It is a pleasure to be here at the LSE to give my first speech on economics as Shadow Chancellor.

And it will come as a relief to hear that I don't intend to lecture you on economic theory today.

In my speech at the headquarters of Bloomberg last August, I set out the lack of economic theory underpinning George Osborne's economic strategy – as well as the large extent to which political calculations were already driving the new Government's policy.

And I want today to look at what happens when policy-makers are confronted with a choice between politics and economics – and the consequences of getting that choice wrong.

Throughout history, pivotal moments when leaders have faced a choice between two opposite courses of action have often been described as 'a fork in the road'.

But in peacetime politics or economics, such moments tend to involve less of a clear-cut choice between two divergent paths and more of a gradual drift in one direction or another.

Take the fateful decision for Britain to join the ERM.

That wasn't the result of great minds sitting around a table one day weighing up the pros and cons: it was the product of years of deliberation and delay, persuasion and preparation, through which a consensus was slowly built and those who disagreed – like Alan Walters – were gradually isolated.

And the decision not to join the Euro in 2003 – while much debated at the time – is also seen by many historians as pre-ordained from the moment the five tests, and responsibility for their assessment, were agreed six years before.

I am not sure they are right because the circumstances at the time were critical in determining the final outcome.

But it is certainly true that many people believed the case to have been weak for some years beforehand – and hindsight has undoubtedly proved them right.

So in contrast to those gradual shifts, it is all too rare in recent history to see a Chancellor genuinely coming to a 'fork in the road'.
German reunification, twenty years ago this month, was one such moment.

So was Winston Churchill’s decision to re-join the Gold Standard in 1925 at the dinner at No11 Downing Street where John Maynard Keynes famously made – but lost – the argument against a return to gold.

And I believe another ‘fork in the road’ took place a year ago when George Osborne entered the Treasury.

Because whatever the bluster of the election campaign and whatever the private talks between his advisers, Treasury officials and Liberal Democrats, it could only have been when George Osborne arrived at his desk and examined the figures presented to him that he could properly assess the choice he faced.

And there was a choice.

On the one hand, to continue with Labour’s economic plan: maintain the emphasis on jobs and growth, while continuing a steady and balanced approach to halve the deficit in four years.

On the other, a political decision to eliminate the structural deficit in a Parliament – a fiscal tightening of such scale and severity that it would have to begin immediately.

It is the right of a new government to change course.

But while he might have been expected to carefully contemplate the fork in front of him and consider the consequences of his decision, George Osborne did not hesitate in making a rash and headlong lunge down the path of rapid deficit reduction.

Within two weeks of taking office, he announced £6 billion of immediate spending cuts – cancelling the Child Trust Fund and the Young Person’s Job Guarantee.

A few weeks later, a year ago next Wednesday, his first Budget announced plans to take billions more out of the economy through a combination of deep spending cuts, new tax rises and benefit cuts.

He said:

- Rapid deficit reduction is the priority;
- There is no choice – the markets demand it;
- The faster we cut, the better for confidence;
- No alternative is possible;
- And anyone who says otherwise is a “deficit denier”.

Shortly afterwards at Bloomberg, with the Labour Party caught up in its leadership election and the economic data looking up, the Chancellor allowed himself to become prematurely complacent:

- He declared that we could be: “cautiously optimistic about the economic situation”;


- And he highlighted the recent economic data, saying: “As the Bank of England confirmed last week, this is consistent with the kind of gradual recovery forecast by the Office for Budget Responsibility at the time of the Budget.”

It was even more striking when David Cameron claimed in October that our economy was: “out of the danger zone”.

But the figures they quoted in support of this argument weren’t the result of their policies – they were just taking the credit for the actions taken by the Labour government before the election.

Even now, George Osborne berates the media for not reporting that 377,000 net jobs have been created in the past year; but omits to mention that 69% of those jobs were created in the six months before his Spending Review last October – less than a third since.

When I myself spoke at Bloomberg, a few weeks after the Chancellor, I explained my concerns about the state of the economy and about the impact that George Osborne’s decision would have on jobs and growth.

I was – and remain – deeply suspicious that he was using the imperative of deficit reduction as convenient cover to drive through a deeply ideological programme of cuts to public services and the welfare state.

But since then, I have become more convinced that George Osborne’s plan was primarily about electoral politics – rapid tax rises and spending cuts chiefly designed to fit a political timetable that:

- gets the pain over early;
- makes Labour take the blame;
- uses the Liberal Democrats as a human shield;
- hoping to store up a Tory war-chest - bolstered perhaps with the proceeds from a quick sale of Northern Rock - to cut income taxes before the election.

In my Bloomberg response, I argued that:

- Of course, getting the deficit down is necessary and important;
- But going too fast for political reasons risks killing off the recovery and crushing confidence - perversely make it harder to get the deficit down;
- I recognised that the prevailing consensus was against me in making this argument;
- But also that economic history shows that the contemporary political consensus in Britain about the right course for economic policy is often wrong;
- And I argued for a slower and more balanced approach to deficit reduction, which only kicks in once the recovery is secured.

As for which of the two Bloomberg speeches last August was right…
...it is still too soon to say.

But it is not too soon to continue the debate.

And today I will argue that the accumulating evidence shows that George Osborne’s political gamble is taking our economy down the wrong path at huge cost to families and businesses – but that it’s not too late for him to change course.

THE DOWNING STREET STAIRCASE

I don’t doubt that - twelve months on - George Osborne will, in his private moments behind the door of No 11 Downing Street, be asking himself – did I choose the right path? How will history judge me?

Traditionally, every outgoing Chancellor chooses a picture to hang above the staircase leading up to the Chancellor’s state rooms.

In the earliest days, the Chancellors chose simple ink portraits or caricatures of themselves. But at some point over the last century, Chancellors began choosing cartoons that they believe best sum up their time in office.

George Osborne will have seen Nigel Lawson’s choice of cartoon, from The Economist in February 1988.

With the economy booming, Lawson is depicted as a fisherman sitting on the bank, resting contentedly against a mountain of fish as he feels yet another tug at the line.

A month later, he delivered a Budget proclaiming that the economy was at its strongest since the war and providing a final flourish of a 2p cut in income tax for middle earners.

Of course, things didn’t quite turn out as Nigel Lawson planned…

The Chancellor will also have seen the Nicholas Garland cartoon hanging on the No 11 staircase chosen by Norman Lamont.

Lamont the gardener is smiling in the sunshine, bending down to water his green shoots of recovery.

Behind him a tornado is gathering.

And in the swirling darkness, a farmer is sharpening his scythe to cut down those green shoots.

On the scythe, it says ‘Public Sector Deficit’…

So what does George Osborne take from these lessons of history?

Quite possibly:

- He convinces himself that the sole threat to his political dream of emulating Lawson by cutting income tax before the election is the public sector deficit;
- But does he conclude from the Lamont cartoon that his rapid deficit reduction plan is the biggest threat?

- Or does he draw the wrong economic lesson that it is the deficit itself that is stifling the recovery and that if he does not take the political decision to roll back the state, there will be no room for the private sector investment he is relying on to ride to the rescue?

Only the latter would explain why in March he delivered what – now the dust has settled – must be considered a do-nothing Budget: the Budget of a Chancellor who had already made up his mind last May, whose political course is fixed and who will not be blown off course by economic fact or logic.

THE JUNE 2010 BUDGET – ONE YEAR ON

In April, a month after that do-nothing Budget, George Osborne told the Cabinet that the economy was “roughly in the right place”.

Was he right and where is roughly the right place?

This week marks a year since the newly formed independent Office for Budget Responsibility (OBR) made its first economic forecasts.

And we can now compare those pre-Emergency Budget forecasts with those published in March:

- A year ago, the OBR forecast growth of 2.6% in 2011 – they now predict just 1.7% and even that three time-downgraded figure is looking optimistic compared to recent lower forecasts from the OECD, the IMF, the NIESR and the British Chambers of Commerce;

- Unemployment forecasts for the next four years have all been revised upwards;

- Inflation forecasts for the end of 2011 have risen sharply from 1.6% to 4.2% – with a further increase next year;

- And the result of this slower growth, higher unemployment and higher inflation is that the Government will have to borrow a further £46 billion more than forecast after the Spending Review.

This was definitely not part of the Chancellor’s script a year ago.

So what has gone wrong?

WHY IS THE UK ECONOMIC RECOVERY STALLING?

The first signs that things weren’t going to plan came in the late autumn.

Unemployment started rising again in September – reaching a sixteen year high in December.
Surveys also showed the biggest fall in consumer confidence for nearly twenty years.

But it was in January that alarm bells really started to ring when the GDP figures for the fourth quarter of last year showed that the UK economy contracted by 0.5%.

To begin with, George Osborne famously tried to blame the snow.

But it also snowed in America, Germany and France – and they all posted strong growth.

Indeed, the only other European countries with falling output at the end of last year were Denmark, Ireland, Greece and Portugal – and the latter two countries don’t tend to get much snow, even in winter.

Since then, the economic figures have pointed in different directions – bad news on manufacturing output last Friday, welcome better news on unemployment yesterday.

But overall the evidence has mounted that things are not going according to plan - and George Osborne has developed a new weather-related line.

We heard it last night at the Mansion House when he blamed what he calls “global headwinds”.

Of course there are factors outside of the Chancellor’s control – like rising oil and food prices, the difficulties in the Euro zone and the Japanese earthquake – all of which are having an impact on the British economy.

That is why prudent Chancellors always have to be vigilant and choose caution over complacency.

And let me say - there is a certain irony in George Osborne blaming the global economy now, given how that he and David Cameron spent the last three years insisting that the worldwide recession was made in Britain.

But the fact is that the UK is doing badly compared to other countries also affected by those same global headwinds:

- Looking at growth across the EU over the last six months compared to the previous six months, we have gone from the top end of the economic growth league table to fourth from bottom – with only Denmark, Greece and Portugal below us.

- And while policy-makers in the US are worried that their recovery is slowing down, the US has nevertheless still enjoyed growth of 1.2% over the last six months – compared to our zero.

To many leading economic commentators - and three recent winners of the Nobel Prize for Economics, Christopher Pissarides, Paul Krugman and Joseph Stiglitz – this poor UK economic performance has not come as a surprise.

The scale of the fiscal hit to demand and growth in Britain this year is unprecedented. And it is happening at a time when interest rates are already very low and can’t be cut and when other countries are also trying to cut their deficits at the same time.
It is this combination of factors which suggest that the impact of this fiscal contraction on economic growth in Britain – what economists call ‘the fiscal multiplier’ – will be considerably more severe than even the OBR’s downgraded forecasts suggest.

What has surprised many observers is how - even before the real impact begins - expectations of tax rises and spending cuts to come have drastically weakened confidence and deferred spending.

And confidence will have been further hit by the very public debate about when interest rates will have to rise – in part in response to those global headwinds – but mainly because of George Osborne’s mistaken decision to raise VAT to 20% in January.

So while it isn’t surprising that those who are backing George Osborne have re-affirmed their support in recent weeks, even they are getting worried:

- The outgoing CBI director-general, Sir Richard Lambert, warned in January that: “It’s not enough just to slam on the spending brakes. Measures that cut spending but kill demand would actually make matters worse”;

- The FT’s editorial after the first quarter growth figures were published provided some solace by saying: “This newspaper supported George Osborne, the chancellor, in his decision to reduce the structural deficit faster than his predecessor planned” – but the sting was in the tail as it then added: “But this does not amount to unqualified support for tightening in each and every circumstance”;

- The deputy secretary-general and chief economist of the OECD told The Times last month that: “…we see merit in slowing the pace of fiscal consolidation if there is not so good news on the growth front…”

- The Daily Telegraph said in a recent leader that those growth figures: “should be giving George Osborne some sleepless nights”;

- The Independent has reported that the Chancellor has had to “fend off doubts” and “jitters” about his economic strategy from Cabinet colleagues”;

- As we saw in The Observer a week ago, some of the economists who supported his plan a year ago in a letter to the Sunday Times are having their doubts;

- And most recently, the IMF – while sticking to its familiar script – said: “there are significant risks to inflation, growth and unemployment”.

George Osborne and David Cameron have clearly been paying attention.

Because while there is no change in their policy as yet, we can see a change in their rhetoric.

Now they say:

- The economy is choppy – but it doesn’t really matter because any growth is good, however slow;

- Changing course would be a disaster for our credibility – so there is no choice but to press on regardless;
- And Labour would have to do the same if they were in power – there is no alternative.

In the rest of my speech, I want to examine each of those three claims.
DOES BRITAIN’S ECONOMIC DRIFT MATTER?

It is easy for politicians to convince themselves that short-term trends don’t matter as long as they believe the long-term prize remains within their grasp.

With the most recent quarter’s growth rate positive again – albeit only making up the contraction at the end of last year – George Osborne must be tempted to try to:

- batten down the hatches;
- rely on his supporters to talk him up;
- try to pin the blame on Labour, by blatantly re-writing history;
- and hope that everyone forgets the damage done along the way.

But as well as being hugely irresponsible, this strategy misses the point entirely.

I have been consistent in saying that a double-dip recession was never the most likely outcome – although it does seem that over the last 6 months we have missed it by a whisker.

But the test for the economy is not whether we avoid a double-dip recession, or whether unemployment rises or falls in any particular quarter, but how much pain is inflicted along the way in lost growth and lost jobs.

Because it isn’t the fluctuating quarterly growth figures that really hurt; it’s all the ground that we’ve lost over the past year – and are continuing to lose every day and look set to continue to lose.

While the American, German and French economies have already recovered to their pre-crisis levels of output, we in Britain are still 4% below that level.

And compared to the OBR’s forecast before George Osborne’s first Budget, their latest forecasts imply that by the end of next year we will be £5.6bn worse off as a country. The cost of that slower growth is equivalent to a loss of income of over £300 for every family.

If UK growth came in 0.5 percentage points below trend in every year of this Parliament, our country would be £58bn worse off in 2015 – that’s £3,300 for every family.

And the OBR has warned that we should expect unemployment to be up to 200,000 higher over the coming years than expected just a few months ago.

So the test for the Treasury isn’t just whether they can post better growth rates - we all know the economy will return to stronger growth eventually – it’s whether they can make up all this lost ground in jobs and living standards.

On the Today programme a few months ago, Evan Davis put to me the view that, with the underlying trend growth rate of the economy fixed, whether tax rises and spending cuts come now or later is really only a matter of timing:

- that the overall amount the structural deficit will need to be reduced by will remain the same;
- that given the rate of growth, the overall amount of spending cuts or tax rises will also remain the same;

- and so, given that it is just a matter of pain now or pain later, why not get the pain over with quickly?

But – and this is the crucial point – the trend growth rate of the economy is not fixed – so this isn’t just about growth postponed versus pain deferred.

Months – or years – of slow growth aren’t something that will be quickly repaired.

It risks leaving a permanent dent in our nation’s prosperity – relative to how prosperous we might have been and how prosperous we are relative to other countries.

Because economic history also teaches us that economies don’t simply bounce back to where they would have been.

Who now doubts that the depth of the recession of the early 1980s had long-term and permanent effects?

Manufacturing jobs and companies lost – never to return.

Small businesses gone bankrupt – losing skills, ideas, networks and potential.

Capital investment plans first postponed eventually dropped and never resurrected.

And most importantly of all, adults and young people out of work for months, which turned into years, and left a permanent scarring effect on their skills, their health, and their ability and willingness to ever work again.

How many people in this room would feel confident about their job prospects if you’d been out of work for over a year and had to compete against other candidates with an unbroken employment record?

So the claim that the current debate about the pace of cuts is simply deferring pain misses the point.

The risk is that George Osborne will wreak long-term, as well as short-term, damage on the British economy by creating a vicious circle of permanently lower business investment, lower income and lower employment, which in turn requires bigger tax increases and deeper spending cuts to get the deficit down.

All at a time too when people are already suffering up and down our country – north and south.

Life is already tough enough if you’re unemployed – and we need to help those people into work.

It’s also tough for all those who have worked all their lives but for whom flat wages, the fear of unemployment, higher fuel and food prices and growing debt means they’re seriously worrying about their futures – and those of their children – for the first time. As Ed Miliband has said, this is a threat to the Promise of Britain – the promise that the next generation will be better off than the last.
And it’s difficult too for pensioners dependent on fixed incomes, as well as for young people wondering what prospects they will have.

But there is a further reason why this matters.

We all know that the financial crisis exposed the vulnerability of banks and the over-reliance of the British economy and tax receipts on financial services.

But it also accelerated the rise of India and China as our competitors – not just in low-cost manufacturing; but in top-class design, education and attracting international investment.

And we can’t afford to be left behind.

We need to rebuild our banking and financial sectors – and do so by rewarding investment and sustainable growth, not short-term risk-taking.

We need a modern industrial policy that provides incentives for technological and scientific innovation.

And we must ensure every company takes their responsibilities seriously and every employee gets the chance to up skill.

As Shadow Business Secretary John Denham has argued, while the Conservative Liberal notion is that support for market-led growth means that the ideal state is one in which government does as little as possible, in truth, markets are inevitably and unavoidably shaped by what governments do, and by what government doesn’t do.

The government boasted of a ‘big bang’ Budget for growth - all we saw was backtracking on large-scale infrastructure projects, the abolition of the RDAs and the scrapping of skills programmes.

And the longer we spend with no or slow growth, the longer the road to recovery becomes, the greater the pain that will have to be endured and the further we fall behind.

So, yes, the current economic drift really does matter.

WOULD IT BE DISASTROUS TO CHANGE COURSE?

The second claim George Osborne now makes is that, however bad things get, it would be disastrous to change course.

This is really the crux of the new argument, as well as the reason why the Chancellor looked so satisfied with IMF Acting Managing Director John Lipsky’s endorsement last week at their joint press conference.

Last autumn, the Conservative-led government said that we didn’t need an alternative.

When news first broke that George Osborne’s plan had sent the economy into negative growth, he said:
“There is no question of changing a fiscal plan that has established international credibility on the back of one very cold month. That would plunge Britain back into a financial crisis. We will not be blown off course by bad weather.”

And he told The Politics Show:

“If on Monday morning I went to parliament and got up at the dispatch box in the House of Commons and said I am abandoning the deficit reduction plan that Britain set out last year, what do you think the reaction would be, I mean within minutes Britain would be in financial turmoil, now I’m not prepared to let that happen,”

But in my experience, maintaining credibility and market confidence involves much more than just talking tough.

There are three tests for a credible economic plan:

- first, there has to be a transparent plan with clear medium-term goals;
- second, that plan must command sufficient political support for it to be implemented;
- but, third, it also has to work – which means, crucially, that the goals must be realistic and achievable, the plan must deliver results and the policy must be flexible enough to deal with unforeseen events.

It was these three tests that Gordon Brown and Alistair Darling knew they had to pass when they put together Labour’s response to the global financial crisis.

The plan was to halve the deficit in four years.

Political support was secured through the legislation that was introduced.

It’s no secret that, back in 2009, I thought even this was too fast.

But the early signs in 2010 were that this plan was working – the economy was growing strongly, unemployment was falling and borrowing came in over £20bn lower than planned – which meant we had the flexibility to slow the pace of spending cuts or tax rises, while still keeping on course for the medium-term goal.

So all three tests for a credible plan were being met.

And then came the General Election.

I have no principled objection to a new government wanting to put in place their own, tougher plan.

After all, it is precisely what we did in 1997.

But it really is absolute nonsense to say that the markets or the Governor of the Bank of England demanded a tougher plan – or that it was the only way to make fiscal policy credible.

George Osborne now claims that, like Greece, Britain was “on the brink of bankruptcy”.
That must have been the first time in history that a British Chancellor has looked not to America, France or Germany, but to Greece, Portugal or Ireland for economic insights.

But while politically convenient, it is also a claim that reveals a complete lack of understanding not just about market credibility, but about how the Eurozone works and about international economic history too.

The truth is that – thankfully unlike Britain – those countries are locked into the Eurozone, where they have no exchange rate flexibility and they are stuck with the same rising interest rates as countries like Germany.

Furthermore, the structure of their debts bears no comparison whatsoever. We have the longest-term bonds of any country – which means we need to raise much less each year and are not so subject to short-term moods in the markets.

And while Greece was descending into turmoil, the UK economy was already recovering, tax rises and spending cuts had been pre-announced, we were over-achieving on a deficit reduction plan entirely in line with the G20 commitment last June and our long-term interest rates were at historic lows.

Historians will debate whether Labour would have been better off conducting a full spending review before fighting the 2010 general election. It would certainly have allowed more detail to be set out about spending cuts, as well as which taxes would have to rise and which we could guarantee would not.

But I don’t for one moment think that had any impact on our macro-fiscal credibility with the markets. The Darling plan was tough – and widely acknowledged to be so, as the term structure of interest rates demonstrated.

Gilt yields had already started falling well before the election - and at a time when opinion polls were narrowing in the run-up to what was clearly going to be a close election.

And while further decisions would have come after the election, what we had already set out went way beyond what other countries had done.

The fact is that we have seen a blatant attempt to rewrite history to suit a political purpose. In my view, the decision to make the need for a much-accelerated deficit plan a matter of ‘credibility’ was entirely political – and was seen by David Laws and Nick Clegg as the smokescreen they needed to explain their complete economic policy volte-face to worried Liberal Democrat MPs and supporters.

Nevertheless the result was that George Osborne was able to meet the first two tests for credible fiscal policy – a clear plan and political support.

But to meet the third test it still has to work.

Because there is one comparison between Britain and Greece, Portugal and Ireland which is worth noting.

George Osborne’s logic is that if Greece, Ireland and Portugal had adopted the same approach that he is taking, they would not be facing such severe and deepening crises.

The problem for him – and for them – is that they did.
In fact, the Portuguese Chancellor went one better by introducing two VAT rises in the past year.

And what they, Ireland and Greece have all discovered – just like Argentina, Brazil and Turkey before them – is that it doesn’t matter how much they cut spending or how much they raise taxes; if they can’t create jobs and growth, their debt and deficit problems get even worse and market confidence falls further still.

My concern is that we are starting to see the same thing happen here in Britain.

If the economy isn’t growing, there are fewer jobs and fewer people in work than there should be, fewer taxes paid and more benefits claimed – which makes it progressively harder to get the deficit down.

And when we see that output has become stagnant over the last six months and that the Bank of England and virtually every major international organisation are downgrading their growth forecasts, this isn’t just bad news now; I fear it will make it harder to get the deficit down – and undermine long-term credibility, investment and confidence at precisely the wrong time.

As the former chief economist at the Cabinet Office, and now director of the National Institute of Economic and Social Research, Jonathan Portes, said last weekend:

“You do not gain credibility by sticking to a strategy that is not working.”

And that is why I – and others – have consistently argued that George Osborne needs to at least consider a Plan B.

History shows that many politicians have fallen into the trap of sticking stubbornly to their guns, in the misguided belief that any deviation will indicate weakness and in the false hope that things will eventually sort themselves out.

But they just dig themselves into deeper and deeper holes.

I’ve already referred to Nigel Lawson and to the ERM.

Let us not forget that there were more than two years between the decision to enter the ERM and the fateful events of Black Wednesday.

Nor that - vitally - once the wrong decision had been taken, there was no retreating.

Twenty years ago this month, John Major defiantly declared in the House of Commons:

“It was right to enter the ERM a year ago; it is right for us to be members now. We are in the exchange rate mechanism; we are staying in it.”

That was the plan.

It had cross-party support.

It had support from the City too.
Speaking to the New York Times in November 1991, the respected Chief Economist of Salomon Brothers said there was: “no indication of currency misalignment” in Europe. For Britain to give in to realignment pressures: “would be neither beneficial for the stability of the ERM nor conducive to achieving [its] economic and currency goals.”

The man who said that?

The IMF’s John Lipsky.

He was far from being alone in the City in holding those views.

But the consensus of that time was not right.

Political support crumbled, credibility collapsed and the pound was withdrawn.

I was working at the FT at the time and watched events unfolding.

David Cameron had an even closer view, working as he did as Chancellor Norman Lamont’s special adviser.

And he will remember as I do the insistent and increasingly shrill ‘jaw-boning’ from a defiant Chancellor who could not acknowledge that continued ERM membership was making the recession worse.

At the end of August 1992, three weeks before Black Wednesday, Norman Lamont summoned reporters to the Treasury at 8am and declared:

“There are going to be no devaluations, no leaving the ERM. We are absolutely committed to the ERM. It is at the centre of our policy. We are going to maintain sterling’s parity and we will do whatever is necessary – and I hope there is no doubt about that at all.”

So will history repeat itself?

And can George Osborne change course if he wants to?

Back then, the pound was constrained by a fixed exchange rate and announcing that the UK would leave the ERM would have led to market chaos - even though Major and Lamont could see their credibility ebbing away as the policy was clearly not working.

Had we joined the Euro, there would have been an even greater constraint on UK economic policy autonomy.

But neither constraint exists now.

Objectives for monetary policy and fiscal policy lie squarely in the Chancellor’s gift.

As I argued back in 1997 when making the case for central bank independence, it is absolutely vital for a country like Britain to have constrained discretion – by which I mean setting clear, transparent and achievable policy goals, but allowing flexibility to decide how to meet them and over what time period.

That is why it is so important that we have both the inflation target and the open letter system, which allow the Bank to explain its actions.
And it is also why it is important to set fiscal objectives over the economic cycle, allowing what economists call the ‘automatic stabilisers’ to keep the economy growing and unemployment down.

But the fundamental problem with George Osborne’s deficit plan is that he has set a political goal to a political timetable which defies economic logic.

And the lesson of monetary policy – and fiscal policy too – over the last twenty years is that changing course when things aren’t working isn’t knee-jerk and doesn’t damage credibility; it’s the only way to stay in control of your destiny and avert a crisis before it’s forced upon you.

It is because George Osborne has from the beginning had the flexibility and discretion to set a new and credible course that I find it so frustrating that he has boxed himself in and now has to ignore the mounting evidence by sticking stubbornly to his guns –making the Major-Lamont ERM mistake all over again.

Every time he says he can’t change course, he makes it harder to do so – and increases the pain of lost jobs and lost growth.

As I argued last week, the cautious thing to do is not to plough on and simply hope for the best.

The cautious thing is to act – and to act now – before any more ground is lost.

And contrary to George Osborne’s claims, there was a credible alternative a year ago – and there is a credible alternative now, which brings me to the third of George Osborne’s arguments.

**WHAT WOULD LABOUR HAVE DONE – THE ROAD NOT TAKEN**

Politically, I can see why George Osborne says there is no other way:

- if his plan works, he can claim Labour failed to face up to the tough decisions;
- and if it fails, he can claim Labour wouldn’t have made any difference.

But on the first charge, I would say that:

- setting out tough fiscal rules just before the 1997 election and sticking to Tory spending plans for the first two years;
- delivering Bank of England independence;
- ensuring that in 1999 all the proceeds from the 3G mobile license sale were used to repay the national debt;
- and resisting UK membership of the Euro;

…they all show that I’m not someone who shirks tough decisions.
And I am making the case for a slower and more balanced approach not because I am a deficit denier, but because this is the tough – but cautious and credible – thing to do.

Let us be clear – when a year ago, we urged George Osborne to:

- stick to a slower pace of deficit reduction;
- rule out a VAT increase;
- and take immediate action on jobs and to support investment;

…that would have been tough.

As Schools Secretary, I set out £1 billion worth of cuts. We identified a 12% reduction to the policing budget.

We had tightened rules on incapacity benefit

But we were proceeding with proper consultation, sensible decision-making and measured reductions – instead of the rush to cut that inevitably happens once you announce that policing budgets aren’t going to be cut by 12% but by 20%.

And we would have avoided what inevitably follows from the rush to cut - humiliating U-turns on forests, school sport, free school milk, the NHS and last week on sentencing policy too.

Sometimes George Osborne tries to claims that Labour’s spending cuts would be similar to his. But this is wrong on two grounds:

- first, because George Osborne is trying to eliminate the deficit rather than halve it – as he boasted in his Budget a year ago, with £40 billion more in tax increases and spending cuts than our plan set out;
- and second, because the Coalition ignores the fact that Labour was over-achieving on its balanced deficit reduction plan by £21bn – which would have given us some flexibility to scale back spending cuts or tax rises if necessary, while staying on course to halve the deficit.

So when I am asked in interviews, what would I be doing differently to cut the deficit…

…the first thing I say is that – in the words of the old farmer being asked for directions by a passing driver – I wouldn’t be starting from here.

And when I say we wouldn’t have put up VAT in January or we wouldn’t have scrapped the Future Jobs Fund and I’m asked how much that would have cost…

…I say the better question is how much has it cost us to lose the growth and jobs that George Osborne has sacrificed?

But if I am arguing that the evidence shows that George Osborne should change course - so what should he do now?
LABOUR’S PRESENT-DAY ALTERNATIVE – A BALANCED PLAN FOR THE DEFICIT, GROWTH AND JOBS

The decision now facing George Osborne is whether to:

- stick to his guns in the face of increasingly gloomy forecasts and hope for the best – but accept that he risks economic credibility, as well as growth and jobs;
- or accept the mounting evidence and move now to a more balanced plan that is credible and will work.

Labour’s plan a year ago was a balanced plan because:

- everyone paid their fair share – with a fair balance between rich and poor, young and the old, and – yes – bankers and the rest;
- there were fair, gradual spending cuts;
- the need to reduce the deficit was balanced with a proper plan for growth and jobs;
- and it was cautious, instead of a headlong lunge down a pre-ordained path.

That is why I believe it would have worked.

And I now urge George Osborne to adopt Labour alternative plan:

- radically slow the pace of deficit reduction;
- re-open the Spending Review and set out a steadier and fairer approach to spending cuts;
- and take-up the plan that Shadow Employment Secretary Liam Byrne and I have set out to take immediate action on jobs financed by a new bank bonus tax.

With the £2 billion that could be raised this year from repeating the bank bonus tax, we believe the Government should provide £1.2bn to fund the construction of more than 25,000 homes across the country. This would generate more than 20,000 jobs and several times more in the supply chain, and as many as 1,500 construction apprenticeships.

He should establish a £600m fund for youth jobs. This would help more than 90,000 young people into work at a time when youth unemployment has reached almost one million.

And he should boost the Regional Growth Fund by £200m.

But I fear that George Osborne will bury his head in the sand for political reasons and stick to his spending plans regardless.

So I have another suggestion for the Chancellor to consider.

When the last Labour government temporarily cut VAT to 15 per cent for 13 months, he dismissed it, saying people wouldn’t even notice.
He may not have noticed – but at the end of each month, millions of families did see extra money in their pockets, and thousands of businesses saw the difference in their bottom line.

As the IFS has said it proved an “effective stimulus”. And the economy received a much-needed injection which helped it return to growth, led unemployment to fall and saw the deficit come in £21 billion lower than expected.

So my suggestion to George Osborne is that, while he will not agree to reverse his mistaken VAT rise permanently, he should now reverse it temporarily until the economy is growing strongly again:

- By putting more money directly into people’s pockets, it would be a boost for consumers who are feeling the squeeze from rising prices and rising taxes – especially pensioners and those on low and fixed incomes;

- The inevitable increase in consumer confidence would help the struggling retail sector;

- It would help to push down inflation – and so reduce the risk of a recovery-choking interest rate rise later this year;

- And it would give the flat lining economy the jump-start it so urgently needs, boost jobs and help us get the deficit down for the long-term.

The question is not the cost to George Osborne of paying for this temporary emergency tax cut, but the price our country will pay if he carries on regardless.

Slowing down the pace of deficit reduction with a temporary VAT cut now would give the flat lining economy the jump-start it so urgently needs, boost jobs and be a better way to get the deficit down for the long-term.

CONCLUSION

So this is my conclusion:

- the path that our economy is being taken down is the wrong one, as the evidence is increasingly suggesting;

- it could prove very damaging for growth, for jobs, for public services, for living standards, for the deficit and for interest rates too;

- at the very least, it looks set to be a path of slower growth and higher unemployment than would have been the case;

- there is an alternative;

- it is more credible than the current plan, not less;

- and it is not too late to change course;

- but George Osborne must put the national interest first and stop trying to score cheap political points by blaming Labour for all his problems.
Of course I am not saying that we are without blame. I have been very clear in saying we should have been tougher in regulating the banks in government.

And I do believe the Vickers commission is a hugely important opportunity for Britain to get the future of banking regulation right – and to lead the global debate.

But trying to blame the deficit on Labour’s supposed wasteful public spending and fiscal profligacy – as the Conservative Party tried to do in last weekend’s Daily Telegraph – won’t work because it is based on total fiction.

The fact is that before the global financial crisis, Britain had a lower deficit and national debt than Labour inherited from the Conservatives in 1997.

The 2007 Spending Review showed the budget was moving into structural surplus – even with our commitments in Iraq and Afghanistan.

And it halved the growth of public spending, while setting demanding efficiency targets.

I do not believe blaming Labour is a viable economic or political strategy.

And neither is waiting.

Keeping your fingers crossed and stubbornly ignoring the economic evidence is no way to make economic policy.

But by doing so, George Osborne risks joining the ranks of Chancellors, Finance Ministers and economists who should have known better, but allowed political imperatives to trump economic realities.

Back in January 1991, explaining why the ERM would succeed despite Britain’s imminent slide into recession, John Lipsky said:

“There is so much political capital tied up in political and monetary union…It is hard to imagine any of the authorities giving up on their goals. By admitting the possibility of a shift in currencies as a policy option it may lower the sense of commitment to irrevocably locked exchange rates.”

He might almost have said: whatever you do, don’t talk about a Plan B.

And today, when I hear George Osborne refuse even to countenance a Plan B, I do not believe this is economic judgement at work – but a political gamble with the nation’s economy from a Chancellor shaping his policies not around constitutional responsibility, sound economics and the protection of jobs, growth and homes; but around a fixed political strategy to win an election in 2015.

I spoke earlier about the staircase in No11 Downing Street.

There is another cartoon that I hope George Osborne has noticed.

It is the one chosen by John Major.

The cartoon by Trog – drawn in April 1990 – depicts the Chancellor at one end of a boat rowing towards the ERM, shouting ‘In In’.
From the riverbank, Nigel Lawson and the Governor of the Bank of England are cheering him on.

At the other end of the boat is Margaret Thatcher, desperately pulling in the opposite direction, shouting ‘Out Out’.

From drawn-out beginning to ignominious end, Britain’s membership of the ERM was a constant battle between politics and economics.

And when you consider it took John Major more than 15 years to even choose that cartoon, you can start to understand how deep the scars were.

But there are crucial differences between then and now.

First, George Osborne has a choice: this time he is not stuck in the ERM or the Eurozone.

And second, he cannot fall back on the argument that Labour supports his policies: this time there is a clear alternative.

When I said as much in my Bloomberg speech last year, it felt like the road less travelled.

Today, a few more voices are joining mine.

George Osborne cannot say he has not been warned.

We are now set on a path of slower growth and higher unemployment than was forecast just a year ago this week.

But he has a choice.

And as long as he is prepared to start putting economics over politics, it is not too late to change course.

ENDS