



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

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

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-