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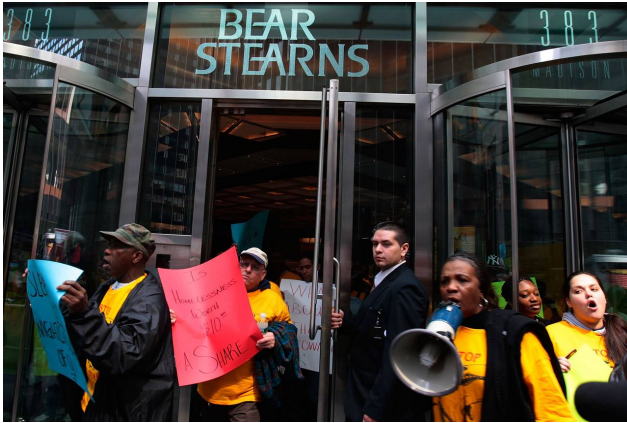
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# A Decade After Bear's Collapse, the Seeds of Instability Are Germinating Again

A big financial-firm collapse in near future is exceedingly unlikely, but another crisis isn't



Housing activists protested the government-backed bailout and sale of Bear Stearns in March 2008.

PHOTO: CHRIS HONDROS/GETTY IMAGES



By *Greg Ip*

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Since the bailout of Bear Stearns Cos. a decade ago this week and the failure of Lehman Brothers six months later, regulators have made it their mission to prevent a repeat.

Yet even though a big financial-firm collapse in the near future is exceedingly unlikely, another crisis isn't. Bear and Lehman were the manifestation of deeper economic forces that since the 1970s have produced crises roughly every decade. They are still at work today: ample flows of capital across borders, mounting debts owed by governments, corporations and households, and ultralow interest rates that nurture risk-taking in hidden corners of the economy.

For a quarter-century after World War II, the world was virtually crisis-free. Widespread defaults during the Great Depression and the war left a relatively debt-free path for economic growth, says Harvard University economist Kenneth Rogoff, co-author with Carmen Reinhart of "This Time

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is Different: Eight Centuries of Financial Folly.” Capital controls limited how much money could cross borders, while rules such as interest-rate ceilings limited who could borrow and how much.

By the early 1980s, though, deregulation had allowed capital to flow freely within and across borders and crises became a regular occurrence: the Latin American debt crisis that began in 1982, the U.S. commercial real estate and savings and loan crisis of the 1980s, the Asian and Russian financial crisis of 1997-98, the dot-com bubble of 1998-2000, the U.S. mortgage crisis of 2007-2009 and the European sovereign debt crisis of 2009-2013, interspersed with country-level crises such as in Scandinavia in the early 1990s and Japan throughout that decade.

Bear was both facilitator and victim of a housing bubble inflated by low interest rates and huge inflows of foreign capital—a “global saving glut” as then-Federal Reserve Chairman Ben Bernanke put it. It arranged mortgages that financed the housing bubble while borrowing heavily with short-term IOUs. When those mortgages went bad, Bear’s creditors yanked their funds—a de facto run on the bank.

Most of the regulatory effort since has been to ensure the largest financial institutions such as JPMorgan Chase & Co., which bought Bear Stearns in a fire sale brokered by the Fed, don’t succumb to anything similar: thicker buffers of capital to absorb losses, more reserves of cash and liquid assets to pay off skittish creditors, restrictions on trading and compensation that incentivize risk-taking, and new procedures for winding down failing institutions without taxpayer bailout or a chaotic bankruptcy. Though President Donald Trump’s appointees and Congress are beginning to dial back the regulations, the failure of a systemically-important institution now looks pretty remote.

But Hyun Song Shin, research chief at the Bank for International Settlements, warned in a 2014 speech against the tendency to “focus on known past weaknesses rather than asking where the new dangers are.” Banks may be stronger than a decade ago, but the financial system hasn’t returned to its pre-1980 repressed state.

Mr. Shin pointed out that bond markets are growing at the expense of banks in supplying credit, enabling business and government debt loads in many countries to surpass their precrisis peaks. Emerging markets have borrowed heavily in dollars, which leaves them vulnerable should the dollar’s value rise sharply. Before the crisis, 80% of investment-grade corporate debt world-wide yielded more than 4%; as of last October, less

than 5% did, according to the International Monetary Fund.

Total U.S. debt, at around 250% of GDP, still stands at crisis-era peaks while debt levels in China have caught up and passed the U.S., according to the BIS. U.S. companies' debts had reached 34% of assets by the end of 2016, the highest at least since 2000. Debt-servicing burdens haven't risen commensurately thanks to low inflation and low rates, but they have begun climbing. More than \$1 trillion a year still flows into emerging markets each year, according to the Institute of International Finance.

This tells us little about when or where a crisis will happen or what may trigger it. Crises surprise because they usually start with an assumption so sensible that everyone acts on it, planting the seeds of its own undoing: in 1982 that countries like Mexico don't default; in 1997 that Asia's fixed exchange rates wouldn't break; in 2007 that housing prices never declined nationwide; and in 2011 that euro members wouldn't default. James Bianco, who runs his own financial research firm in Chicago, speculates that the equivalent today might be, "We will never see higher inflation or higher growth." If either in fact occurs, the low interest rates that have raised household stock and property wealth to an all-time high relative to disposable income won't be sustainable.

Mr. Rogoff concurs: "It's much harder to get a crisis when you can borrow for virtually nothing and keep rolling it over." A 1.5 to 2 percentage point increase in real interest rates, which he isn't forecasting, would be small by historical standards but could potentially make the debts of Italy or Portugal unsustainable.

Central banks know this, of course, which is one reason they are wary of raising interest rates too quickly—while nervous that if they raise them too slowly, the problem will get worse.

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