What have we learned from the 2008 credit crisis?

Ten years after the Great Recession, any new downturns look to be more localized. But there are risks to be aware of.

Susan Lund

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The ingredients of the world's worst financial crisis in 70 years, we now know, had been simmering for some time, mercurial and unattended. Even before the global credit crisis exploded in September 2008, obliterating storied financial institutions and enveloping financial markets, factories, and homeowners, the formative elements of the Great Recession were in plain view. Simply put, surplus global liquidity, combined with an interconnected global financial system, had helped set the conditions for a massive housing bubble.

Banks gave out mortgages at very low interest rates to increasingly risky borrowers. Trillions of complex, opaque derivative securities were built atop these underlying mortgage assets, and investors around the world bought them. Households were borrowing more than they could afford, and when the economy fell into a recession and people lost jobs, they defaulted on their mortgages and set off a catastrophic global crisis. Banks had only a thin layer of equity capital to withstand the accumulating losses on their balance sheets. As more and more mortgages fell into default, banks faced losses that pushed them into a solvency crisis.

The rest, as they say, is history. The question now, ten years after the credit crisis, is: What lessons have we learned? Could we see a repeat of the same pattern—a real-estate bubble that fuels a banking crisis that spreads across the world? History shows us that real-estate bubbles and banking crises go hand in hand and have plagued countries throughout history. It would be foolish to say that this combination couldn't rear its ugly head again, but it is worth noting how the landscape has changed since 2008.

Most notably, the global financial system is less interconnected than it was. The average amount of money crossing borders has shrunk by about half since 2007. Banks have sold foreign assets; they have exited some foreign markets. Before the crisis, two-thirds of German banking assets would have been outside Germany; today only about a third are.

Banks are more stable: they hold more capital and liquid assets, they are subject to a host of new regulations, and they have reduced the risk on their balance sheets in regard to the assets they hold and the activities, like proprietary trading, that they engage in. In addition, the complex derivatives that allowed the crisis to ripple across the global system have shrunk substantially.

Overall, the minders of the global financial system did well in responding to the 2008 crisis. They battened down the hatches, managed over time to restore trust in institutions, and created a stronger financial system to guard against those particular risks. But old risks remain, and new ones have arisen.

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Increase in corporate, government, and household debt

In contrast to postcrisis expectations, the total amount of debt in the world has continued to grow rather than decline. In absolute terms, the world has $72 trillion more debt than there was in 2007, on the eve of the crisis. Government debt has grown rapidly in advanced economies (exhibit).

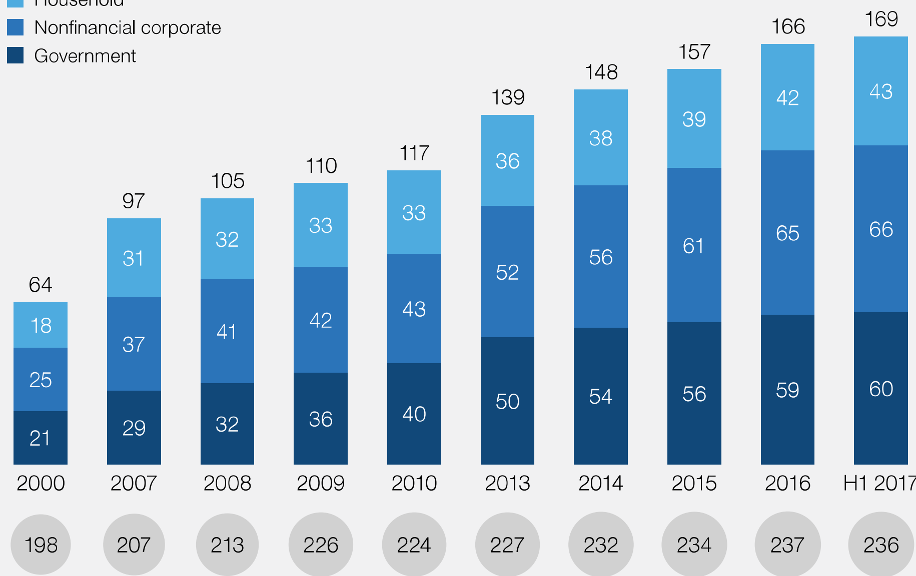
Prior to the credit crisis, governments around the world owed some $32 trillion; now they owe about $60 trillion. The recession reduced tax revenues and increased social-welfare payments for things like unemployment, a situation that put a big dent in government fiscal balances. And around the world, governments, to one extent or another, provided financial support to the banking system and other critical industries. All of that has made governments more indebted than ever before.

At the same time, companies have borrowed almost as much as governments have borrowed. Globally, nonfinancial corporate debt is even larger than sovereign debt. The growth of corporate debt in developing countries poses a particular risk when interest rates rise and debt is denominated in

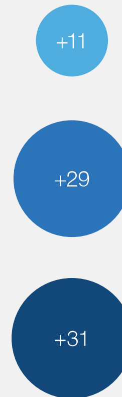
Exhibit

Global debt has continued to swell since the financial crisis but has remained stable relative to world GDP since 2014.

Total debt outstanding,[1] constant H1 2017 exchange rate, $ trillion



Change, 2007–H1 2017, percentage points



Note: Figures may not sum to listed totals, because of rounding.

[1] Includes household, nonfinancial corporate, and government debt; excludes debt of the financial sector. Estimated bottom up using data for 43 countries from Bank for International Settlements and data for eight countries from McKinsey's analysis.

Source: Bank for International Settlements; McKinsey Global Institute analysis

foreign currencies. If the local currency depreciates, companies might be caught in a vicious cycle that makes repaying or refinancing their debt difficult.

Real-estate bubbles and mortgage risk

Households in the United States borrowed too much before the crisis—but so did households in other countries, a pattern that was somewhat overlooked. Ireland, Spain, and the United Kingdom all experienced real-estate bubbles that were similar to or larger than those in the United States. Over the past ten years, households in those four countries have reduced their debt levels substantially.

Australia, Canada, Norway, South Korea, and Sweden all have household debt, relative to GDP, at levels similar to—or higher than—that of the United States at the peak of the crisis. A common thread among them? Continued growth in housing prices has prompted more household borrowing through mortgages. Real-estate prices have soared to new heights in sought-after markets like Shanghai, Sydney, and Vancouver. Even in the United States, pockets of risk remain in the mortgage market. Roughly half of all new mortgages are coming from nonbank lenders that have significant liquidity risks.[1] It is not the same "shadow banking" entities that we saw before the 2008 crisis, but the situation still bears watching as these entities become a significant part of the market.

China's rapid growth and debt

Over the past ten years, China's debt, in absolute terms, has more than quadrupled in size—from \$5.8 trillion to \$32.4 trillion. The country's ratio of debt to its GDP is now near to or higher than that of economies like Canada, Germany, and the United States. One thing we know from financial crises around the world is that whenever there is rapid growth in credit, there is a high likelihood that lending standards have fallen, and that underwriting is not as strict as it should be. And so we can see some potential risk in China's debt: much of it is related to real estate. If the market were to go into reverse, we could see many defaults. Additionally, about one-fourth of loans are from China's own type of shadow-banking entities—for instance, wealth-management funds and other vehicles outside of the banking system. This combination of an over-extended property sector and unsustainable finances of local governments could eventually combust. Of course, China's government has ample fiscal capacity to bail out the financial system in the event of rising loan defaults, but the debt overhang could slow China's growth and have repercussions for the global economy.

The good news? If any one of these potential bubbles were to burst, it might cause pain for a subset of investors and lenders, but none seems poised to produce a 2008-style meltdown. These run-ups would tend to be localized, and crashes would be less likely to cause worldwide collateral damage. The likelihood of contagion has been greatly reduced by the fact that the market for complex securi-tizations, credit-default swaps, and the like has largely evaporated.

But if 2008 taught us anything, it is the importance of being vigilant when times are still good. ■

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[1] You Suk Kim et al., "Liquidity crises in the mortgage market," *Brookings Papers on Economic Activity*, Spring 2018, pp. 347–13, brookings.edu.

Susan Lund (Susan_Lund@McKinsey.com) is a partner at the McKinsey Global Institute and is based in McKinsey's Washington, DC, office.

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