

## **The New Capitalism**

There's next year, and then there's the next decade.

Economic conditions in 2009 will be treacherous. There'll be a formal recession in most developed economies, and the economic contraction is highly likely to be more severe in the UK than almost anywhere else.

Companies and consumers will continue to tighten their belts. There'll be a sharp rise in unemployment. The extraordinary volatility we've experienced in the price of sterling, commodities, energy, shares and capital - which makes it so hard for businesses and investors to plan - is unlikely to dissipate.

Many businesses, especially big ones, will become unviable - and will present the Government with an appalling dilemma of which ones to put on life support.

So it's understandable that most of us, including ministers, central bankers and regulators, are planning for the next few months. We're building the economic equivalent of bomb shelters and mobile hospitals.

But this is no downturn like any we've seen since the Second World War, for two reasons: it's global; and its primary cause is the pricking of a massive debt bubble.

We borrowed too much, especially in the US and the UK. And the process of paying the money back is not only leading to a fall in living standards but is also precipitating very significant changes in how the global financial economy operates.

Capitalism is changing in fundamental ways. For many years to come, what's happening will affect the relationship between business and government, between taxpayers and the private sector, between employers and employees, between investors and companies.

Arguably the global economic crisis will turn out to be more significant for us and other developed economies than the collapse of communism.

A New Capitalism is likely to emerge from the rubble. And although it's impossible to be precise about how the reconstructed economy will operate, parts of its outline are taking shape. What lies ahead can be determined from an understanding of what's gone wrong with the existing model.

This, in itself, is no reason for gloom or despair. For many, the New Capitalism may well seem fairer and less alienating than the model of the past 30 years, in that the system's salvation may require it to be kinder, gentler, less divisive, less of a casino in which the winner takes all.

Here are some of the numbers that tell us what's gone wrong. For the UK, if you aggregate together consumer, corporate and public-sector debt, the ratio of our borrowings to our annual economic output is a bit over 300%, or over £4000bn. That's a similar ratio of debt to GDP as that of the US, and it's a record. Over the past decade, we borrowed and we borrowed and we borrowed: we assumed that the day

when we had to pay it back would never arrive, that there would always be an opportunity to roll over the debt.

Households borrowed too much, £1200bn on mortgages alone. Big companies borrowed too much, especially those taken off the stock market in private equity deals. Note however that for all the political fuss about the need for banks to maintain lines of credit to small companies, they're the unsung heroes of our tale of monumental financial folly: even today, the aggregated savings of small companies exceed their debt.

One of the best ways of understanding how all our debts were accumulated is to look at the gross foreign current liabilities of our banks. These rose from £1,100bn in 1997 to £4,400bn this year (again, about three times the size of our annual economic output).

This trend tells two stories. It shows the massive and unsustainable growth in the City of London and our financial services industry - which is now shrinking with a vengeance, at the cost of massive job losses and evaporating tax revenues (perhaps £30bn to £40bn of income for the Exchequer gone forever).

But it also shows that our debts are, to a large extent, the recycled savings of other countries, notably the massive savings and surpluses of China, other Asian economies and the Middle East (one note of caution here: a sizeable proportion of these foreign currency liabilities, but by no means all, were used to buy foreign currency assets).

To put it in crude terms, for much of the past decade, millions of Chinese slaved away on near subsistence wages and still managed to save, both as a nation (China swanks £1,400bn in foreign exchange reserves) and as individuals. And to a large extent they were working to improve our living standards, because they made more and more of the stuff we wanted at cheaper and cheaper prices - and clever bankers took their savings and lent the cash to us, so that we could buy the houses we cherished, the cars we desired, the flat-screen TVs.

This imbalance - between the savings of China, India, Japan and Saudi and our indebtedness, between their massive trade surpluses and our deficits - was never sustainable. At some point, the Chinese were bound to say, "we'd like some of the cake now please, which means you'll have to have a bit less".

Tragically, they toiled for our prosperity - or we lived high on the hog while they fattened the pigs for us - for too long. Which is partly why the return to equilibrium, to a more balanced global economy, is happening in a horribly painful way that's impoverishing millions of people.

For me, therefore, the most important event of the past week was the chastising of the US Treasury Secretary, Hank Paulson, by Zhou Xiaochuan, governor of the Chinese central bank. Zhou said that "over-consumption and a high reliance on credit is the cause of the US financial crisis" and "as the largest and most important economy in the world, the US should take the initiative to adjust its policies, raise its savings ratio appropriately and reduce its trade and fiscal deficits."

This seemed a pretty unambiguous statement by the Chinese that they're no longer prepared to finance the spendthrift ways of the US and UK: they don't want to lend more and they want to be confident that what they have lent won't disappear in a puff of bad debts and inflation.

So the big question is how much debt will we have to repay until our economy is returned to some kind of stability.

This is tricky to calculate.

One important number, which gives us a clue, is the difference between what our banks have lent and what they've borrowed from British households, businesses and institutions that are too small to be players in global financial markets. It's what the Bank of England calls the customer funding gap. And it matters because it's a guide to the dependence of British banks on funds from overseas that are diminishing and could well, over time, drop to zero.

This customer funding gap was nil in 2001. But by the end of June this year, according to the Bank of England, the gap had soared to £740bn. To be more specific, a typical British bank has been raising the funds for 40% of all the loans it makes to you and me from big financial institutions, money managers, giant companies and other so-called wholesale sources.

The problem for British banks (and for those in many other countries) is that this source of funds dried up in August 2007 and it's not at all clear that the tap will ever be turned on again in the way that it was. The trigger of the closing down of wholesale markets was the horrifying realisation by financial institutions in every country that hundreds of billions of dollars lent to US homeowners in the form of low quality subprime loans – and repackaged into putatively high quality investments as collateralised debt obligations – were going bad. This undermined trust within the financial system, in that none of the players could be confident which of them had been poisoned beyond rehabilitation by subprime. And this trust disappeared altogether in September of this year, when the US Treasury chose not to rescue one of the world's biggest investment banks, Lehman Brothers.

This malfunctioning of money markets has also been the trigger for the end of the recycling of the surpluses from China, or others parts of Asia or the Middle East, into loans to us. Over the longer term, it would be a very good thing if these great exporting nations were to consume more of the wealth they generate. That would, for example, create great opportunities for our trading companies. But in the transitional period it's something of disaster for our financial system, because there's a progressive and painful withdrawal of funds from our banks (although this withdrawal of overseas funding from our banks happens in an indirect way, via assorted financial institutions, since China – for example – rarely lends directly to them).

Our banks have been forced to reduce their dependence on these diminishing sources of wholesale funds, which is why they've been lending less to us. And it's also why they've had to turn to taxpayers for financial succour on an unprecedented scale. Since the summer, as an ever increasing number of money managers, huge companies and financial institutions demanded their money back from our banks, the entire

banking system came perilously close to collapse. Our banks didn't and don't have the reserves, for the obvious reason that the cash had all been lent out in the form of mortgages and loans to companies and consumers.

So you and I, as taxpayers, came to the rescue and filled the gap. Over just the past few months, British taxpayers have provided loans, commitments, guarantees and capital to our banks in excess of £600bn (in the US, the equivalent figure for taxpayer support is around \$5,500bn). Which is probably just the beginning.

In the UK, taxpayer funding for our banks is very likely to rise, probably to more than £1000bn, perhaps more still. And the reason is that many of our banks are still some way from equilibrium between the borrowing needs of British companies and households and the deposits and loans they receive from British companies and households.

Here it's necessary to take a detour into the way that credit was created in the boom years and is in the process of being destroyed.

The recycling of Asian and Middle Eastern surpluses to the UK, Europe and the US in the form of loans wasn't a simple conversion of a pot of savings into an identical pot of debt. When loans were used to buy houses, or to support property developments, or to finance hedge funds that trade in every imaginable security and commodity, or to fund the buyouts of companies by private equity firms, these loans pushed up the value of assets. This rise in the value of assets sparked yet more lending, often at higher ratios of the loan to the value of the asset, to do more deals – which in turn pushed up asset prices further.

As we entered 2007, whether you were borrowing several billion pounds to buy a company or £250,000 to buy a house, lenders were prepared to lend you almost 100% of the purchase price with few strings attached.

There's a subtle but important point here. There were twin connected bubbles in assets and credit. Both of those bubbles have burst. Falling asset prices are leading to losses for those who borrowed to buy those assets (hedge funds, private equity firms, billionaire corporate raiders, banks, homeowners). And as they struggle to pay their debts, they sell other assets, driving down the price of those assets and causing losses for other borrowers. And when they can't repay banks, the resources of banks are depleted, which means there's less credit available – and no 100% mortgages or other loans – which drives down asset prices further, which leads to a further contraction of lending, and so on in vicious cycle of decline.

So it is unrealistic to expect our banks to cease the insidious process of contracting the volume of credit they'll provide - whatever the coaxing and bullying of politicians - unless and until the price of property, shares, commodities and other assets stops falling. Or to put it another way, asset prices have to find a floor – and they haven't found the floor yet – before the financial economy can rebuild itself and the real economy can receive the necessary finance that will allow the recovery to begin.

As for alleviating the burden of all that debt, history would suggest that'll necessitate the printing of money on a colossal scale, a revival of inflation, to reduce the real

value of the debt. But as a deliberate strategy, that would be fraught with risks for the Government, since the influential babyboomer generation is now old enough to consist mainly of savers rather than borrowers – who would be the victims of spiralling prices rather than the beneficiaries.

A couple of questions follow. Who's to blame? And where will all this taxpayer support for banks - and probably, before long, for real companies and the real economy too - lead us?

It takes a whole book to assign culpability. But the short answer is that we're all at fault to varying degrees.

The authorities in the US and the UK were aware of the dangers of allowing the financial and trade deficits with China and other exporting nations to persist. They could have corrected these deficits by using tax and interest rate policies to reduce our rampant consumption. But they chose not to do so, because it all looked too difficult. Our own Government turned a blind eye to all the evidence that a rampant lending binge was taking place, because the Exchequer was receiving all those lovely tax revenues from the housing and City bubbles – and because there was kudos to be had from the world renown of our financial services industry.

In 2006 and 2007, I had long conversations with ministers, officials and regulators about how the hedge-fund and private-equity booms – the mind-bogglingly huge rewards available to the stars of these industries - were symptomatic of a malfunctioning in markets. I saw the frenetic activity of these young financial firms as a manifestation that too much debt was available on ludicrously cheap terms that didn't remotely reflect the risks – and this seemed to me to be worrying. The standard response from those who now know better was that it would all come out in the wash in a painless way, that these new firms were a great asset to the UK, and I was fussing about nothing.

A corollary of precisely this complacency was that central banks, such as the Bank of England, were hopelessly wrong in believing that the explosive growth of credit and the surge in the price of assets such as houses was somehow hermetically sealed from the rest of the economy, such that it wouldn't damage everything when the bubble was finally popped. That said, most would say that Alan Greenspan, the former chairman of the Federal Reserve, the US central bank, was the most benighted of all about how the global economy had become safer and sounder.

Also regulators were negligent in allowing the creation of what's become known as a shadow banking system, in which trillions of pounds of long term loans in the western economies were financed with credit that could be withdrawn far too quickly. As for the media, we certainly could have shouted louder about the risks of all that debt being accumulated – but perhaps the volume control was set a little too low because of all the splendid advertising revenue that was generated by the property boom.

And, to repeat, most of us were prone to forget that if you borrow £100, or indeed £4000bn, you have to pay it back one day.

But it's quite hard to mount a convincing argument against the notion that most at fault were the banks and bankers – because they systematically failed to do what they were handsomely remunerated to do, which was to properly assess the risks of all that lending.

Their survival as institutions now wholly depends on the goodwill of governments and taxpayers around the world. From Australia, to South Korea, to Germany, France, the UK and the US – inter alia – taxpayers financial support for the banking system is now equivalent to more than one quarter of global GDP, or more than £9,000bn.

There are reasons to believe that credit from taxpayers can't and won't be repaid for many years, in that this credit is financing the correction of huge financial and trading imbalances between the western and eastern economies. So if we've witnessed a semi-permanent nationalisation of the banking system and will soon see significant taxpayer support for real companies in the real economy, then our banks and private-sector companies will have to work much harder to sustain the goodwill of those who are keeping them alive: millions and millions of taxpayers.

That means, I think, that those running our biggest commercial businesses will have to be more visible. They'll have to manifest a genuine understanding not only of the anxieties of their employees but of all taxpayers. Those chief executives who succeed will be those who imbue in their businesses very simple, commonsense standards of decency. And they'll almost certainly be paid less for doing more, because the pricking of the debt bubble has undermined the institutions – the private-equity firms, hedge funds and investment banks – that were ratcheting up the pay of all business leaders.

But the biggest lesson of all is that we are a million miles from having created the political and regulatory institutions to help us contain the risks of globalisation. We and most of the world may well have been beneficiaries of the open global economy. But as millions lose their jobs in Europe and the US in the coming year, the benefits will be forgotten.

If the unfettered movement of capital, goods and services is going to survive, if there's not going to be a retreat into national fortresses that could impoverish all of us over the longer term, we'll have to find a far better way of monitoring global risks and of bringing governments together to deal with these risks.

Some may see this as a threat to national sovereignty, as the thin end of an anti-democratic wedge that'll see the world ruled by unaccountable bureaucrats. Reconciling our political traditions with the imperative of making safe the globalised world will be a challenge, to put it mildly. But it's not a challenge we can shirk.

Robert Peston, 8 December 2008