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How Many More "Lehman Moments" to Come?

Standard and Poor's delivered another knockout moment of this crisis by lowering the credit rating of US economy on Friday evening (August 5, 2011). The event should not have been a surprise as rating agencies had been warning over the possibility of a downgrade and had kept US on a watch-list. However, few expected it to come so soon especially after US Congress agreeing to revise the debt ceiling three days earlier (August 2, 2011). The financial markets had turned euphoric post debt ceiling outcome but again did a sharp U-turn post US credit downgrade.

The recent spate of events has quickly pointed to eerie similarity to events around Lehman crisis. Some call this US downgrade a Lehman moment where as others think the current events have set in a Lehman moment about to come. Actually, there have been several Lehman moments since start of this crisis – collapse of major investment banks of US, European debt crisis, few sudden soft patches in the economy leading to policy responses etc. However given the shock value, Lehman and US downgrade surely top the list.

This paper reviews the similarity between these two events – Lehman fall and US downgrade and explores the outlook for US and global economy going ahead.

I. Lehman vs. US downgrade

There are both similarities and differences in the two events. First let us review the similarities:

- The first similarity is the unprecedented pace at which the two events have occurred. Markets were aware of troubles at Lehman with most firms and policymakers opining that they are ready in case there is bankruptcy. Same was the case with US downgrade event as well. However, in both cases markets were unprepared to handle the event and there were sharp knee-jerk reactions which fed into broad based expectations leading to a wide meltdown in asset classes.

- In both cases, though markets were aware, they were not willing to accept that these events could be true. They felt Lehman would not be allowed to fail as it was Too Big to Fail and as Bear Stearns was saved, Lehman would be saved as well. If this was the feeling for Lehman, to imagine that US could be downgraded was a more bitter pill to swallow.

- The cause for the two events was similar that of having higher debt than the ability to pay. Lehman was highly leveraged and managed its large asset book via repo transactions. Once the repo market dried demanding higher collaterals/haircuts, Lehman collapsed. US debt situation has worsened significantly post the crisis with declining tax revenues and rising expenditure. Hence, the US debt situation is more because of the financial market collapse which fed into real economy. However, even before the crisis US had piled up debt on account of expenditure in wars in Iraq and Afghanistan.

- How both the events were handled by the leaders throws up some important lessons. Before Lehman fallout, its executives sounded over-optimistic over firm's finances and turned down lower share price offers from potential capital providers to the firm. This led to Lehman being hugely undercapitalized which finally got no bidders resulting in bankruptcy. Same was the case with US debt downgrade though in this case policymakers did manage to raise the debt ceiling. US Congress has known that it needed to raise debt ceiling since a long time but only chose to raise it in the last days. The ceiling could have been raised much earlier and avoiding much of the trouble. Even the S&P downgraded US as it deems that political situation would not be able to resolve US deficit situation.

- Once again, the events point to huge interconnectedness of financial markets and sovereign debt. Post Lehman, it was seen how private bank liabilities become government's liabilities in case former are in trouble. It does not really matter whether banks are government owned or privately owned as both have to be saved by government. Post US downgrade, we see the linkage working in the reverse direction with banks and financial markets getting impacted due to concerns over debt situation in US (and European) economies.

- With respect to emerging markets the decoupling myth was once again proven false. Before Lehman, it was felt emerging economies would not be impacted and again same was expressed before the downgrade event. The emerging markets may not be impacted as severely thanks to their better policies and cautiousness. But to say they have decoupled completely is just a baseless assumption.

The differences are:

- The obvious difference is that Lehman was a financial firm and the downgrade is with respect to a country. Hence, government can step in to save fallouts from failure of financial firms but there is not an easy solution if government itself is under fiscal stress. Firms can fail and die but countries do not have that option. Countries can default on their debt but the whole event is very painful with most resulting in civil strife. Hence, countries try and avoid this at all costs.

- The US policymakers and government took quick responses post Lehman whereas the downgrade was a result of continued delay and lack of political will to resolve the situation.

Given the similarities and differences, one can only say how dramatic the crisis has been. Each time the experts think the crisis is over, it rears another ugly head to put the economy back into a tailspin. Why is this happening?

II. Renaming the 2007 Crisis as Great Contraction

Despite many warnings and research papers, the mainstream view is that it is a typical recession of the old times when business cycle just gets derailed. Hence, all that is needed is that central banks would cut rates and if needed government will pass fiscal stimulus and the cycle would come back on the desired growth path.

In this crisis similar crisis measures were taken - policy rates were cut to zero, central banks expanded balance sheets and governments passed fiscal stimulus and supported financial sector. Despite this, the economies continue to struggle.

Kenneth Rogoff of Harvard University in an article (The Second Great Contraction, 2-Aug-11) explains that the biggest mistake is to treat this crisis as a simple recession. It is actually the second great contraction with first one being Great Depression in 1930s. Such contractions involve credit and housing and not just output and unemployment seen in earlier crisis. During such events, it typically takes an economy more than four years just to reach the same per capita income level that it had attained at its pre-crisis peak. In his tome on financial crises (co-written with Carmen Reinhart called This Time is Different), he explains how such severe contractions preceded by banking crisis lead to multiple disruptions in an economy:

- First, asset market collapses are deep and prolonged. Real housing price declines average 35% over six years, while equity price collapses average 55% over a downturn of about three and a half years.
- Second, the aftermath of banking crises is associated with profound declines in output and employment. The unemployment rate rises an average of 7% over the down phase of the cycle, which lasts on average over four years. Output falls (from peak to trough) an average of over 9%, although the duration of the downturn, averaging roughly two years, is considerably shorter than for unemployment.
- Third, the real value of government debt tends to explode rising an average of 86% in three years of crisis. Interestingly, the main cause of debt explosions is not the widely cited costs of bailing out and recapitalizing the banking system. The main reason for rising debt is decline in tax revenues.

As per NBER (National Bureau of Economic Research the official US body that maintains a chronology of the U.S. business cycles), recession period was Dec-07 to Jun-09. Hence, it has been more than three and a half years since the recession started. Let us compare the various data points of US economy based on Reinhart-Rogoff analysis:

Table 1

	Rogoff-Reinhart Analysis	**US Economy Since 2007**
Housing	35% decline over six years	Declined by 23.8% between Dec-07 and Mar-11 Declined by 46.6% since peak reached in Apr-06
Equity Markets	55% over 3.5 years	Declined by 53.7% in 1.5 years. Average decline since Oct-07 is around 27%
Unemployment	Rises to 7% over 4 years	9.1% in 3.5 years
GDP	9% decline over 2 years	4% decline over 2 years
Public Debt	86% over 3 years	79% over 3 years

Source: Various Agencies

- The housing market clearly continues to underperform with persistent declines in housing price indices. The Case-Shiller housing price index has so far declined by 23.8% since Dec-07 to Mar-11. As per Rogoff-Reinhart, average decline is 35% over six years so most likely this sector is going to decline further.
- The equity markets declined by 53.7% from peak in 9-Oct-07 to bottom in 9-Mar-09 (S&P 500), over a period of 1.5 years. The average decline since Oct-07 peak to 8-Aug-11 is around 27%. Hence, the performance is better of equity markets compared to previous crisis analysed by Rogoff - Reinhart. But as the crisis is still unfolding, we may see similar numbers seen in future.
- Unemployment rate of US is around 9% which clearly has been an outlier compared to previous crises. It also declines over 4 years and as of now 3.5 years have been complete. But people do not expect this data to improve and It might actually rise if the crisis continues as unemployment numbers lag behind the financial and economic performance.
- GDP numbers were revised lower recently for previous quarters, indicating US has grown much slower than thought previously. Rogoff-Reinhart mention output declines over a period of two years by around 9%. From 2007 to 2009, output fell by 4% lower than R-R estimates. If we use

potential growth estimates provided by CSO, we see output decline by 4.2% from 2007-09 (two years) and by about 7.8% in 2011.

- Public debt has increased by nearly 79% during 2007-10, almost inline with 86% projection by Rogoff-Reinhart.

Based on above, one can actually say all these declines in various parameters are on expected lines and people should not be surprised. Barring higher unemployment and lower GDP, most others are in line with the R-R analysis. One is likely to get a similar analysis for Europe as well.

Rogoff says naming the crisis correctly will lead to better policy diagnosis and tools to resolve the crisis. The most obvious solution is to clean up balance sheets quickly and also maintaining the integrity of the financial system. This obviously is painful and will take time. He offers two more radical solutions:

- **Higher inflation target:** Economies should actually look at higher inflation of around 4-6% and inflate the debts. The higher inflation targets were mentioned by IMF chief economist Olivier Blanchard in his controversial paper (Rethinking Macroeconomic Policy, Feb-10). However this was opposed strongly by most central bankers saying it would do away with years of hard work of keeping inflation expectations anchored at around 2%. Rogoff argues this is not a typical recession and such events take place once in 70-80 years and "These are times when central banks need to spend some of the credibility that they accumulate in normal times."

- **Financial repression:** Financial repression is when official policies that direct government to use (and usually at below-market rates) funds that would otherwise go to other borrowers. This includes policies like lending to the government by captive domestic audiences (such as pension funds or domestic banks), explicit or implicit caps on interest rates etc. Research shows post World War - II countries resorted to financial repression for getting rids of debt levels. Similar measures are already being taken in this crisis. For example, at the height of the financial crisis U.K. banks were required to hold a larger share of gilts in their portfolio. Greek, Irish, and Portuguese banks have already liquidated a substantial fraction of their foreign assets and used the proceeds to buy domestic public debt. Hence, policymakers can look at this option actively as well.

However, both inflating debt and financial repression are not really appreciated by most economists/policymakers. This implies policymakers fall back on the balance sheet cleaning solution which will take long time.

III. Reminisces of Japan in 1990s and Great Depression in 1930s

In a previous paper (US in Liquidity Trap – What are the options, 26-Oct-10), we had shown various policy options for US during that time. Little has changed since then with Fed in Aug-11 meeting expressing that interest rates will remain at exceptionally low levels till atleast mid- 2013. This is two nearly two years away from now showing the continued depth of the crisis. In upcoming Jackson Hole Symposium hosted by Kansas Fed, Ben Bernanke is expected to speak on the tools Fed would use to fight this new round of weak growth and high uncertainty. He might speak on possibility of another round of quantitative easing (called QE-III) as well.

However, not much is expected from QE-III as little gains were made in QE-II. The liquidity trap situation continues with Fed pumping liquidity but it not having the desired effect on economy. Fed has also faced criticisms for creating huge global liquidity stoking prices of commodities, equities and oil. Banks and companies are sitting on large pools of cash but preferring not to lend/invest given the crisis ridden environment.

Given this, it is amazing how the US crisis is so similar to what Japan faced in 1990s and the global nature of the crisis is so similar to what we saw in Great Depression.

- **US and Japan**: Japan may have reacted slowly to the crisis but did similar things like US has done now. Japanese policymakers were lectured by number of US economists and policymakers (including Fed Chairman Ben Bernanke) on how to resolve the crisis and how Japanese policymakers have created and prolonged this crisis. To this, Japanese policymakers only reacted saying one only knows the situation when one faces it. Best way to get out of Japanese situation is not to have it at the first place.

  After seventeen years, US faced the same crisis and reacted swiftly but finds itself in similar Japanese situation. Each time the economy recovers and talks begin of exiting the easy policies, the economy declines. Like Japan there are many false starts in the economy which gives confidence that economy has started to recover but expectations dry-up quickly.

  The central problem in both economies was high leverage. Japan had high leverage in corporate sector and US had high leverage in households. Kiyohiko Nishimura, BoJ Deputy Governor in a speech pointed that Japan's corporate sector's loan-to-GDP ratio increased by 29 percentage points in the ten years before the bubble burst in 1991. In the United States, it was the household sector that leveraged, especially in housing. The household sector's housing loans-to-disposable income ratio jumped by 39 percentage points in the ten years before the bubble burst in 2007. The high leverage before the crisis had led to higher asset prices. After the crisis, asset prices declined leading to evaporation of wealth forcing people to lower leverage.

  As the leverage levels were very high, it takes time to adjust and deleverage. For instance in US case, housing formed major part of wealth. With housing prices declining by nearly 45% from their peak in Apr-06, people are finding it tough to deleverage. The cost of mortgage is higher than price of houses, preventing people to sell off their homes and relocate to more productive areas. Till this leveraging process does not get over, US economy will struggle. Japan's economy shows that deleveraging takes a very long time and one needs many good years to achieve it. Japan could not even recover despite 1992-07 being phase of great moderation with high global growth. It is difficult to imagine how US would recover given bleak global growth prospects.

  Apart from similar monetary policy, both US and Japan have tried fiscal stimulus. The size of the fiscal stimulus was less given the size of the economy and policymakers were reluctant to raise it as debt levels increased. The fiscal situation of both was not good before the crisis and post crisis it became even worse. Japan also lost its AAA rating as it could not present a credible plan of fiscal consolidation. The political unwillingness and chaos was seen in Japan as well, like we are seeing in US.

- **Great Depression and Global Economy:** In the early part of the 2007 crisis, there was an unprecedented policy coordination globally to recover from the crisis. However as economy showed signs of recovery, coordination has waned. We discussed this in our previous report as well (Exploring Policy Trade-offs in Domestic and Global Economies, 18-May-11). Great Depression became a global event as policymakers did not coordinate and followed their own domestic strategy like protection of domestic industries by raising tariffs, licencing etc. This led to decline in overall international trade and countries could not grow via exporting and devaluing their currencies.

As there is yet another soft patch in global economy, there is a need for global coordination even now. However, the policies are again getting like seen in Great Depression with little coordination and cooperation. The Chinese blame the US for allowing downgrade, US blames China for keeping its currency undervalued at cost of the whole world and European leaders keep delaying responses to the debt crisis. The turmoil and lack of political willingness to resolve issues is not just seen in US but in most parts of the world. It might not lead to a depression, but surely points to slower global growth ahead.

IV. Concluding Thoughts

Going by the available policy choices, we are likely to see similar policies which have already been tried in this crisis. Fed is likely to announce a new round of QE-III and Chairman Bernanke is expected to provide some hints in the upcoming Jackson Hole conference. There is already wide dissent amidst FOMC members that low policy rates and rounds of QE could lead to build up of asset bubbles and take the economy back to the point from where the crisis started. It might be even more difficult for Fed this time to form consensus on QE-III given the dissent. Even if Fed manages to start QE-III its efficacy is always going to be debatable. Fiscal stimulus as an option cannot even be considered given the political impasse and huge deficits.

The other solution of having higher inflation target is unlikely to work as well. Federal Reserve is not an inflation targeting central bank and does not have an official inflation target. Various FOMC members do mention their own internal inflation target of around 1.75% - 2%. If Fed has to become an inflation targeting central bank, it will require consent from US Congress. Given the political environment, it looks highly unlikely that there would be any consensus on this option. Moreover, a higher inflation target could itself become a problem if it leads to higher inflation expectations and inflation in future. As there have been no cases where such policy of higher inflation target has been implemented, one is never sure of its impact.

Overall, escaping from the second great contraction is going to be a huge challenge for financial markets and policymakers. It is going to be a while before confidence returns in all three drivers of economy- businesses, markets and consumers. There are likely to be more “Lehman moments” on the way with swings of optimism and pessimism.

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