Five years on, the Great Recession is turning into a life sentence

Five years into the Long Slump it almost seems as if we are back to square one.

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China is sufficiently alarmed by the flint hardness of its "soft-landing" to talk up trillions of fresh stimulus. The European Central Bank is preparing to print "whatever it takes" to save Spain and Italy. Markets are pricing in an 80pc chance of yet more printing by the US Federal Reserve in September or soon after.

There is no doubt that the three superpowers acting in concert can launch a mini-cycle of growth early next year - assuming they deliver on their rhetoric - but the twin headwinds of debt-leveraging and excess manufacturing plant across the globe cannot easily be conjured away.

The world remains in barely contained slump. Industrial output is still below earlier peaks in Germany (-2), US (-3), Canada (-8) France (-9), Sweden (-10), Britain (-11), Belgium (-12), Japan (-15), Hungary (-15) Italy (-17), Spain (-22), Greece (-27), according to St Louis Fed data. By that gauge this is proving more intractable than the Great Depression.

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For me, the defining moment was twelve days later when yields on 3-month US Treasury bills to crashed from 3.76pc to 2.55pc in just two hours. At first we thought it was a mistake, a screen glitch. Nothing like this had happened before, not during the crashes of 1929 or 1987, or after the Twin Towers attack on 9/11.

Investors were pulling money out of America's $2.5 trillion money market industry in panic. This was the long-feared heart attack in the credit system, even if the economic malaise behind it did not become clear for another year.

The original trigger for the Great Recession has since faded into insignificance. America's house price bubble -- modest by European or Chinese standards -- has by now entirely deflated. Warren Buffett is betting on a rebound. Fannie and Freddie are making money again.

Five years on it is clear that subprime was merely the first bubble to pop, a symptom not a cause. Europe had its own parallel follies. Britons were extracting almost 5pc of GDP each year in home equity by the end. Spain built 800,00 homes in 2007 for a market of 250,000. Iceland ran amok, so did Latvia and Hungary. The credit debacle was global. If there was an epicentre, it was Europe's €35 trillion banking nexus.

Monetarists blame the ECB and the Fed for keeping money too tight in early to mid 2008, pushing a fragile credit system over the edge. They blame "pro-cyclical" regulators for aborting recovery ever since by forcing banks to raise asset ratios too fast. They are right on both counts.

Yet the `Austrian School' is surely right as well to argue that a rise in debt ratios across the rich world from 167pc of GDP to 314pc in just thirty years was bound to end badly. There comes a point when extra debt draws down prosperity from the future. The future arrived in 2008.

A study by Stephen Cecchetti at the Bank for International Settlements concludes that debt turns "bad" at roughly 85pc of GDP for public debt, 85pc for household debt, and 90pc corporate debt. If all three break the limit together, the system loses its shock absorbers.

"Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare. Used imprudently and in excess, the result can be disaster," he said.

Creditors and debtors may in theory offset each other, but what actually happens in a crunch is that borrowers cut back feverishly. Creditors do not offset the effect. The whole system spins downwards. It is debt's fatal "asymmetry", long overlooked by New Keynesian orthodoxy.

It is how people behave, and how countries behave. Creditor Germany did not offset the squeeze in Club Med. Creditor China did not offset the squeeze in the US. The world contracted.

But why did the credit bubble happen in the first place? You could argue that it is merely the flip-side of too much saving. The world savings rate has crept up to a modern-era high of 24pc of GDP. That is the most important single piece of information you need to know to understand the great economic drama we are living through.

There is nowhere for this money to go. The funds flood into investment -- now a world record 49pc of GDP in China -- or into asset bubbles.

So my candidate for chief cause is Asia's `Savings Glut', and indeed whole the structure of East-West trade under globalisation.

The emerging powers built up $10 trillion of foreign reserves -- ie bonds -- in a decade. They flooded the global bond market. That is why spreads on 10-year Greek debt fell to a wafer-thin 26 basis points over Bunds in the bubble.

They also flooded Western markets with cheap goods, driving down goods inflation. Western central banks -- in thrall to inflation-targeting -- cut short-term interest rates ever lower. They set the price of credit too low, forcing pension funds and insurers to hunt frantically for yield to match their books. The central banks compounded the effect.

Western multinationals played their part in this saga. They drove up the profit share of GDP to historic highs, playing off wage rates in the US and Europe against cheaper labour in China, Latin America, or Eastern Europe. That too concentrated wealth among those who tend to buy shares, land, and Impressionist paintings, rather than goods. The GINI coefficient of income inequality went through the roof, as it did in the late 1920s. It is a formula for asset bubbles.

The credit bubble disguised the exorbitant imbalances in trade, capital flows, and incomes. The game could continue only as long as the West in general -- and the Anglosphere and Club Med in particular -- were willing to run ruinous current account deficits, borrowing themselves into dire trouble.

As soon as the debtors hit the brakes and slashed spending, the underlying reality was exposed. There is too much saving and too little consumption in the world to keep growth, and people in jobs. It is the 1930s disease. On this the Keynesians are right.

None of this would have been any different if banks had been saints. The forces at work are tidal in power.

So this is where we are in the summer of 2012. The imbalances are slowly correcting. Wage inflation has eroded Asia's competitiveness. China's current account surplus has dropped from 10pc of GDP in 2007 to around 2.5pc this year.

Yet Europe refused to adjust. Germany is still running a surplus of 5.2pc, down from 7.4pc in 2007. The North has refused to offset the demand squeeze in Club Med. Indeed, Germany legislated its own internal squeeze through a balanced budget law and imposed this curse on the rest of Euroland. The effect is to trap Euroland in chronic slump, at least until the victims rebel and take matters into their own hands.

As for our debt mountain, we have barely begun the great purge. Michala Marcussen from Societe Generale says the healthy level is around 200pc of GDP for advanced economies. If so, we have 100 points to cut.

This cannot be achieved by austerity alone because economic contraction would tip us all into a

Grecian vortex. Such a cure is self-defeating.

Much of the debt will have to be written off. Whether this done by inflation (1945-1952) or default (1930-1934) will be the great political battle of this decade. Pick your side. Pick your history.