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The Confidence Game

by Kenneth Rogoff

CAMBRIDGE – Next month marks the one year anniversary of the collapse of the venerable American investment bank, Lehman Brothers. The fall of Lehman marked the onset of a global recession and financial crisis the likes of which the world has not seen since the Great Depression of the 1930's. After one year, trillions of dollars in public monies, and much soul searching in the world's policy community, have we learned the right lessons? I fear not.

The overwhelming consensus in the policy community is that if only the government had bailed out Lehman, the whole thing would have been a hiccup and not a heart attack. Famous investors and leading policymakers alike have opined that in our ultra-interconnected global economy, a big financial institution like Lehman can never be allowed to fail. No matter how badly it mismanages its business – Lehman essentially transformed itself into a real estate holding company totally dependent on a continuing US housing bubble – the creditors of a big financial institution should always get repaid. Otherwise, confidence in the system will be undermined, and chaos will break loose.

Having reached the epiphany that financial restructuring must be avoided at all costs, the governments of the world have in turn cast a huge safety net over banks (and whole countries in Eastern Europe), woven from taxpayer dollars.

Unfortunately, the conventional post-mortem on Lehman is wishful thinking. It basically says that no matter how huge the housing bubble, how deep a credit hole the United States (and many other countries) had dug, and how convoluted the global financial system, we could have just grown our way out of trouble. Patch up Lehman, move on, keep drafting off of China's energy, and nothing bad ever need have happened.

The fact is global imbalances in debt and asset prices had been building up to a crescendo for years, and had reached the point where there was no easy way out. The United States was showing all the warning signs of a deep financial crisis long in advance of Lehman, as Carmen Reinhart and I document in our forthcoming book *This Time is Different: Eight Centuries of Financial Folly* .

Housing prices had doubled in a short period, spurring American consumers to drop any thought of saving money. Policymakers, including the US Federal Reserve, had simply let the 2000s growth party go on for too long. Drunk with profits, the banking and insurance industry had leveraged itself to the sky. Investment banks had transformed their business in ways their managers and boards clearly did not understand.

It was not just Lehman Brothers. The entire financial system was totally unprepared to deal with the inevitable collapse of the housing and credit bubbles. The system had reached a point where it had to be bailed out and restructured. And there is no realistic political or legal scenario where such a bailout could have been executed without some blood on the streets. Hence, the fall of a large bank or investment bank was inevitable as a catalyst to action.

The problem with letting Lehman go under was not the concept but the execution. The government should have moved in aggressively to cushion the workout of Lehman's complex derivative book, even if this meant creative legal interpretations or pushing through new laws governing the financial system. Admittedly, it is hard to do these things overnight, but there was plenty of warning. The six months prior to Lehman saw a slow freezing up of global credit and incipient recessions in the US and Europe. Yet little was done to prepare.

So what is the game plan now? There is talk of regulating the financial sector, but governments are afraid to shake confidence. There is recognition that the housing bubble collapse has to be absorbed, but no stomach for acknowledging the years of slow growth in consumption that this will imply.

There is acknowledgement that the US China trade relationship needs to be rebalanced, but little imagination on how to proceed. Deep down, our leaders and policymakers have convinced themselves that for all its flaws, the old system was better than anything we are going to think of, and that simply restoring confidence will fix everything, at least for as long as they remain in office.

The right lesson from Lehman should be that the global financial system needs major changes in regulation and governance. The current safety net approach may work in the short term but will ultimately lead to ballooning and unsustainable government debts, particularly in the US and Europe.

Asia may be willing to sponsor the west for now, but not in perpetuity. Eventually Asia will find alternatives in part by deepening its own debt markets. Within a few years, western governments will have to sharply raise taxes, inflate, partially default, or some combination of all three. As painful as it may seem, it would be far better to start bringing fundamentals in line now. Restoring confidence has been helpful and important. But ultimately we need a system of global financial regulation and governance that merits our faith.

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