Ten Years After Lehman—Lessons Learned and Challenges Ahead

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A trader on the New York Stock Exchange the day US investment bank Lehman Brothers filed for bankruptcy: the global crisis that followed is a defining moment of our time (Photo: Nancy Kaszerman/ZUMA Press/Newscom)

The global financial crisis remains one of the defining events of our time. It will forever mark the generation that lived through it. The fallout from the crisis—the heavy economic costs borne by ordinary people combined with the anger at seeing banks bailed out and bankers enjoying impunity, at a time when real wages continued to stagnate—is among the key factors in explaining the backlash against globalization, particularly in advanced economies, and the erosion of trust in government and other institutions.

In this sense, the crisis cast a long shadow, which shows no sign of going away any time soon. Yet the tenth anniversary of the collapse of Lehman Brothers—what I once referred to as a “holy cow” moment—gives us an opportunity to evaluate the response to the crisis over the past decade.

The collapse of Lehman Brothers provoked a broader run on the financial system, leading to systemic crisis. All told, twenty-four countries fell victim to banking crises, and economic activity has still not returned to trend in most of them. One study suggests that the average American will lose $70,000 in lifetime income because of the crisis. Governments continue to feel the pinch too. Public debt in advanced economies rose by more than 30 percentage points of GDP—partly due to economic weakness, partly due to efforts to stimulate the economy,
We are now facing new, post-crisis, fault lines.

Looking back today, the pressure points seem obvious. But they were less obvious at the time. Most economists failed to predict what was coming. It is a sobering lesson in groupthink.

What were these pressure points? At the core was financial innovation that vastly outpaced regulation and supervision. Financial institutions—particularly in the United States and Europe—went on a frenzy of reckless risk-taking. This included relying less on traditional deposits and more on short-term funding, dramatically lowering lending standards, pushing loans off balance sheets through murky securitizations, and more generally, shifting activity to the hidden corners of the financial sector that were subject to less regulatory oversight. For example, the market share of subprime mortgages in the United States reached 40 percent of overall mortgage-backed securities by 2006—up from almost nothing in the early 1990s.

In turn, the increased globalization of banking and financial services caused the crisis to cascade rapidly and dangerously. European banks were major buyers of American mortgage-backed securities. At the same time, the introduction of the euro led to large capital flows to the periphery as borrowing costs fell. These flows were financed by banks in the core—another channel of financial contagion. Globalization also contributed to the problem through regulatory arbitrage—financial
If the policy response to these pre-crisis risks was inadequate, I would say that the immediate policy response to the crisis was impressive. The governments of the major economies represented by the G20 coordinated policies on a global scale. Countries with banking problems limited the drag of flailing financial sectors on the real economy—through measures such as capital support, debt guarantees, and asset purchases. Central banks slashed policy rates and later sailed deep into unknown seas with unconventional monetary policy. Governments propped up demand with large fiscal stimuli.

The IMF played its part too. We mobilized member countries to expand our financial resources dramatically—and as a result, were able to commit nearly $500 billion to countries hit by crisis. We also pumped an unprecedented $250 billion of global liquidity into the system. We modernized our lending frameworks, to allow a faster and more flexible response to country needs—including by moving to zero interest rates on loans to low-income countries. And we engaged in a serious rethink of macroeconomics, to get a better handle on what we all had missed, including the complex linkages between the financial sector and the real economy.

Together, these policies—in the context of collective international action—largely worked in the sense that a worst-case scenario was averted. This was not a sure thing—in the immediate aftermath of Lehman, we were really staring into the abyss. Holy cow, indeed...

Policy also addressed the mistakes that led to the crisis. Banks have much healthier capital and liquidity positions. Off-balance sheet entities have been curtailed and brought under the regulatory umbrella. Big banks face tighter regulation, and leverage is lower. Subprime mortgage origination is largely gone. A big chunk of over-the-counter derivatives has been shifted to central clearing.

This is all good, but still not good enough. Too many
problem as banks grow in size and complexity. There has still not been enough progress on how to resolve failing banks, especially across borders. A lot of the murkier activities are moving toward the shadow banking sector. On top of this, continued financial innovation—including from high frequency trading and fintech—adds to financial stability challenges. In addition, and perhaps most worryingly of all, policymakers are facing substantial pressure from industry to roll back post-crisis regulations.

There is one other important area that has not changed much—the area of culture, values, and ethics. As I have noted before, the financial sector still puts profit now over long-range prudence, short-termism over sustainability. Just think of the many financial scandals since Lehman. Ethics is not only important for its own sake, but because ethical lapses have clear economic consequences. Good regulation and supervision can do a lot, but they cannot do everything. They must be complemented by reform within financial institutions.

In this context, a key ingredient of reform would be more female leadership in finance. I say this for two reasons. First, greater diversity always sharpens thinking, reducing the potential for groupthink. Second, this diversity also leads to more prudence, with less of the reckless decision-making that provoked the crisis. Our own research bears this out—a higher share of women on the boards of banks and financial supervision agencies is associated with greater stability. As I have said many times, if it had been Lehman Sisters rather than Lehman Brothers, the world might well look a lot different today.

So where do we stand on the tenth anniversary of the collapse of Lehman? The bottom line is this: We have come a long way, but not far enough. The system is safer, but not safe enough. Growth has rebounded but is not shared enough.

Complicating matters, the political economy landscape has shifted, with a fading commitment to international
Depression. Think of the role played by the G20, the FSB, the IMF, and others who worked so well together over the past decade. Indeed, the importance of international cooperation in meeting 21st century challenges is one of the enduring lessons of the crisis.

We are now facing new, post-crisis, fault lines—from the potential rollback of financial regulation, to the fallout from excessive inequality, to protectionism and inward-looking policies, to rising global imbalances. How we respond to these challenges will determine whether we have fully internalized the lessons from Lehman. In this sense, the true legacy of the crisis cannot be adequately assessed after ten years—because it is still being written.