The next great crisis

The tenth anniversary of the bankruptcy of Lehman Brothers, the event which, in the collective imagination, marked the beginning of the biggest global financial crisis since 1929, has served as an opportunity for us to consider the causes of the financial crisis and the remedies that have been implemented to try to prevent it from reoccurring.

With regards to the causes, there is broad consensus that several factors played an important role. These include an excessively accommodative monetary policy that fuelled the US housing bubble, the banking sector's limited capacity to absorb losses (due to a lack of capital), excess short-term borrowing, corporate governance issues, banking supervision mistakes and the creation of highly complex financial products that concealed their real risk.

As for the remedies, there is also broad agreement that much has been done to correct the deficiencies that were identified. In particular, banks must meet higher capital, liquidity and transparency requirements, and the role of the management bodies and supervisors has been strengthened. New requirements (resolution plans) have also been introduced, which should facilitate the restructuring of banks experiencing difficulties and minimise the risks to the system as a whole. Some still think that not enough has been done, but perhaps they are ignoring the fact that aspiring to achieve zero risk would entail a huge cost (capital requirements and the cost of complying with regulation make financial intermediation more expensive). A balance must be struck. To judge whether we have achieved this, we must give the new regulatory framework some stability and give ourselves time to analyse how it operates.

In any case, the next great crisis – which we hope will not come anytime soon – will no doubt be different to the previous one. In fact, the European sovereign debt crisis, which was not as severe as the Great Recession of 2009 but caused the euro area to relapse, had very different causes: excessively loose fiscal policies (particularly in Greece), large differences in competitiveness between countries and the institutional weaknesses of the euro area. Europe has also introduced major reforms in order not to repeat another similar crisis, but there is still a lot of work remaining to shore up the Economic and Monetary Union (among other things, the Banking Union still needs to be completed and fiscal capacity needs to be created at a European level).

Looking to the future, what could cause the next great financial crisis? Two pockets of risk stand out on the radar – although the likelihood of them materialising is low.

China is a usual suspect due to its high debt, which has practically doubled in the last 10 years and now stands above the levels of the US prior to the 2008 financial crisis. Given its relevance in the global economy and its extensive trade and financial connections with the rest of the world, a crisis in China would be felt throughout the global economy. The good news is that the Chinese authorities are well aware of the risks and have begun to take measures to reduce the levels of debt.

The other candidate is the rise of populism and its consequences. One example of this is very close to home: Italy, where massive public debt, anaemic economic growth and a populist government make up a high-risk cocktail that could feed doubts over the country's continuity in the euro area. The good news is that the majority of the population wishes to keep the euro. What remains to be seen is whether this desire is compatible with the above combination or whether it will prove essential to change one of the ingredients of this cocktail.

Enric Fernández
Chief Economist
30 September 2018