George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money - in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let's take Alistair Darling and Gordon Brown at their word. Let's assume they really mean it when they say they're abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That's not just a tax bombshell, it's a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn't understand that there are limits to borrowing, even after he's abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is 'how much more does the British government want to borrow from the markets?'

Talk to former Chancellors and they will tell you that at some point the question becomes 'how much more are the markets prepared to lend?'

That's why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

"The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years."

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government’s record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn’t it?

Until you hear that two thirds of Labour’s new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown’s economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don’t just want Britain to survive the recession.

We don’t want to go back to Labour’s old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it’s the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world’s first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won’t.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

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This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

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As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

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Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government’s record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn’t it?

Until you hear that two thirds of Labour’s new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown’s economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money **-** in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That’s not just a tax bombshell, it’s a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn’t understand that there are limits to borrowing, even after he’s abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is ‘how much more does the British government want to borrow from the markets?’

Talk to former Chancellors and they will tell you that at some point the question becomes ‘how much more are the markets prepared to lend?’

That’s why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

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Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, “Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face.”

That is a technical way of saying that he didn’t fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That’s a difference of £39 billion in today’s money - in the wrong direction.

But if Gordon Brown’s practice of prudence was already long dead, what’s striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government’s pronouncements it’s not very clear what their position actually is.

Just consider the headlines:

“Darling: We must spend spend spend our way out of crisis”

“Darling to reassure on borrowing”

“Darling: tax may rise in the downturn”

“Darling hints at tax cuts to help poorer families”

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That’s not just a tax bombshell, it’s a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn’t understand that there are limits to borrowing, even after he’s abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is ‘how much more does the British government want to borrow from the markets?’

Talk to former Chancellors and they will tell you that at some point the question becomes ‘how much more are the markets prepared to lend?’

That’s why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government’s record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn’t it?

Until you hear that two thirds of Labour’s new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown’s economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

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This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

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That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

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“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown’s desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain’s unusual dependence on external finance.

The coverage of Mervyn King’s speech last week was dominated by his use of the “R” word, but in a sobering passage he noted that “those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s.”

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: “Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run.”

Rising domestic saving and weak domestic spending are central banker’s code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: “We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed.”

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That’s 50% higher than for French debt and twice as high as for German debt.

And there’s another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that “increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good.”

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

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Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

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We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown’s first Permanent Secretary, put it earlier this week, “I think that monetary policy ought to be used as the main weapon.”

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don’t know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term “the automatic stabilisers.”

That is not a virtue, it is a necessity.

So these “automatic stabilisers” should be allowed to function.

That is what is starting to happen now. But we shouldn’t be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that “we have learned from past mistakes… you cannot spend your way out of recession.”

The year before that he said that “Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back.”

And a Treasury document he published in 1999 concluded that “Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended.”

Labour’s abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the ‘prudent’ Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, “Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face.”

That is a technical way of saying that he didn’t fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That’s a difference of £39 billion in today’s money - in the wrong direction.

But if Gordon Brown’s practice of prudence was already long dead, what’s striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government’s pronouncements it’s not very clear what their position actually is.

Just consider the headlines:

“Darling: We must spend spend spend our way out of crisis”

“Darling to reassure on borrowing”

“Darling: tax may rise in the downturn”

“Darling hints at tax cuts to help poorer families”

But let's take Alistair Darling and Gordon Brown at their word. Let's assume they really mean it when they say they're abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That's not just a tax bombshell, it's a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn't understand that there are limits to borrowing, even after he's abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is 'how much more does the British government want to borrow from the markets?'

Talk to former Chancellors and they will tell you that at some point the question becomes 'how much more are the markets prepared to lend?'

That's why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

"The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years."

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

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And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

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We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money - in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That’s not just a tax bombshell, it’s a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn’t understand that there are limits to borrowing, even after he’s abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is ‘how much more does the British government want to borrow from the markets?’

Talk to former Chancellors and they will tell you that at some point the question becomes ‘how much more are the markets prepared to lend?’

That’s why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government’s record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn’t it?

Until you hear that two thirds of Labour’s new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown’s economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

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That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

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That's not just a tax bombshell, it's a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn't understand that there are limits to borrowing, even after he's abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is 'how much more does the British government want to borrow from the markets?'

Talk to former Chancellors and they will tell you that at some point the question becomes 'how much more are the markets prepared to lend?'

That's why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

"The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years."

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

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This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

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We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

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a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown’s first Permanent Secretary, put it earlier this week, “I think that monetary policy ought to be used as the main weapon.”

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don’t know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term “the automatic stabilisers.”

That is not a virtue, it is a necessity.

So these “automatic stabilisers” should be allowed to function.

That is what is starting to happen now. But we shouldn’t be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that “we have learned from past mistakes… you cannot spend your way out of recession.”

The year before that he said that “Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back.”

And a Treasury document he published in 1999 concluded that “Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended.”

Labour’s abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the ‘prudent’ Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money **-** in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let's take Alistair Darling and Gordon Brown at their word. Let's assume they really mean it when they say they're abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

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Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child’s empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson’s Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown’s first Permanent Secretary, put it earlier this week, “I think that monetary policy ought to be used as the main weapon.”

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don’t know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term “the automatic stabilisers.”

That is not a virtue, it is a necessity.

So these “automatic stabilisers” should be allowed to function.

That is what is starting to happen now. But we shouldn’t be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that “we have learned from past mistakes… you cannot spend your way out of recession.”

The year before that he said that “Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back.”

And a Treasury document he published in 1999 concluded that “Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended.”

Labour’s abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the ‘prudent’ Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, “Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face.”

That is a technical way of saying that he didn’t fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That’s a difference of £39 billion in today’s money - in the wrong direction.

But if Gordon Brown’s practice of prudence was already long dead, what’s striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government’s pronouncements it’s not very clear what their position actually is.

Just consider the headlines:

“Darling: We must spend spend spend our way out of crisis”

“Darling to reassure on borrowing”

“Darling: tax may rise in the downturn”

“Darling hints at tax cuts to help poorer families”

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That’s not just a tax bombshell, it’s a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn’t understand that there are limits to borrowing, even after he’s abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is ‘how much more does the British government want to borrow from the markets?’

Talk to former Chancellors and they will tell you that at some point the question becomes ‘how much more are the markets prepared to lend?’

That’s why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

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And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

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As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

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And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

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These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

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This approach learned from the failures of big state solutions.

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The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

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That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

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But let's take Alistair Darling and Gordon Brown at their word. Let's assume they really mean it when they say they're abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That's not just a tax bombshell, it's a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn't understand that there are limits to borrowing, even after he's abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is 'how much more does the British government want to borrow from the markets?'

Talk to former Chancellors and they will tell you that at some point the question becomes 'how much more are the markets prepared to lend?'

That's why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

"The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years."

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

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Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child’s empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson’s Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money - in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

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“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

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We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, “Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face.”

That is a technical way of saying that he didn’t fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That’s a difference of £39 billion in today’s money - in the wrong direction.

But if Gordon Brown’s practice of prudence was already long dead, what’s striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government’s pronouncements it’s not very clear what their position actually is.

Just consider the headlines:

“Darling: We must spend spend spend our way out of crisis”

“Darling to reassure on borrowing”

“Darling: tax may rise in the downturn”

“Darling hints at tax cuts to help poorer families”

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That’s not just a tax bombshell, it’s a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn’t understand that there are limits to borrowing, even after he’s abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is ‘how much more does the British government want to borrow from the markets?’

Talk to former Chancellors and they will tell you that at some point the question becomes ‘how much more are the markets prepared to lend?’

That’s why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government’s record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn’t it?

Until you hear that two thirds of Labour’s new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown’s economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

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a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

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These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

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This approach learned from the failures of big state solutions.

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And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

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In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money - in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let's take Alistair Darling and Gordon Brown at their word. Let's assume they really mean it when they say they're abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That's not just a tax bombshell, it's a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn't understand that there are limits to borrowing, even after he's abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is 'how much more does the British government want to borrow from the markets?'

Talk to former Chancellors and they will tell you that at some point the question becomes 'how much more are the markets prepared to lend?'

That's why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

"The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years."

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

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We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

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The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money **-** in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That’s not just a tax bombshell, it’s a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn’t understand that there are limits to borrowing, even after he’s abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is ‘how much more does the British government want to borrow from the markets?’

Talk to former Chancellors and they will tell you that at some point the question becomes ‘how much more are the markets prepared to lend?’

That’s why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

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That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

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Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, "Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face."

That is a technical way of saying that he didn't fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That's a difference of £39 billion in today's money - in the wrong direction.

But if Gordon Brown's practice of prudence was already long dead, what's striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government's pronouncements it's not very clear what their position actually is.

Just consider the headlines:

"Darling: We must spend spend spend our way out of crisis"

"Darling to reassure on borrowing"

"Darling: tax may rise in the downturn"

"Darling hints at tax cuts to help poorer families"

But let's take Alistair Darling and Gordon Brown at their word. Let's assume they really mean it when they say they're abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That's not just a tax bombshell, it's a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn't understand that there are limits to borrowing, even after he's abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is 'how much more does the British government want to borrow from the markets?'

Talk to former Chancellors and they will tell you that at some point the question becomes 'how much more are the markets prepared to lend?'

That's why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

"The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years."

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

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We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.

George Osborne: Recovery through fiscal responsibility

Speech at the London School of Economics and Political Science (LSE) Friday 31 October 2008

On the wall of my office in Westminster is a set of cartoons from the 1970s depicting the economic calamities of the time.

One shows Denis Healey sitting at a desk with his in-tray piling up with problems – home economy, unemployment, inflation, world trade recession.

Another shows him raiding a child's empty piggy bank.

A third shows the manifesto promises of the Labour Government of the time overwhelmed by an economic avalanche.

Visitors to my office used to look at these cartoons and remark how the world had changed.

I now look at them and think how much is now the same.

Simple Keynesian economics and the active demand management that it recommended were comprehensively discredited in the stagflation of the 1970s.

Repeated attempts to prevent unemployment rising by pumping demand into the system through public spending only succeeded in raising inflation and undermining the credibility of the public finances.

These attempts at Keynesian demand management culminated in 1976 with the humiliation of an IMF bail out – the last time that the IMF had to come to the assistance of a major economy. So far.

Today I want to set out the choice that is now becoming clear over how to deal with this recession.

Why we disagree with the Keynesian approach that Gordon Brown is taking.

And why we believe that our positive alternative, based on fiscal responsibility, is not only the best way to deal with the recession, but is the best way to prepare for prosperity and a new, better economy in the years ahead.

We left the old Keynesian world behind when we adopted a fundamentally different approach.

This approach learned from the failures of big state solutions.

But the approach that learned from the economic disasters brought about by Keynesian demand management was not laissez faire.

The new approach recognised the vital role that the state must play in managing the economy and actively helping families and businesses through difficult times.

In macroeconomic policy, this approach was best encapsulated by Nigel Lawson's Mais lecture of 1984.

He said that it was the job of monetary policy not fiscal policy to manage demand.

And while monetary policy is still free to act in order to stimulate demand, the priority of fiscal policy should be stable public finances and long term sustainability – fiscal responsibility.

That Conservative approach of monetary flexibility and fiscal responsibility became the consensus in developed economies around the world and remains the consensus two decades later.

As Terry Burns, Gordon Brown's first Permanent Secretary, put it earlier this week, "I think that monetary policy ought to be used as the main weapon."

Of course, it would be irresponsible to assume that the future will always be like the past.

For a start we enter this recession with record government borrowing and the highest personal debt any major economy has ever had.

We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, “Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face.”

That is a technical way of saying that he didn’t fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That’s a difference of £39 billion in today’s money **-** in the wrong direction.

But if Gordon Brown’s practice of prudence was already long dead, what’s striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government’s pronouncements it’s not very clear what their position actually is.

Just consider the headlines:

“Darling: We must spend spend spend our way out of crisis”

“Darling to reassure on borrowing”

“Darling: tax may rise in the downturn”

“Darling hints at tax cuts to help poorer families”

But let’s take Alistair Darling and Gordon Brown at their word. Let’s assume they really mean it when they say they’re abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That’s not just a tax bombshell, it’s a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn’t understand that there are limits to borrowing, even after he’s abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is ‘how much more does the British government want to borrow from the markets?’

Talk to former Chancellors and they will tell you that at some point the question becomes ‘how much more are the markets prepared to lend?’

That’s why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

“The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years.”

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

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We don't know how that and the credit crunch will affect the traditional transmission mechanism that turns lower interest rates into higher demand.

So if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times.

But with interest rates still at 4.5% in the UK, we are a long way from that point.

But while monetary policy should play the active role in stimulating demand, fiscal policy does not simply stand still.

Government borrowing rises automatically in a recession, as tax revenues fall and spending on unemployment benefits rises.

This is what is meant by the term "the automatic stabilisers."

That is not a virtue, it is a necessity.

So these "automatic stabilisers" should be allowed to function.

That is what is starting to happen now. But we shouldn't be fooled. This increase in borrowing is the inevitable consequence of recession not a strategy to fight it.

It is an overdraft, not a plan.

The fact remains that you should let monetary policy do the heavy lifting in stimulating demand.

This economic consensus was endorsed by Gordon Brown in his 1999 Mais lecture.

Indeed he sought repeatedly throughout the 1990s to demonstrate his adherence to this approach, in order to persuade people that Labour had changed and would not repeat the mistakes of the 1970s.

Gordon Brown told the Labour Party conference in 1997 that "we have learned from past mistakes… you cannot spend your way out of recession."

The year before that he said that "Losing control of public spending doesn't help the poor. It's those who depend on public services who suffer if spending has to be reined back."

And a Treasury document he published in 1999 concluded that "Loosening fiscal policy when the underlying structural fiscal position was poor could damage consumer and business confidence, thus having the opposite effect to that intended."

Labour's abandonment of Keynesian demand management and adoption of Conservative fiscal responsibility was the centrepiece of the image of the 'prudent' Chancellor that Gordon Brown initially tried to portray.

But, as we all now know, it was always more image than reality.

Gordon Brown started to abandon the practice of prudence almost as soon as he had delivered the Mais lecture in which he most extensively set it out.

Instead of using monetary policy to manage demand, an unsustainable debt-fuelled bubble was allowed to develop.

And instead of fiscal responsibility, reckless government borrowing meant that fiscal policy proved totally unsustainable as soon as the bubble burst.

This was contrary to the tenets of even Keynesiansim, never mind the new consensus around Conservative fiscal responsibility – because Keynes did not just argue that governments should borrow in the bad times – he also argued that they should put money aside in the good times.

But as the Institute for Fiscal Studies put it, “Mr Brown did not leave his successor as Chancellor with the fiscal room to cope with even a modest economic slowdown, let alone the problems we currently face.”

That is a technical way of saying that he didn’t fix the roof when the sun was shining.

The facts show that our economy is in significantly worse shape to cope with this recession than it was before the last one.

In the last full fiscal year before the recession of the early 1990s, Britain had a small budget *surplus* of 0.2% of GDP.

In the last full fiscal year before this recession we had a *deficit* of 2.6% of GDP.

That’s a difference of £39 billion in today’s money - in the wrong direction.

But if Gordon Brown’s practice of prudence was already long dead, what’s striking is that in the last four weeks he has abandoned the rhetoric of prudence as well.

In the process he has explicitly abandoned the modern mainstream consensus on fiscal responsibility and returned to the failed and discredited approach of the 1970s.

He has surrendered the intellectual ground of responsible economic management in favour of good old-fashioned Keynesian demand management.

So he has abolished the fiscal rules.

But he has not replaced them with anything.

He has encouraged speculation about Keynesian spending splurges.

But he has not set out any kind of plan.

In fact if you listen to the Government’s pronouncements it’s not very clear what their position actually is.

Just consider the headlines:

“Darling: We must spend spend spend our way out of crisis”

“Darling to reassure on borrowing”

“Darling: tax may rise in the downturn”

“Darling hints at tax cuts to help poorer families”

But let's take Alistair Darling and Gordon Brown at their word. Let's assume they really mean it when they say they're abandoning any pretence of fiscal responsibility, returning to 1970s Keynesian demand management, and are going to try to spend their way out of a recession.

That means that there is a choice emerging between the political parties about how to tackle that recession.

First there is the choice of spending without restraint and borrowing without limit – the choice Gordon Brown seems to be making.

It is a weak and irresponsible choice.

Weak because his talk of a spending splurge is only designed to give the impression of activity and action.

Irresponsible because it is the road to economic ruin.

For it makes it more difficult for the Bank of England to achieve a sustained reduction in interest rates.

It saddles this generation and the next with a burden of debt that could take a decade or more to pay off.

It means you end up spending more on paying debt interest than defending your country or educating your children.

It means damaging tax rises in the future at the very moment when you want to be reducing taxes to help the recovery.

It may even involve another 10p style tax con where he tries to fool people again, but under Gordon Brown everyone knows we will have higher taxes for many many years to come.

Even a modest dose of Keynesian spending – say increasing it by an additional 1% of GDP - means that in the end taxes will have to rise by the equivalent of almost 4p on income tax.

That's not just a tax bombshell, it's a cruise missile aimed at the heart of a recovery.

And in extremis, it can mean you lose the confidence of the international markets.

Gordon Brown doesn't understand that there are limits to borrowing, even after he's abandoned his fiscal rules.

They are not his limits.

Today everyone assumes the only question is 'how much more does the British government want to borrow from the markets?'

Talk to former Chancellors and they will tell you that at some point the question becomes 'how much more are the markets prepared to lend?'

That's why there are limits to borrowing – not political limits, but actual limits.

Limits to what can be lent and limits to what a country can carry into recovery.

Amazingly there are signs that some parts of the political world need to learn these lessons all over again.

As Michael Saunders of Citi Group, one of the few leading economists who foresaw the current crisis, put it last week:

"The speed with which the political debate already is turning to fiscal loosening raises risks that the overall fiscal loosening in the recession and pre-election period will be so big that the fiscal deficit itself will become a destabilising factor for the economy in coming years."

In other words, that Gordon Brown's desire to spend his way out of the recession will not only make the recession worse, it will undermine the recovery too.

This is not some argument about economic theory.

This is about real lives, real jobs, real homes.

The risky consequences of irresponsibility are not merely a theoretical possibility, they are happening all around us.

The citizens of Ukraine, Hungary and Pakistan are now learning what happens when the markets lose confidence in a whole country.

Their sources of external financing that appeared to be reliable have dried up with astonishing speed.

Several countries in Eastern Europe, Asia and Latin America now risk a repeat of the Asian financial crisis of the late 1990s.

At the moment these problems are limited to emerging markets, but given the remarkable events of recent weeks we cannot be certain they will remain so.

The Governor of the Bank of England himself has highlighted Britain's unusual dependence on external finance.

The coverage of Mervyn King's speech last week was dominated by his use of the "R" word, but in a sobering passage he noted that "those external inflows have fallen sharply – a mild form of the reversal of capital inflows experienced by a number of emerging market economies in the 1990s."

That is an extraordinary parallel for the Governor of the Bank of England to have to make.

Even more sobering was the warning that followed: "Unless they are replaced by other forms of external finance, the adjustments in the trade deficit and exchange rate will need to be larger and faster than would otherwise have occurred, implying a larger rise in domestic saving and weaker domestic spending in the short run."

Rising domestic saving and weak domestic spending are central banker's code for a severe and lasting recession.

Most of these capital inflows have been used to finance private sector borrowing, but the same dangers now apply to government borrowing.

In the fourteen quarters from the beginning of 2005 to the middle of this year, overseas investors bought three quarters of total net UK gilt issuance.

But the head of one fund has already warned that the Treasury can no longer take it for granted that foreign buyers will turn up at bond auctions: "We are nearing the point where Asian and Middle East investors are going to charge a much higher premium for holding British sovereign debt. Once a government loses credibility, these investment shifts can happen with alarming speed."

Already the spread on credit default insurance for UK Government debt has widened from almost zero a year ago to 60 basis points today.

That's 50% higher than for French debt and twice as high as for German debt.

And there's another vital reason why we must resist spending splurges and irresponsible borrowing.

An IMF survey published earlier this month concluded that "increases in interest rate risk premiums as a result of debt concerns can render fiscal multipliers negative, suggesting that discretionary fiscal stimulus may do more harm than good."

Put another way, there's no point pumping more government money in one end of the economy if it delays the lower interest rates that will stimulate private sector activity at the other end.

There's another reason for fiscal responsibility in a recession.

If you don't keep control of public finances, you risk saddling your economy with so much debt that it stifles the recovery for many years to come.

That is not a rock of stability. It is more like a ball and chain.

So everyone needs to understand the true weakness of our fiscal position under Labour.

We need to confront Gordon Brown with the reality.

He has got to stop blithely pretending that he can borrow as much as he wants.

He can't.

Borrowing has limits.

We risk Britain's international credibility at our peril.

So that is the choice that Labour offers.

Irresponsible borrowing now and higher taxes later.

Threatening the country's economic recovery in order to try to achieve its own political recovery.

But there is a positive alternative.

The other choice is to stick with fiscal responsibility – that is the responsible road to recovery.

Allow monetary policy to do its job.

Allow the automatic stabilisers to work.

And do nothing that makes the Bank of England's job more difficult.

And use timely and targeted intervention through the tax system to help families and businesses through difficult times.

By ensuring that we don't borrow without limits in a recession, we will open the way to lower interest rates now and lower taxes later, in the recovery.

At the root of this entire approach is fiscal responsibility.

Fiscal responsibility is not merely the absence of irresponsibility.

It is a positive virtue that requires hard work and discipline to achieve.

It is what strong governments do and what weak ones cannot achieve.

It is what a Conservative Government will achieve.

That is the economic change we will offer.

How will we achieve it in practice?

Let me set out very clearly what we would do if we were in office tomorrow, with the responsibility of dealing with Labour's recession and clearing up the mess that Labour have made of our economy.

First, we would establish a credible framework for bringing the public finances under control.

Second, we would use timely and targeted interventions through the tax system to help families and businesses through the recession.

And third, we would start even now to prepare the economy for the recovery.

Let's take each in turn.

First, the vital importance of a credible fiscal framework.

As Martin Wolf wrote earlier this month: "The UK needs a renewed fiscal framework if fiscal credibility and sterling's acceptability are to be preserved. Without these, all will be lost."

After Alistair Darling's speech earlier this week, Britain doesn't now have a fiscal framework at all.

He scrapped the fiscal rules but put nothing in their place. He has left a vacuum at the heart of the Government's economic policy.

In its place, we would put a credible medium term strategy for restoring the public finances to balance.

We set it out last month in our detailed plan for economic reconstruction.

It establishes the target of a balanced current budget and falling debt at the end of the forecast period, policed by a powerful and independent Office for Budget Responsibility that will publish independent fiscal forecasts and hold governments to account.

We are being advised by two exceptionally capable and renowned economists on how to put this framework into practice, Sir Alan Budd and Professor Ken Rogoff.

We believe that this is the only way to restore credibility to the public finances and to minimise the possibility of a disastrous loss of international confidence.

Since Alistair Darling regularly adopts Conservative policy, I hope he steals this policy too – it's in the national interest that he does.

The second component of our plan to deal with the recession is to help families and businesses through the recession with timely and targeted interventions through the tax system.

This is the duty of government when times are difficult – we should not stand by while families are losing their homes and good businesses are forced under due to short term cash flow problems.

But the help we give should always be responsible.

We should not try to help people in a way that imperils the public finances – because in the end that would harm everybody.

So our plan would help people directly by getting money into their pockets through the tax system.

Despite Labour's claims, there is no evidence to support the effectiveness of trickle-down spending – the effect on demand of big government spending programmes.

Indeed the evidence from around the world suggests that tackling recession with big spending does not work.

The timing is almost always too late.

Value for money is often very poor.

And public spending can stand in the way of or push aside much-needed private investment.

Japan is the classic example of all three.

Between 1992 and 2002, Japanese government net debt grew by 58 per cent of GDP. Over the same decade, the economy grew by only 9 per cent.

The result was a crippling debt burden and a landscape littered with the evidence of endless white elephant public works programmes.

Big spending and big government is just as wrong in a bust as it is in a boom.

The Government say they will bring forward specific programmes that have already been budgeted for.

But the Government's record at delivering big capital projects on time and to budget does not exactly give you faith that this is the way to beat the recession.

Not this one, anyway – it will all be too late for that.

To take the example that Labour themselves give to justify their neo-Keynesian approach: a school building programme.

Sounds simple, doesn't it?

Until you hear that two thirds of Labour's new school building projects are currently delayed.

And then there's PFI.

£23.3 billion worth of PFI projects are due to be signed over the next five years.

But these projects are now in doubt because the credit crunch means it's next to impossible to raise money in the private market.

I find it astonishing that a Labour government can put its faith in this kind of trickle-down economics.

It is a completely inadequate and unserious response to the tough economic times this country is facing as a result of Gordon Brown's economic incompetence and mismanagement.

Instead of trickle-down public spending, we would focus on a much more timely and targeted tool: taxation.

We have set out a series of fully-funded and practical policies that would help families and businesses immediately.

These include:

a council tax freeze;

a chance for small and medium sized companies to defer their VAT bills for up to six months, so that they are not driven out of business by cash flow problems;

and a cut in payroll taxes for the smallest companies, to boost employment.

On top of these we would stop the planned tax rises on family cars and small businesses.

On their own, these individual measures won't stop Labour's recession.

But taken together they would reduce the human cost of this crisis and speed the recovery – without ruining the public finances in the process.

The third component of our plan to help deal with the recession would be to make sure we prepare for recovery, not just survive the downturn.

Over the past decade, seventy percent of our economic growth has come from just three sectors - housing; financial services and government spending.

We have seen where this dangerously narrow economic base has left us.

More vulnerable to the financial crisis than any other major economy.

And facing a tax black hole as receipts from property transactions and the City dry up.

As Warren Buffett so memorably put it: "You only learn who has been swimming naked when the tide goes out."

Well the tide has gone out and it isn't a pretty sight.

But Gordon Brown's imbalanced economy hasn't just brought us to where we are today.

Looking forward, it means our prospects for growth are weaker than they should be.

Unlike many other countries in Europe, we can't turn to a strong manufacturing base to provide export-led growth, because manufacturing has shrunk by more than a million jobs over the past decade.

And we can't put our faith in the high-tech service sector – like in America – to drive growth, because we haven't created the right conditions for it to flourish sufficiently over the past decade.

Take a sector like green technology, for example – an emerging global market that is expected to be worth trillions of pounds in the decades ahead.

The UK is clearly failing to fulfil its potential.

According to official government figures, UK firms have less than a five per cent share of the global market for green goods and services – less than France, Germany, Japan and the United States.

But the structural imbalance of the British economy after 11 years of Labour goes beyond the narrow sectors upon which growth has relied.

It applies to the geography of growth too.

Labour's multi-billion pound regeneration schemes have fundamentally failed to achieve the goal of stimulating regional growth outside the South East.

All this has got to change.

We don't just want Britain to survive the recession.

We don't want to go back to Labour's old economy.

We want to help build a new, better economy.

We need economic change, not more of the same.

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So we will introduce a simpler and more competitive tax system, cut the headline rate of tax for businesses, and tackle red tape.

But creating a better, balanced, modern enterprise economy is not simply a matter of government getting out of the way.

As I have said many times before, while we must be aware of the limitations of Government, we should never be limited in our aspirations for Government.

So we need a new vision to bring about the skills, energy and transport infrastructure that will enable new jobs and new growth in new industries and new markets.

Here, it's the Conservative Party that is showing the way forward.

To improve our skills base, we would transform our school system through supply side reform, creating more and better school places in every community.

To help British companies claim a bigger share in the market for green goods and services, we would lead a change to green taxes, introduce the world's first trading market for green companies and create a system of feed-in tariffs to incentivise the development of microgeneration technologies.

To promote enterprise in every corner of the country, we would implement our detailed plan to open up the £125 billion government procurement budget to small businesses.

And to unleash dynamic regional growth, we would build a high speed rail system that will link cities across Britain and transform regional economies.

Never again must we leave ourselves so dependent on a few narrow sectors and regions for growth.

With our plans – we won't.

We will create an economy that is truly built to last.

So the keystone of modern Conservative economic policy is responsibility.

Responsibility when times are good to fix the roof and set money aside for a rainy day.

Responsibility too when times are tough so that the country is not crushed under such a burden of debt that it kills off any chance of lower taxes in the future.

Gordon Brown has abandoned not only the practice of prudence but its rhetoric too.

He is trying to spend his way out of a recession and that will not work.

That means there is now a clear choice in British politics.

Irresponsible borrowing now and higher taxes later under Labour.

Or the responsible Conservative plan, enabling the Bank of England to deliver a sustained cut in interest rates and lay the ground for lower taxes later.

Helping families and businesses today by getting money into their pockets directly, instead of hoping that trickle-down public spending will work one day.

Building a better economy for the future through economic change, not more of the same.

And above all, preparing for the recovery through fiscal responsibility, not burying it under a mountain of debt before it starts.