Reboot for a new economy

How did we get here?

The economic crisis explained

We are in the second phase of an economic crisis which is global in its scale and reach, affecting all our major institutions and established ways of thinking. How did we get here? And what can we do now to prevent worldwide economic meltdown?

Phase 1: The financial crisis of 2008

The current economic meltdown is a continuation of the financial crisis of 2008, when the bankruptcy of Lehman Brothers (then the world's third-largest investment bank) threatened the whole financial system with collapse.

Banks had spent the previous decade fuelling a credit boom with increasingly risky loans. They believed that they could manage these risks, which encouraged further risk-taking. The result was that bad debts became stacked up on more bad debts inside bank balance sheets, hidden by increasingly complex financial products.

Confidence in the whole system tottered when those at the bottom of the debt pile – the US subprime mortgage holders – began to default. Lehman Brothers collapsed, and because it was so large, its failure threatened the rest of the financial system. The response of governments was to use their own powers of borrowing to support the banks. **The Bank of England estimates that the total cost of bailing out the UK financial system was £1.3 trillion,** more than ten times the entire NHS budget.

Phase 2: The crisis of state debt

The immediate crisis was halted but not resolved. Private financial institutions were saved from collapse. The cost of preventing their collapse was increased public debt. **Increased public indebtedness has nothing to do with excess public spending**. It is the direct result of the 2008 financial crisis.

But states, too, can default on their debts. The risk of this increases when economies are weak, since they cannot find the funds needed to repay debt through taxation. And across the old developed world, in North America and Europe, economies are weak.

National debts are held inside the banking system. Sovereign default therefore threatens banks. This is the phase of the crisis we have now entered. A financial crisis was transformed into a crisis of sovereign debt through bailouts and a recession that cut tax receipts and raised the benefits bill. That sovereign debt crisis is now leaking back into the financial system. Financial collapse threatens further bailouts. **Public and private debt crises are intertwined.**

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The crisis of sovereign debt is most acute inside the Eurozone because of the way the single currency works. The euro, since it was created in 1999, has suffered chronic imbalances. Each country, on entry, fixed its exchange relative to other euro members. Over the decade, northern Europe and Germany in particular squeezed real incomes, cutting costs for its exporters. But fixed exchange rates meant other countries could not devalue to compete. Exports from the north became cheap for the south. Large trade surpluses (where a country exports more than it imports) developed in the north, especially in Germany. These were matched by large trade deficits (where imports exceed exports) in the south. And export earnings were recycled, through European banks, as debt which flowed straight back to the south. This enabled them to keep on buying from the north. Surplus and savings on one side were matched by deficits and debts on the other.

This imbalanced system was shattered by the events of 2008. Countries already indebted in the south were suddenly saddled with further debts. Greece could not bear the strain. Its sovereign debt is now unpayable, with interest payments alone forecast to reach 15 per cent of GDP next year. It will have to default.

European banks hold European sovereign debt. French and German banks have about 69 per cent of Greek debt held abroad. A messy default threatens financial calamity, but Greece's creditors cannot yet agree on how to manage the process. And yet default is inevitable for Greece, and a credible threat elsewhere. This threat is freezing up financial markets. The system is deadlocked.

The result: austerity and stagnation

Governments across the developed world have not been able to break the deadlock. Instead they have opted for austerity, cutting public spending and hoping debts can be repaid quickly. But austerity cripples economic growth. As spending cuts bite, firms sell fewer goods and services. They cut salaries and make redundancies. Economic activity freezes up, as Ireland, Greece and now the UK are discovering. Austerity privileges financial assets at the expense of real economic activity. It is self-defeating, but governments are driven towards it.

The slow decay of the developed economies is now menacing fast-growing new centres. **China, which had sailed through the previous financial crisis, is now threatening recession**, with orders declining as its major export markets stagnate. As Japanese experience shows, stagnation, compelled by debt, can last for decades. A genuinely global recession is possible.

Reboot the economy

The old system is broken beyond repair. A new economic model is needed. There can be no return to the old economy, fuelled by debt – and by carbon. New ways of thinking about the economy are urgently needed, that challenge the primacy of financial markets and debt-fuelled growth. It's time to:

- **Radically transform the financial system.** From democratising the banking system to writing off bad debts and stamping out speculation and tax avoidance.
- **Restart productive economic activity.** That means ending austerity, ensuring banks lend to businesses and using public investment to create new, low-carbon infrastructure and affordable housing.
- **Refocus and rebalance our economy with a plan for jobs** that regenerates local economies, reduces inequalities and establishes a 21st century industrial strategy.
- **Overhaul the tax system to shift the burden off jobs and incomes** and onto assets and pollution.

Even if growth returns, we cannot go back to the old ways. A sustainable new economy must be built without the chronic dependence on either debt or carbon.

Read more about the economic alternative at: **www.neweconomics.org/reboot**

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