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By Ann Pettifor

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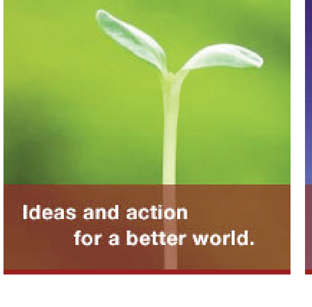


The Credit Crunch and the Green New Deal

By Ann Pettifor

'Finance must be the servant, and the intelligent servant, of the community and productive industry; not their stupid master".

National Executive Committee of the British Labour Party (June 1944), Full Employment and Financial Policy.

The world is now faced by a terrifying prospect: large scale, systemic and long-term economic failure of a liberalised, highly integrated economy, popularly defined as 'globalisation'. This crisis was caused by the bursting of a massive bubble of privately-created credit, issued at high real rates of interest; rates which have now made these debts un-repayable.

The credit bubble was and is the product of actions of policy-makers, from the 1970s onwards. It is the creation of central bankers and political de-regulators, from Nixon through Reagan, Thatcher, Heath, Blair and Brown - not innocent home-buyers and borrowers. De-regulation, liberalisation, globalisation was cheered on by both Conservative and Labour politicians, and it was these frameworks that enabled and encouraged financial institutions to inflate the biggest credit bubble in history.

Excessive 'easy' credit at high real rates of interest, inflated asset bubbles. In other words, easy money blew up bubbles in property, stocks and shares, brands, works of art, vintage cars, and commodities like oil, grains and gold. *(The finance sector, engaged in special pleading, would have us believe that the housing bubble is a root cause of the Credit Crunch. That is self-serving nonsense, and must be challenged.)*

Assets are on the whole owned by the rich, and so 'easy money's' inflation of the value of assets explains why the rich grew so much richer over the last three decades. Why those who owned a property, e.g. could borrow/leverage far more than those who did not.

As we all know, the owners of assets do not need to engage in productive activity, and instead can live by collecting rent on their assets – whether in the form of rents and returns on property, dividends from stocks and shares, rent from the intellectual property on brands, or capital gains from the sale of works of art etc. These are all effortless ways of becoming richer.

Those engaged in productive activity – the owners of small businesses, farms or companies, the waged and middle-income working classes - have not enjoyed a parallel inflation of prices for their goods and services, or of their wages or salaries. Indeed compensation as a share of the national cake that is the economy has shrunk over the last decades. To make up for that, wage- and salary- earners and small businessmen and women have had to borrow and get into debt, just to invest in their businesses, or to pay for a roof over their heads, or to send their children to university, or to stay afloat. They are now burdened by debts, which become unpayable because of rocketing interest rates, or because of the shock of bankruptcy or unemployment.

The first to fall victim to this process on a large scale were the 'sub-prime' debtors of the United States – hit by a hike in rates, and a rise in job losses. But the UK has a bigger debt problem than the US, and so debt dominoes are falling all over the Anglo-American economies, and in countries like Spain.

Defaults and arrears on debts damaged the balance sheets of highly leveraged banks (who had used their mortgage assets to borrow up to 35 times more) and precipitated the Credit Crunch of August, 2007. Their leveraged borrowing and liabilities were hidden behind financial products deliberately obscured and made complex. As banks began to be damaged by defaults on debts that had become too expensive to repay, their complexity, secrecy, deception and often outright fraud led to an evaporation of trust between banks. Inter-bank lending froze, which in turn threatened to freeze the whole financial system. It was this crisis – which hit the headlines on 9th August, 2007, a day we have dubbed 'debtonation day', that forced central banks to pump $150 billion - into the financial system to keep it functioning. However this did not help.

More defaults led to major bank failures and losses; notably the collapse of Northern Rock in the UK and Bear Stearns in the United States, and to the write-off of hundreds of billions of dollars debt. This in turn caused banks to cut back on new lending, and to raise interest rates on loans, worsening the crisis.

A bank is a place where they lend you an umbrella in fair weather and ask for it back when it begins to rain.

Mark Twain (1835 - 1910)

Despite this financial crisis, the Anglo-American economies have not yet, a year later, technically fallen into recession. Unemployment is still relatively low, although it rose each month for the last seven months in the United States, and has started to rise in the UK.

Unemployment is a key determinant of the ability to repay debts. People don't, by and large, pay their debts by e.g. selling their houses or businesses. They pay their debts out of income or revenue. When this is cut, or dries up, debts are invariably defaulted upon.

With rises in bankruptcies and job losses, we can expect another wave of defaults, leading to deeper, more systemic banking crises. It is this negative feedback loop – between the real economy and the imploding finance sector – that poses the biggest threat to the global economy. By contrast a positive feedback loop is what is accelerating climate change – and posing a parallel threat to national and international security. The one – easy credit – has fuelled the other. That is, easy money has fuelled easy shopping (consumption) which in turn has fuelled the growth in fossil fuel emissions by e.g. the coal-fired factories of China, producing goods for consumption, paid for on credit cards, i.e. debt.

This Thinkpiece considers the financial crisis in the context of a proposal by a group of 'new economists', of which I am one, for a Green New Deal (new economics foundation).

How did we get here? By ignoring the lessons of history.

The massive deflation/de-leveraging of credit and debt that is now cascading through the banking system and rapidly deflating the value of housing and other assets in the Anglo-American economies will precipitate large-scale, global economic failure, for years to come. The tragedy is that our predicament is the result of ignoring, denying and even concealing lessons known to our predecessors, especially those that dealt with the Credit Crunch of the 1920s and 30s. The most important of these lessons is that the interests of the private financial sector are opposed to the interests of society as a whole, and therefore have to be carefully regulated by bodies accountable to the public.

Central bankers and elected politicians have, since the 1970s gradually transferred to the private finance sector powers to create credit effectively out of thin air. In addition the private sector, notably the British Bankers Association enjoys the extraordinary power of being able to fix the price of this credit – the rate of interest, in this case the LIBOR rate (the London Inter Bank Offer Rate). Because powers to create credit and fix interest rates are such an extraordinary power, they have almost always been strictly regulated and governed by central banks and governments. The periods during which credit creation and control over interest rates escaped regulation have invariably ended in disaster, most notably the Great Depression of the 1930s. That catastrophe led Keynes and Roosevelt to apply system-wide regulation that lasted for three decades after the war – a period now often defined as 'the golden age' of financial stability.

'We have to put a stop to this financial system which is out of its mind and which has lost sight of its purpose.'

President Sarkozy quoted by Reuters, 26th January, 2008.

Since the 1970s we have been subjected by our politicians to the 'liberalisation' of the economy. Under pressure from the finance sector, politicians and central bankers once again de-regulated finance, and celebrated their 'light touch' over private credit creation, and the setting of interest rates.

The dangers of de-regulation

Because the creation of unregulated credit is almost costless; because the gains are so extraordinary; and because the private sector believed for too long that unregulated credit was without risk, they lent without limit or caution. Their massive, effectively unearned gains were then used to gamble recklessly.

In order to make gains on lending, many in the finance sector deceived fellow bankers about the creditworthiness of their borrowers and about the value of assets on their books. They used false accounting to borrow more on international capital markets; paid large fees to rating agencies for inaccurate ratings on some very questionable assets; paid even larger fees to organisations like AIG to insure these assets, and mis-named them Credit Default Swaps. (They're not swaps at all, just a form of un-regulated insurance, for which there appears to be very little 'collateral' with which to meet claims.) They then used these dodgy ratings and this 'insurance' to entice investors like pension funds into buying their financial 'assets'.

Market players, earnest central bankers and commentators call this misleading and fraudulent activity 'mispricing risk'. In fact it is simply unethical behaviour. Outright intentional deception was employed to deceive bankers, investors (including pension funds) and regulators as to the true state of a financial institution's liabilities. Only when this deception 'debtonated' on 9th August, 2007 did a more accurate assessment of liabilities become possible. Today, in September, 2008, central banks continue to scramble to make sense of the scale of outstanding liabilities. It is clear that even now, they do not know what is owed, and to whom.

Because of their ignorance of the scale of the debts, and therefore the scale of insolvency within the financial system, central bankers have rushed to pour 'liquidity', or new loans, into the banking system. However, more liquidity, we have learned, does not address the root cause of this crisis.

The root cause is a build-up of a bubble of excessive and unpayable credit/debts which have led to widespread insolvency. This includes the insolvency of banks and other shadow financial institutions; the insolvency of companies and the insolvency of individuals and households. Insolvency – as all civilised western bankruptcy law accepts - can only be addressed by writing off, or re-structuring debts. This clears the slate, enables the debtor to start again, and by doing so, restores the economy's overall health.

How to restore stability to the economy.

In order to salvage the global financial system it will be vital to recognise this reality and declare a Grand Jubilee of debt cancellation, to enable debtors to write off unpayable debts, and to allow banks to restore their balance sheets to health. That way the economy could get started again too.

However, such a proposal might well prove unpalatable to financial institutions. The only alternative then, if we are to salvage the financial system, is to raise the incomes of those that must repay debts. Indeed, the UK Labour government's policy of holding down incomes as the debt crisis accelerates is counter-intuitive, and poses a fundamental threat to the interests of the City of London. Mervyn King, the governor of the Bank of England, in his June 2008 Mansion House speech warned that mean average real take-home pay will stagnate this year and the squeeze on real income growth is likely to mean that both house prices and consumer spending weaken together. But it will also mean an increase in debt defaults.

The situation is already becoming urgent in the United States, where the phenomenon of 'jingle post' has emerged. The implicit social contract that ensures that debtors have sufficient income to repay debts has broken down, and so debtors are taking matters into their own hands. Unable to repay their mortgages, increase their incomes or secure their jobs, they simply pop the keys of their property into the post, return it to the bank, and walk away from their debts. As the scale of these defaults rise, so the authorities lose control over the enforcement of debt payments, and over the financial system as a whole. Only until a new social contract is established, either through debt cancellation or through higher incomes for debtors, can we expect the financial system to be restored to stability.

A system-wide transformation.

The Green New Deal goes further and proposes the re-regulation of the finance sector, in particular careful, system-wide regulation of the finance sector's powers to create credit, move capital abroad, and control the rate of interest.

To achieve this we we must end the government's and the Bank of England's policy of 'inflation targeting' – just a cover for keeping interest rates high, and wages low. High interest rates are great for lenders/creditors, but a killer for debtors, and there are far more debtors in the economy than savers. And if we are to face both this financial crisis, and the threat of climate change, we need cheap, but not easy, money to help finance investment in energy security.

Next the Bank of England and the Fed should regain control over interest rates – all rates. The interbank lending rate (LIBOR) should no longer be set by a closed committee of private bankers meeting daily at the British Bankers Association. They must be set by a committee accountable to society, and, when setting rates, must consider the interests of all who make the economy work – labour and industry – not just finance.

To once again exercise control over all rates, the Bank of England will have to re-introduce capital controls. That might require a new international agreement, along the lines agreed at Bretton Woods in 1947.

Such changes are vital if we are to deal with this crisis. But they are vital too if we are to do with two other major 'crunches'. The coming oil crunch, and the coming climate change crunch.

How to create jobs

To create jobs it is vital that central banks build a framework of sustained, low rates of interest to enable affordable public and private investment in the Green New Deal's proposals for "a massive £50 billion a year public and private spending programme to slash fossil fuel use and dramatically increase energy efficiency and renewables' use in every building in the country. This programme, focusing initially on the goal of 'every building a power station' will involve traditional energy-saving measures such as insulation through to large-scale combined heat and power and a greatly accelerated uptake of renewable technology.
The Green New Deal will generate high skilled jobs in energy analysis, design and production of hi-tech renewable alternatives, and large-scale engineering projects such as combined heat and power and offshore wind. Lower skilled work will include loft lagging, draught stripping and fitting more efficient energy systems in all the UK's homes, offices and factories."

New political alliances

In proposing such a strategy, we hope to correct a number of critical oversights. These include the ways in which environmentalists have tended to neglect the role of the finance sector and economic policy; how those involved in industry, broadly defined, have failed to grasp the malign effects of the finance sector on the overall economy; and how trade unionists have for too long downplayed, or under-estimated the role of the finance sector and the threat of climate change.

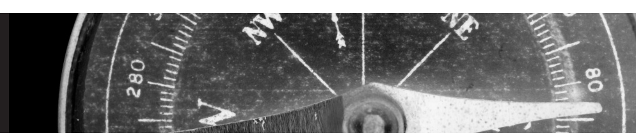
We hope that the publication of the Green New Deal pamphlet by the new economics foundation will help bring these diverse social and industrial forces together, leading to a new progressive movement. An alliance between the labour movement and the green movement, between those engaged in manufacturing and the public sector, between civil society and academia, industry, agriculture and those working productively in the service industries.

Such a political alliance is vital if we are to challenge the dominance of the finance sector in the economy, its threat to the productive sectors of the economy, its corruption of the political system and its corrosion of social and environmental values.

All of this is do-able. Indeed urgently do-able. They are the system-wide fixes needed to deal with systemic threats, and the public expect the guardians of the nation's finances and of the nation's security to implement these system-wide fixes promptly.

Download a copy of A Green New Deal from the New Economics Foundation at http://www.neweconomics.org

The full length version of this Thinkpiece will appear in Soundings journal issue 40, out in November



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"Compass is the democratic left pressure group, whose goal is to debate and develop the ideas for a more equal and democratic world, then campaign and organise to help ensure they become reality."

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