophe. First, the US Fed provided the tinder by blowing up a massive credit bubble with average annual credit growth to the private sector of 9.5% from 2004 through 2007. The Fed mistook the disinflationary impact of positive supply shocks (cheap imports from China, strong gains in productivity at home) for a potential harbinger of dangerous deflation. Worrying about a risk of insufficient demand, the Fed kept its policies too loose for too long despite healthy gains in real GDP. As a result, the "great moderation", as the period was misleadingly called, turned into a time of grave credit-fuelled excesses in real estate markets.

*The Fed blew up a big bubble…*

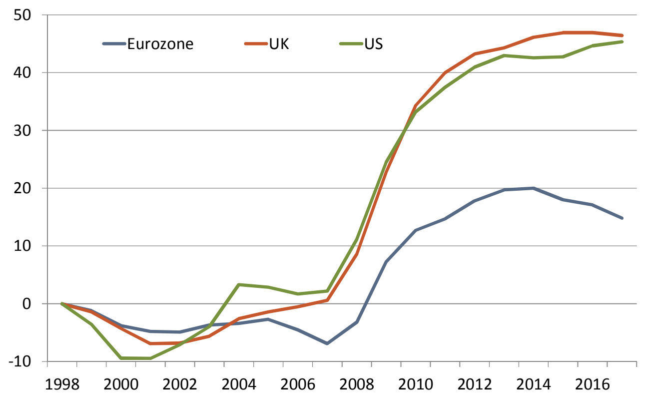
Overly lax regulations, the irresponsible behaviour of many banks and strong capital inflows from China contributed to the credit excesses. But that is no valid excuse for the central bank. Whatever the micro issues, the central bank is in charge of the monetary macro. Taking into account the fiscal policies and regulations as set by parliaments and executive agencies, the central bank must employ its monetary and regulatory policy tools to steer the aggregate growth in nominal credit and money responsibly. It can and must avoid dangerous excesses.

*…to which banks happily contributed…*

As the second mistake, US authorities lit the fire by triggering a virtual collapse of wholesale financial markets with their decision on the weekend of 13/14 September 2008 to simply close a struggling investment bank, Lehman Brothers, instead of winding it down in an orderly fashion. Having started to deflate somewhat gently in mid-2007, the US credit bubble burst with devastating effect. Six months earlier, the trouble at Bear Stearns had caused merely a minor financial and economic ripple as the authorities pushed it into the arms of JP Morgan. Stung by heavy criticism for having facilitated JP Morgan's orderly takeover of Bear Stearns, the US authorities shied away from limiting the risk which Bank of America or Barclays would have incurred by taking over Lehman in September 2008. After the unexpected und unceremonious closure of Lehman, contagion spread like wildfire through the financial system, spilling over into the real economy almost immediately in the US and abroad. Far away from the US sub-prime market, orders for Swedish motor vehicles had plunged by 62% yoy in January 2009.

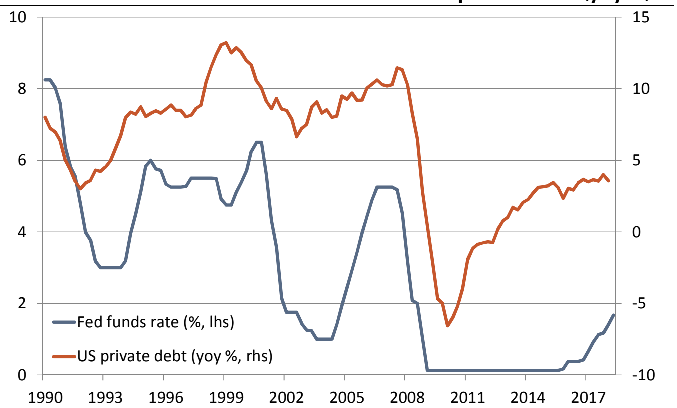
*…until the US let the bubble burst spectacularly*

**Chart 2: Change in public debt ratio since 1998, in % of GDP**




*Annual data. Increase in the ratio of gross government debt to GDP since the end of 1998, in percentage points of GDP. End-2017 ratios: Eurozone 88.8%, UK 87.7% and US 107.8%. Sources: Eurostat, European Commission.*

**Chart 3: Too much debt: Fed funds rate versus private debt (yoy %)**




*Yoy change in % for private debt. Quarterly data. Source: Federal Reserve Board.*

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## The sad European follow-up

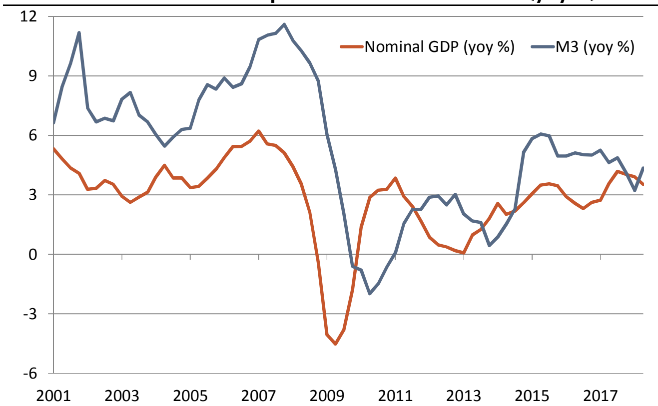
*Much smaller credit excesses in the Eurozone*

On a smaller scale, the Eurozone mirrored some of the US mistakes and added its own mishaps. In the boom years, the European Central Bank allowed nominal growth in M3 money supply and credit (7.1% average yoy 2004 through 2007) to run well ahead of the 4.7% pace of nominal GDP growth (see chart 4). However, the money and credit excesses were far less pronounced than in the US, except for regional bubbles in real estate credit in Ireland and Spain as well as a bubble in public borrowing in Greece.

*The ECB hesitated far too long before stopping the Greek contagion*

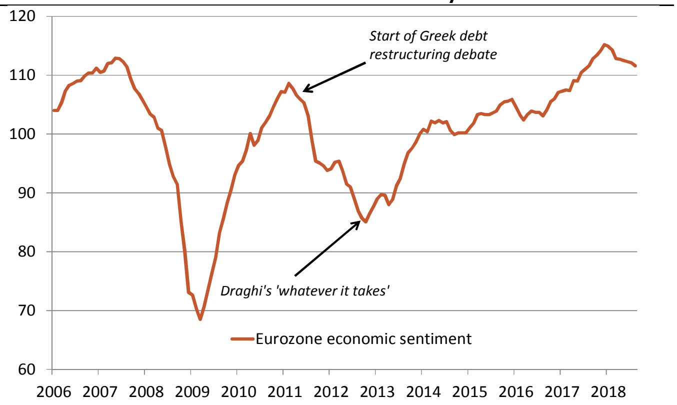
As a result, the Eurozone enjoyed a rapid recovery from the initial shock until early 2011. Not even the Greek debt crisis of 2010 hurt the overall Eurozone very much. However, the discussion about a "voluntary" restructuring of Greek public bonds sent shockwaves through bond markets and the financial system in spring 2011, pushing the region into a mild recession. The rot stopped only when the ECB put an end to contagion risks by taking on the role of lender of last resort in summer 2012 (see chart 5). As in the case of the Fed in early 2009, it took a strong signal from the institution that can print more money than any speculator can muster to stop the financial panic and the ensuing costly economic recession.

**Chart 4: Modest excesses pre-Lehman: Eurozone M3 (yoy %)**




*Nominal GDP and M3 money supply, yoy change in %; quarterly data. Source: ECB, Eurostat.*

**Chart 5: Eurozone confidence: double whammy of 2008 and 2011**




*Eurozone economic sentiment; monthly data. Source: European Commission.*

## 10 lessons from the crisis

*Credit excesses are dangerous*

**1) Mind the leverage.** Keeping consumer price inflation close to or below 2% is not good enough for central banks. In addition, they must watch money and credit growth and other risks to financial stability, which can severely affect the transmission of monetary policy to the real economy. If need be, central banks should use their instruments to restrain credit growth and leverage even if inflation is on target.

*Banks must be wound down in an orderly fashion*

**2) Prevent the panic.** If systemically relevant financial institutions hit trouble, they must be wound down in an orderly fashion to prevent a run on the banking system. Owners, managers and most employees of troubled institutions may well lose their entire stake and creditors may have to incur serious losses. However, the institution must remain open for long enough to honour its contractual obligations to its clients.

*Act fast to prevent or stop a panic*

**3) In case of a financial panic, central banks must act fast and decisively** to restore confidence.

*Central banbks are the key player*

**4) To combat a financial crisis, fiscal policy plays only a minor role.** The huge stimulus programmes which the US passed in early 2009 did little to calm the situation. Only central banks with their ability to "do what it takes" can impress hyper-nervous investors enough to stop a panic in its tracks.

*Do not stick to dogmas*

**5) Unconventional times can require unconventional measures.** Even the best rules for normal times must allow for exceptions under exceptional circumstances. Insisting on the dogmatic application of rules (no bailout ever, no deviation from fiscal rectitude) under all circumstances can be very costly. The resulting damage of a dogmatic application can also undermine the political acceptance of such rules once times have become more normal again.

*Restore the health of the banking system fast*

**6) Countries need to restore the health of their banking system fast** in the wake of a crisis, as the US did after 2008, while many Eurozone members hesitated for too long. That can involve injections of public money into struggling banks on tough conditions that should include serious losses for owners and managers of such banks.

*Adequate buffers needed*

**7) Strengthen the shock absorbers.** Making finance more boring through adequate regulation and higher capital requirements limits the risk of financial crisis. For example, the banking systems of Canada and Sweden weathered the post-Lehman storm comparatively well because regulators and the banks had heeded the lessons of earlier financial crises here.

*Monetary policy may need to be aggressive*

**8) Financial crises do not beget inflation.** Instead, the cleansing of prior excesses unleashes strong deflationary tendencies. Expansionary monetary policies that were misguided during the boom can be required during and after the bust. At times of an elevated preference for liquidity, central banks must provide such additional liquidity to stabilise economies and to forestall deflation risks.

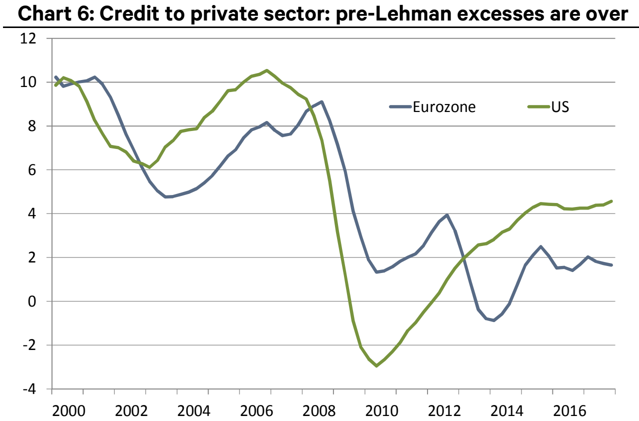
*More pro-growth reforms, less austerity*

**9) Get the priorities right.** Countries that have lost access to funding markets may have to tighten their belts initially to reassure investors. However, pro-growth supply-side reforms are a much better way to improve the outlook for growth and fiscal sustainability than cuts in public investment coupled with tax hikes. To regain market confidence, countries need to focus on such reforms rather than on mere austerity.

*Crises should be used as handmaidens of change*

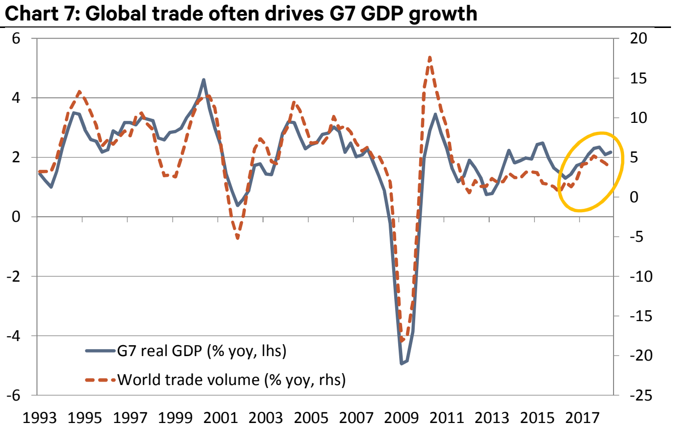
**10) Do not waste a crisis.** Fixing the roof while the sun is shining makes eminent sense. However, as good times usually breed complacency, it rarely happens. If a crisis lays bare the underlying weaknesses of a country (or company), it should be seized as the opportunity for fundamental pro-growth reforms. To some extent, this has happened in the Eurozone, notably in Spain, Portugal, Ireland and – with a sad setback in 2015 – in Greece. France is now following suit. Still, too much remains undone and, especially in Italy, some of the earlier reform momentum seems to be going into reverse.

**Chart 6: Credit to private sector: pre-Lehman excesses are over**




*Credit to the non-financial private sector, including debt securities, yoy change in %; quarterly data; Eurozone 2015 adjusted for one-off surge due to a re-classification of some debt. Source: BIS*

**Chart 7: Global trade often drives G7 GDP growth**




*Quarterly data; G7: US, Japan, Germany, UK, France, Italy and Canada. Source: OECD, Netherlands Bureau for Economic Policy Analysis, Berenberg calculations.*

## Can it happen again?

*The next crisis will come eventually…*

Complacency in good times and herd behaviour in rough times are part of human nature. Swings from excessive euphoria to irrational pessimism, from boom to bust, have happened throughout history. They will happen again. The next crisis will come eventually.

*…but it will be a different one*

However, humans rarely make the same big mistakes twice in rapid succession. The next crisis will probably not be caused by the bursting of a credit-fuelled real estate bubble. By and large, western economies have strengthened their defences against a replay of the post-Lehman or euro crisis. Aggregate credit growth remains modest across the western world despite very low interest rates (see chart 6). The authorities are more aware of the risks of excess leverage and have established procedures for an orderly winding down of failing financial institutions. Banks have built up bigger buffers. Central banks know that, if need be, they have to intervene fast and massively to stop contagion in its tracks.

No upswing lasts forever. Current US cyclical dynamics suggest that an economic correction that may well turn into a run-of-the mill recession in the western world may be due by 2021. But it will most likely not turn into a 2008/09-style mega crisis exacerbate by wholesale financial collapse.

*No upswing lasts forever*

## Trade wars and protectionism: the risks to watch

In the 1930s, rampant protectionism exacerbated the financial and economic downturn and retarded the subsequent recovery. Widespread misery and popular disillusionment with economic and political elites nurtured a rise in ultra-right extremism especially in Europe that culminated in Nazi Germany's hitherto unimaginable atrocities.

*Protectionism can hurt badly*

This time, the policy response to the financial crisis, once it had happened, had been much more effective. The post-Lehman fall in GDP was over after three quarters. Policy makers largely avoided the protectionist temptation. As a result, many advanced countries now enjoy full employment again. Even in the less fortunate countries, labour markets are healing.

*Much better policy response than in the 1930s*

For the first eight years after Lehman, the occasional use of more non-tariff barriers and the more polarised political disputes within and among nation states remained no more than a very faint echo of the 1930s. Trade remains a major engine of global growth (see chart 7). Over the past two years marked by Britain's Brexit vote and the rise of Donald Trump, the protectionist risks have become somewhat more acute, though. As debates about migration dominate parts of the political discourse, anti-establishment parties are also making some headway. Still, unless mainstream political forces make major mistakes, the risks seem containable. We will discuss these issues in more depth in an upcoming report.

*Protectionist risks have become more acute*

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