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The Lehman Shock

Why the bank's failure one year ago was so much more devastating for the rest of the world than for the United States.

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The failure of Lehman Bros. on Sept. 15, 2008, was an epic calamity, but it may have been more important overseas—where September 2008 is referred to as "Lehman Shock"—than it was here.

In the United States, the sudden bankruptcy of America's fourth-largest investment bank was the cathartic culmination of a process that had been building since subprime lenders began to go bust in 2007. Before Lehman was allowed to fail, we had witnessed the shocking demise of well-known firms such as Bear Stearns and of much larger institutions Fannie Mae, Freddie Mac (the two largest U.S. financial institutions as measured by the size of their balance sheets), and AIG. Throughout the summer of 2008, Treasury Secretary Henry Paulson and the Federal Reserve had been dealing with systemic failure. Yes, Lehman's demise kicked the level of hysteria up several notches and required unprecedented intervention, particularly in the commercial paper market. But it wasn't a solitary event. The same day Lehman failed, Bank of America and Merrill Lynch—a larger firm than Lehman—merged. The same week, Goldman Sachs and Morgan Stanley converted to bank holding companies so they could access new sources of credit. Meanwhile, the Bush administration began to concoct a large-scale bailout and a hot presidential election took a [decisive turn](#). Our attention quickly shifted from the dead to the living and wounded.

But for the rest of the world, Lehman's failure stands out, in part because it marked a beginning rather than an end, and in part because Lehman's failure triggered a series of events that affected economies around the world to a much greater degree than the other failures did. It seemed to be the direct cause of serious problems in a way that these other events weren't.

Lehman had issued hundreds of billions of dollars in short-term debt, including [commercial paper](#). Commercial paper is usually a boring and unsexy market. But it's a vital cog in the global economic engine. Companies need access to lots of short-term credit (30 days, 90 days, 180 days) to finance production and shipment of goods. Without it, they're toast. When Lehman filed for Chapter 11, it rendered a lot of its commercial paper worthless (or worth a lot less) and caused a panic among the investors and funds that owned it. For all intents and purposes, the commercial-paper market seized up. If Lehman couldn't make good on its short-term debt, was it safe to lend money to anybody? Banks and financial institutions around the world lost trust in one another, causing short-term lending rates to spike. Since short-term credit is both the lubricant and fuel of global trade, the effect of the Lehman failure was a little like sucking the engine oil and gas out of a race car going 180 miles per hour. The whole machine stalled.

All of a sudden, the world seemed to change. Yes, the United States had been in recession since the beginning of 2008. But world trade had held up quite well. But after the Lehman shock, *all* world trade began to shrink rapidly. Starting in September 2008, the volume of world trade began to plummet sharply.



As the World Trade Organization [reported](#) in March, "the months since last September have seen precipitous drops in global production and trade, first in the developed economies, then in developing ones as well." In late 2008, world trade was contracting at a [40 percent annual rate](#). In Japan, exports, which had held up well in 2008, fell 57 percent between August 2008 and January 2009. (Go [here](#) and click on "exports.") Through the first half of 2009, they were down nearly 40 percent from the first half of 2008. In Germany, exports in July 2009 were [25 percent below the level of July 2008](#). [China's exports have fallen, too, although less dramatically](#).

This sharp contraction in exports was as much of a shock to these countries' systems as the sharp fall in housing was to the United States. The United States had built an economy that was highly dependent on housing, leverage, and easy credit—and that was unable to weather stress in any of those sectors. Japan, Germany, and many other countries, by the same token, had built economies that were highly dependent on credit-fueled trade. For other economies, the Lehman shock meant the sudden recognition that what for years had been a source of jobs and growth was no longer reliable. It's not just that exports to the United States shriveled after September 2008; the flow of goods everywhere, in all directions, has fallen.

The real Lehman shock was that the contracting U.S. economy and the failed U.S. financial system could drag the global economy into its first recession since World War II. On the first anniversary of the Lehman collapse, the question is whether the recovering United States can lead the whole world back to growth.

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