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What if?

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If Lehman had not failed, would the crisis have happened anyway?

Illustration by Jac Depczyk



IN AUGUST 2008 Kenneth Rogoff, a Harvard University economist, briefly rocked world stockmarkets when he warned a conference in Singapore: “We’re not just going to see midsized banks go under in the next few months, we’re going to see a whopper, we’re going to see a big one—one of the big investment banks or big banks.” A month later, in the early hours of September 15th, Lehman Brothers filed for bankruptcy.

Harold James, an economic historian at Princeton University, says Lehman’s failure was analogous to the collapse of Creditanstalt, a big Austrian bank, in 1931. Austria and Germany had borrowed heavily from foreign creditors and the bank’s failure rippled around the world, vastly intensifying the Depression. Lehman’s failure is widely seen as a similar turning-point in the current financial crisis: an unexpected blunder that came close to turning a garden-variety recession into another Depression.

Mr Rogoff has a different view. He believes, as he did the month before Lehman’s collapse, that America had the classic preconditions of a massive financial crisis: trillions of dollars of debt secured by an inexorably deflating asset bubble. Bank write-downs already totalled more than \$500 billion in August 2008. If Lehman had not been allowed to fail, some other firm would have, with similar results.

The week before Lehman failed, futures markets predicted a 15% decline in the prices of homes in major metropolitan markets in America over the next nine months, on top of the 24% decline that had already occurred. Such a drop—which is quite close to what actually occurred—would, when combined with similar declines in commercial-property values, have pushed some big banks to the edge. That same week derivatives markets put the odds of default for Washington Mutual, a large thrift (or savings bank), at 85%. Many of the big financial institutions that received bail-outs in the wake of Lehman’s failure, such as American International

Group (AIG) and UBS and Fortis in Europe, would probably have needed one sooner or later anyway.

True, from a purely economic point of view, Lehman's failure created enormous pain. It spawned a panic in the commercial-paper, credit-derivatives and bank-funding markets that dramatically worsened banks' liquidity. Capital and trade flows collapsed. A vicious spiral of credit withdrawal, weakening growth and debt impairment ensued. In July 2008 the IMF thought the world economy would grow by 3.9% in 2009. It now thinks it will shrink by 1.4%. Moody's Economy.com forecast in August 2008 that 2.9m first mortgages in America would default in 2009, itself a disastrous figure (less than a million defaulted in 2006). It now expects the tally to hit 3.8m, a result, says Mark Zandi, its chief economist, of a string of policy errors and the resulting financial panic that sapped employment and income.

But from a political point of view, it is harder to see how these missteps could have been avoided. When the Treasury and the Federal Reserve bailed out Bear Stearns in March 2008, they drew criticism in Congress and elsewhere for creating moral hazard. At the same time their intervention led other firms, including Lehman, to believe that when push came to shove, they too would be spared. Had Lehman been rescued the criticism would have intensified, as would firms' expectations of future rescues. Mr Rogoff maintains that at some point political pressures would have required a big firm to go bust. "If you look at financial crises, the standard playbook is to let the fourth or fifth largest bank go under and you save everybody else," says Mr Rogoff, who bases much of his analysis on extensive research done with Carmen Reinhart of the University of Maryland for a forthcoming book called "This Time Is Different: Eight Centuries of Financial Folly" (see [article](#)).

Wise after the fact

In retrospect, the economically efficient solution would have been, soon after the Bear Stearns rescue, to propose a comprehensive, publicly financed recapitalisation of the banking system while creating a more orderly mechanism for winding up failed institutions (officials still claim they did not have the legal authority to save Lehman). The Treasury and the Fed drew up plans to do just that but worried that Congress would reject them. With good reason: history shows that bank bail-outs are intensely unpopular. Japan's government dragged its feet on recapitalising its banks in the 1990s because its initial aid provoked such outrage. Some American economists who used to carp at Japan's failings are more sympathetic now. "It is easier to be for more radical solutions when one lives thousands of miles away than when it is one's own country," Larry Summers, Barack Obama's economic adviser, told the *Financial Times* earlier this year.

If Mr Rogoff is right and more failures were inevitable, then Lehman's collapse, though painful, may have been necessary. History suggests that systemic banking crises are usually resolved with large injections of public capital. Lehman's failure galvanised policymakers. Only when faced with the post-Lehman, post-AIG chaos did Congress pass the \$700 billion Troubled Asset Relief Programme (and even then, after an initial rejection). Other rich-country governments also moved to guarantee bank debts, raise deposit insurance and inject capital into their banks.

Mr James notes that when Creditanstalt went under in 1931, political tensions hampered international co-operation. The international response to Lehman's collapse, reflecting in part the lessons of the 1930s, was much more effective—as exemplified by the Treasury's willingness to bail out AIG, even though many of the main beneficiaries were European. Mr Rogoff concedes that if the Federal Reserve and Treasury had made flawless decisions unhindered by politics, the outcome would have been happier. But, he says, "it wasn't humanly possible." Lehman's collapse may even have hastened the ultimate resolution of the crisis.