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Picture by Mark Lennihan/Associated Press

10 Years After Lehman's Collapse, Economies Are Sowing the Seeds of the Next Crisis

September 15th, 2008: financial services firm Lehman Brothers files for Chapter 11 bankruptcy protection. This is the largest default in U.S. history, and marks the beginning of the Global Financial Crisis (GFC), the most severe episode of financial instability and economic contraction since the Great Depressions of the 1930s. From late 2006/early 2007, when the first elements of the crisis start to emerge, until September 2008, the crisis is mostly confined to the financial sector, having little impact on real economic activity. After Lehman's collapse, however, the crisis becomes truly global. A number of economies enter a severe recession in 2009; they will emerge from this recession only a number of years later, profoundly transformed.

September 15th, 2018: ten years after Lehman's collapse, it is evident how the consequences of the 2008 GFC have gone far beyond the financial industry and the real economy. New political movements have emerged, and a world-wide retreat of globalization has begun, in a process that is still ongoing. The eventual outcome of this process has not yet become clear. In a Special Paper published by the Systemic Risk Centre of the London School of Economics(derived from a video interview by Angela Antetomaso with Nouriel Roubini and myself, which is available on a page dedicated to the 10th anniversary of the GFC of our website), we analyse what went wrong in 2008, and what lessons have been learnt to prevent another crisis of similar proportions from emerging again. We discuss the perverse relationships that often exist between academics, regulators, market participants and politicians, and why the institutions that were supposed to look after the economic and financial stability of countries failed to prevent the excesses of finance from occurring. We analyse the effectiveness of the instruments of fiscal and monetary policy adopted to counter the effects of the crisis, and we highlight the insufficient use of fiscal policies, which at least in Europe would have helped alleviate the effects of the economic downturn. The link between financial crisis, economic contraction and the rise of populist parties, which led to Brexit and the election of Donald Trump, can clearly be seen. In this context, rising geopolitical tensions occurring within a deteriorating macro environment, as well as increased financial fragility, might trigger a new crisis that could be worse than the GFC.

In recent articles published by the Financial Times and Project Syndicate, we explain how economies today have already sowed the seeds of the next global recession and financial crisis. We expect such a crisis to materialise by 2020, for the following ten reasons: 1) the fiscal drag on the US economy in 2020, as Trump's fiscal stimulus expires; 2) the continuation of monetary policy tightening by the Fed and the beginning of interest rate normalisation by the ECB and BOJ, as inflation rates return toward central banks' target levels; 3) the effects of trade wars and protectionism; 4) the restrictions to FDI and immigration, both reducing economic growth potential; 5) economic burdens deriving from the increase in public and private debt; 6) economic, financial and political fragilities in the Eurozone, China, and other EMs; 7) the potential for bubbles to burst in many over-priced markets; 8) the potential for fire-sales to take place in increasingly illiquid markets; 9) a "wag-the-dog" political risk in the US; e.g. Trump embarking on foreign policy adventures in the lead-up to the 2020 general election; and, 10) the constraints, deriving from the rise of populist parties, that policy makers will face in using policy tools to counter a crisis.

Our Recent Publications

- *ECB Buys Time (Again) On Re-Investment Policy, by Brunello Rosa, 13 September 2018*
- *Still Waiting For Re-Investment Policy Details, by Brunello Rosa, 11 September 2018*
- *Post-Ambrosetti Forum Bullet Points, by Brunello Rosa and Nouriel Roubini, 10 September 2018*
- **The Geopolitical Corner** – *Why Ethiopia is the best political risk story you know nothing about, by John C. Hulsman, 11 September 2018*

The Week Ahead

In Eurozone, inflation is expected to remain unchanged, both headline (CPI Aug y-o-y, *c:* 2.0%; *p:* 2.0%) and core (Aug y-o-y, *c:* 1.0%; *p:* 1.0%).

In Europe, the Swiss National Bank and Norges Bank will hold policy meetings. Norges Bank is expected to increase its policy rate by 25bps to 0.75% (the first rate rise since May 2011), and to indicate 2-3 additional rate hikes over the forecast horizon, with an up-lifted rate path.

In Japan, the BoJ is unlikely to change its policy rate (*c:* -0.1%; *p:* -0.1) given low growth and inflation prospects: CPI Aug (*c:* 0.9% y-o-y; *p:* 0.9%) is expected to remain unchanged, below 1%.

The Quarter Ahead

The US will continue to normalize policy ... Market expectations about "*at least 2 additional hikes in 2018"* remained high, at 79.3% (*pw:* 79.8%), while the likelihood of "*at least 4 additional hikes by September 2019*" increased to 50.1% (*pw:* 37.6%), given that: *a)* US job openings hit 6.9m—a record level—in July (*c:* 6.7; *p:* 6.8); and *b)* inflation softened, but remained above the Fed's target (CPI Aug y-o-y, *a:* 2.7%; *c:* 2.7%; *p:* 2.9%: *Fed's target:* 2.0%). As a result, short positions on UST 10y futures reached a record high of 683k contracts

… while other DMs will remain on hold. In Europe, the ECB and the BoE—both facing weakening economies—left policy rates unchanged (ECB, *a:* 0.0%; *c:* 0.0%; *p:* 0.0%; BoE, *a:* 0.75%; *c:* 0.75%; *p:* 0.75%). In Q4, the ECB will reduce its monthly asset purchases to EUR 15bn; if the EZ economy remains resilient, ECB's QE will end in December 2018. Next week, the EZ's September composite PMI is expected to remain unchanged at 54.5.

In the UK, a no-deal Brexit could hurt real estate prices. Mark Carney, BoE's governor reportedly told cabinet ministers that a no-deal Brexit would see house prices fall by a third within three years.

EM weakness is likely to continue. The divergence between stable DMs and volatile EMs will persist, triggering bouts of volatility: last week, *a)* the ARS weakened a further 7.6% against the USD (to USD/ARS 39.736); and *b)* the BRL depreciated by 2.8% (to USD/BRL 4.174).

In Turkey, the economy will weaken … The government announced measures (i.e.: postponement of new investment projects, reductions of public sector hiring) to reduce the fiscal deficit. Q2 GDP growth fell to 5.3% y-o-y (*c:* 5.3%; *p:* 7.4%) and is likely to decline to between 0 and 1% in Q3. Lower growth will reduce the C/A deficit—which already fell to 6.6% of GDP (July 12m rolling avg., *p:* 7.0%).

… but the TRY will be supported by: *a)* a more proactive CBT—last week, the CBT raised the one-week repo rate by 625bps to 24.0%, above markets' expectations (300-400bps); and *b)* new regulation banning the use of FX in real estate and motor vehicle transactions (sale, purchase, lease or rent).

Saudi Arabia will increasingly rely on bank financing**.** Saudi Arabia needs funding to meet its diversification and investment plans, following the postponement of Saudi Aramco's IPO. Last week, the country's SWF borrowed USD 11bn from a consortium of banks. The loan was reportedly priced at LIBOR +75bps.

In Egypt, the C/A deficit will decrease**.** A presidential decree signed last week: *a)* increased customs tariffs on 5,791 imported products; and *b)* reduced tariffs on materials used as inputs in local assembly lines. The move aims at encouraging local production and raising fiscal revenues.

In Bahrain, the CBB sold USD 254m of debt: six-month Islamic bonds were sold at 4.35% (up from 4.19% in the previous issue), and three-month Treasury bills at 4.13% (*p:* 4.09%).

Brent oil price will likely remain above 70 USD/b. In Q4, the US will keep expanding production: in August, average output reached 10.9 mb/d—making the US the world's leading producer—up from an average of 9.4 mb/d in 2017. However, oil prices rose by 1.6% w-o-w to 78.1 USD/b due to: *a)* in the short term, concerns about the impact of Hurricane Florence in the US: and *b)* in the medium term, the impact of sanctions on Iran.

Last Week's Review

Global stocks rose by 1% w-o-w (MSCI AWCI). ***In DMs***, positive developments on global trade lifted equities (S&P500 +1.2%; Eurostoxx 50 +1.6%; Nikkei 225 +3.5%), shrugging off reports that US President Trump could impose further tariffs on USD200bn of Chinese goods. Volatility declined (VIX, -2.8 points to 12.1; *52w avg.:* 13.6; *10y avg.:* 19.5). Driven by positive data in the US labor-market, the 10-y UST yield rose by 5bps w-o-w to 2.99%. The USD weakened w-o-w against: *a)* a currency basket (DXY -0.4%); and *b)* the EUR (EUR/USD 1.163, +0.7%). ***In EMs***, as Turkey's CB delivered an above-consensus rate hike (by 625bps to 24%) and the Russian central bank rose its policy rate by 25bps to 7.50%, EM stocks (DJEM -0.1% w-o-w) and currencies (MSCI EM Currency index, +0.2% w-o-w) stabilized.

Pablo Gallego Cuervo, Joseph Shupac *and* ***Josiane C. Zhang*** *contributed to this Viewsletter.* *The picture in the front page comes from this website*

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Abbreviations, Acronyms and Definitions

a	Actual	*k*	thousand
AKP	Justice and Development Party, Turkey	*KSA*	Kingdom of Saudi Arabia
ann.	annualized	*LN*	Northern League, Italy
ARS	Argentinian Peso	*M5S*	Five Star Movement, Italy
bn	Billion	*m-o-m*	Month-on-month
BoC	Bank of Canada	*mb*	Million barrels
BoE	Bank of England	*mb/d*	Million barrels per day
BoJ	Bank of Japan	*MENA*	Middle East and North Africa
bpd	Barrels per day	*MHP*	Nationalist Movement Party, Turkey
bps	Basis points	*mn*	Million
BS	Balance sheet	*NAFTA*	North-American Free Trade Agreement
c	Consensus	*NATO*	North Atlantic Treaty Organization
C/A	Current account	*OECD*	Organization for Economic Cooperation and Development
CB	Central bank	*Opec*	Organization of Petroleum Exporting Countries
CBK	Central Bank of Kuwait	*p*	Previous
CBR	Central Bank of Russia	*PBoC*	People's Bank of China
CBT	Central Bank of the Republic of Turkey	*PCE*	Personal Consumption Expenditures
CDU	Christian Democratic Union, Germany	*PE*	Price to earnings ratio
CNY	Chinese Yuan	*PM*	Prime minister
CPI	Consumer Price Index	*PMI*	Purchasing managers' index
DJIA	Dow Jones Industrial Average Index	*pps*	Percentage points
d-o-d	Day-on-day	*pw*	Previous week
DXY	US Dollar Index	*QCB*	Qatar Central Bank
EC	European Council	*QAR*	Qatari Riyal
ECB	European Central Bank	*QE*	Quantitative easing
ECJ	European Court of Justice	*q-o-q*	Quarter-on-quarter
EIA	US Energy Information Agency	*RBA*	Reserve Bank of Australia
EM	Emerging Markets	*RRR*	Reserve Requirement Ratio
EP	European Parliament	*RUB*	Russian Rouble
EPS	Earnings per share	*SHCOMP*	Shanghai Stock Exchange Composite Index
EU	European Union	*tb/d*	Thousand barrels per day
EUR	Euro	*tn*	Trillion
EZ	Eurozone	*TPP*	Trans Pacific Partnership
Fed	US Federal Reserve	*TRY*	Turkish Lira
FM	Future Movement	*UAE*	United Arab Emirates
FOMC	US Federal Open Market Committee	*UK*	United Kingdom
FRB	US Federal Reserve Board	*US*	United States
FX	Foreign exchange	*USD*	United States Dollar
FY	Fiscal Year	*USD/b*	USD per barrel
GCC	Gulf Cooperation Council	*UST*	US Treasury bills/bonds
GBP	British pound	*VAT*	Value added tax
GDP	Gross domestic product	*VIX*	Chicago Board Options Exchange Volatility Index
GOP	Grand Old Party (US Republican Party)	*WTI*	West Texas Intermediate
IMF	International Monetary Fund	*w-o-w*	Week-on-week
INR	Indian Rupee	*y-o-y*	Year-on-year
IPO	Initial public offering	*y-t-d*	Year-to-date
IS	Islamic State	*2y; 10y*	2-year; 10-year
JPY	Japanese yen		