LSE public lecture in association with the British Chambers of Commerce

A lecture by George Osborne MP, Shadow Chancellor of the Exchequer

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Preparing the Economy for the 21st Century

"It is a pleasure to be here at this event organised by the London School of Economics and the British Chambers of Commerce.

I'd like to thank Howard Davies, the Director of the LSE, and David Frost, the Chairman of the BCC, for inviting me here to speak to you today.

The British economy faces its most testing time for a generation.

My argument today is a simple one.

Britain's economy is not prepared for the difficult times that lie ahead.

The past fifteen years of global growth provided the perfect opportunity to prepare our economy for the twenty first century.

Two billion people - a third of the world's population - have joined the global economy in countries like China and India.

The result has been a huge expansion in global supply, and so strong downward pressure across developed economies on prices, inflation and interest rates.

Around the world, countries like Ireland and Australia shrewdly took advantage of these huge opportunities.

They reformed their economies, made themselves more competitive, and strengthened their public finances.

Both of these countries, for example, now have a "future fund" of assets built to provide security against future shocks and liabilities. Their public finances are well placed. Their competitiveness has risen. Their institutions are stronger.

Our competitors used the fat years to prepare for the lean years. Britain did not.

Failure to prepare

Indeed I would argue that we are the least prepared major economy in the developed world to cope with the current financial turbulence.

Our financial reputation has been badly damaged by the only run on a retail bank in the world.

Our double deficits - external and fiscal - are worse than any other European economy.

Taken together, they are worse than the United States.

And our economy is increasingly inflexible, with falling competitiveness thanks to higher taxes, more regulation and failing public services.

The consequence is that respected economic forecasters are predicting that this year we will experience the sharpest economic slowdown of all the G7 countries.

As Alan Greenspan, who now advises our Prime Minister, says, the UK economy is "more exposed" than the United States to financial instability.
The OECD states that the difficulties are "going to be larger in the UK than elsewhere".
And the World Economic Forum highlights the UK as particularly "vulnerable".
The IFS have pointed out we are particularly vulnerable to a downturn in the financial sector.
Morgan Stanley say that the UK is more exposed than most.
Goldman Sachs, the Treasury's advisers, say "the UK is slowing more than the rest of Europe"
The view of international experts is clear. Britain is not prepared if rainy days lie ahead.

And the blame lies squarely and fairly with Gordon Brown.

His eleven budgets have left us with the worst public finances in Europe.

The system of financial oversight he personally insisted on left Britain as the only country facing a run on the bank.

His taxes and regulations have left the British economy more inflexible and less competitive.

Gordon Brown likes to quote the Bible. But he obviously doesn't know about the story in Genesis of the Pharaoh who was warned to use the seven fat years to prepare for the seven lean years - and did.

Well our Prime Minister was also warned in the fat years to prepare for the lean years - but he set nothing aside. Now most say the lean years are here, the cupboard is bare and Britain is vulnerable.

We've got used over the last decade to Gordon Brown boasting about his reputation for economic competence. But his actions betray him. It is his economic incompetence and fiscal incontinence that have left Britain more exposed than any other developed economy to the current crisis.

Of course, the Prime Minister wrings his hands and says that this crisis didn't start here. We've got used to him taking all the credit when times are good and passing off all the blame when things turn bad.

His mantra, repeated in every interview, is that Britain's troubles are all down to problems in the US sub-prime markets.

But he should know that external economic shocks - so-called exogenous shocks - are inevitable. From the oil shock in 1973, to the bursting of the dot-com bubble, they have always happened and always will.

The challenge for a government is to make sure the British economy is well prepared to withstand these inevitable shocks. That's what putting economic stability first means.

Let's be clear: the trigger may have been pulled by American sub-prime lenders - but the gun was loaded at home.

The Credit Crunch

What do current events teach us about how we need to prepare?

The credit crunch began as a liquidity problem in the world's intensely interconnected international money markets.

The crunch came as US mortgage banks found that rising interest rates meant many vulnerable borrowers could not afford to service their credit - and so defaulted.

In the past, this may have caused a problem in the US banking sector, as in the mid-1980s, when a similar crisis hit Savings and Loans.

But not today. The hugely sophisticated and international financial markets packaged up millions of mortgages, and sold the debt on. The innovation was hailed as an efficient way of managing risk.

The problem was that when the loans went bad, no-one knew who was ultimately responsible for the debts. So far, of the estimated $300 billion losses, only $100 billion have been publicly identified.

Banks still don't know the extent of other banks bad debts. It is this uncertainty that is at the heart of the crisis.

No longer able to trust one another's solvency, highly geared banks stopped lending to each other.

What looked like lack of liquidity has become a lack of credit, resulting from a lack of trust. As Paul Krugman said: "pervasive loss of trust" was "like sand thrown in the gears of the financial system".

The result is that the credit crunch has posed three clear challenges to all advanced economies, including Britain's.

The first challenge has been the immediate institutional one. Have the different institutions that oversee financial services in different countries been able to cope with the lack of liquidity and lack of credit?

The answer is 'yes' - except in Britain. Only in Britain has there been a run on a bank.

The second challenge is the medium-term fiscal one. Are governments in the developed world in a sufficiently strong fiscal position to withstand a slowdown and the pressure that puts on government revenues?

The answer is, in most cases, yes. Most countries have used recent economic growth to

build up surpluses or at least reduce deficits. But not Britain - we have the largest budget deficit in Europe.

The third challenge is the long-term economic one. Are the developed economies of the world sufficiently flexible to recover quickly if there is a serious down-turn?

The answer is that many countries have used recent years to free up the supply side, reduce corporate taxes and make their economies more flexible and more competitive. Britain has instead become less flexible and less competitive. And only the British Government is contemplating a major tax increase on business and enterprise as its response to a potential slow-down - which is economic madness.

So faced with these three challenges - institutional, fiscal and economic - the British government has failed.

Let me set out now what their response should have been - and what our response will be when a Conservative Government is elected.

In the short term, our institutional arrangements need reform.

It goes without saying that the Northern Rock crisis needs resolving now - indeed should have been brought to a resolution back in September.

But we also need to improve dramatically the supervision of liquidity and make the Bank of England stronger and more independent by, among other things, giving it the power to rescue future Northern Rocks.

In the medium term we need to sort out our public finances. And we must reform the failed fiscal rules so that never again do we borrow in a boom and leave our economy so exposed to a downturn.

And in the long term Britain needs a new supply side revolution, that brings greater flexibility and more competitive tax rates to our economy, because flexible economies are more stable economies.

Let me take each in turn.

Weak institutional set-up

In the short term, the Northern Rock debacle has exposed the flaws in the institutional arrangements introduced by Gordon Brown to govern financial crises.

As the Director General of the CBI put it: "this was the first big test of the so-called tripartite arrangement … designed to be the bedrock on which to build stability across our financial system. For whatever reason, this tripartite system has failed to deliver the goods."

Visiting China with David Cameron before Christmas, and meeting leading financial institutions there, I was repeatedly told that while they once had seen the British regulatory regime as a goal to aim for, after the past six months they now see it as a set of lessons that they must learn.

No wonder when banks like Goldman Sachs tell their clients that: "the "Northern Rock"

factor has badly dented the UK's reputation for being the world's pre-eminent financial centre"

The key problem was that when things went wrong, no-one was clear who was in charge. The FSA was supposed to be in charge of the liquidity of individual institutions while the Bank was in charge of the liquidity of the system.

Indeed the Chancellor himself implicitly admits that his predecessor's regime failed. That's why he announced a series of changes to the press last week.

He said that he would set up a new "COBRA" committee so everyone knew who was in charge.

COBRA. It sounds impressive. It conjures up images of a West Wing style war room.

Well it's not. Not many people know, but COBRA stands for Cabinet Office Briefing Room A.

It's just a room. I've been in it many times. It's a bit bigger than Cabinet Office Briefing Room B.

The Chancellor could have called a committee meeting with the Bank and the FSA at any time - in the Cabinet Office or anywhere else. He could call one today.

It does not solve the problem of a lack of leadership.

It is clear that much more far reaching reform is needed.

So let me today set out some of the institutional reforms that we need to introduce to give Britain a twenty first century financial infrastructure.

We clearly need to reform's deposit insurance. Four months ago I wrote to the Chancellor offering the co-operation of the Opposition in doing this - although I have yet to have a reply.

Following the run on Northern Rock, the first £35,000 of savings are protected. I think it is sensible to raise that so that we protect at least the first £50,000 of savings - that would cover 95% of all deposits and is equivalent to the $100,000 that is protected in the United States.

Alistair Darling needs to make clear what level of deposit insurance he supports - is it the £100,000 he talked about in his interview to the Times newspaper in September?

We also need to reform the way the Bank and the FSA supervise the liquidity of individual institutions. There was a clear failure to do this with Northern Rock.

And we need to create a new power for the authorities to take control of a bank on the brink of crisis.

Intervention could be triggered by breaches of either solvency or liquidity rules. And it would be the logical consequence when the Bank of England chooses to act as lender of last resort, so that taxpayers' interests are safeguarded.

Crucially, they must have the freedom to act without pressure from shareholders, to safeguard the interests of creditors, including the taxpayer.

This bank rescue power should set out, clearly and in advance, how all parties - shareholders, savers, and other creditors - will be treated.

It would be a form of administration with the goal of a private sector solution - a work-out not a run-off.

And the power must allow the authorities to free up the deposits of retail customers, as part of a reform of deposit insurance.

I proposed this bank rescue power in an article in the Financial Times before Christmas. I am glad that last week in an interview with the same paper the Chancellor agreed with me.

But we disagree about who should exercise this power. The Chancellor says it should sit with the Financial Services Authority. I personally believe it is part of the role of a strong and independent Bank of England.

There are a number of reasons why. For a start a rescue implies that the principal regulator - the FSA - has probably failed in its prudential supervision. And at a practical level, the Bank is close to the money markets through its day to day provision of liquidity. The FSA has no such daily interaction with the markets.

What's more, monetary policy and banking are inextricably linked. That is obvious at moment when you consider that the monetary conditions facing businesses have tightened, because of the credit problems in the banking sector, even though monetary policy has officially loosened.

After all, it is banks that create money. M0, the money printed in banknotes by, or held in account at, the Bank of England, is just three per cent of broad money stock. The health of the banking sector has a direct impact on monetary conditions.

You cannot separate monetary policy and banking. You cannot keep the Bank of England out of the banking system.
The Chancellor's decision to sideline the Bank of England in favour of the FSA fits in with a recent pattern. Whether it is the Treasury's private briefings against Threadneedle Street or the Prime Minister very public dithering over the reappointment of Mervyn King, the Government is undermining the strong and independent Bank of England which the country needs. At a time of great uncertainty in financial markets, this is one bit of uncertainty we could all do with out.
So the short term challenge the Government can address is the need to reform our financial oversight institutions, increase deposit insurance and give new powers that reinforce the independence of the Bank of England instead of undermining it.
Public Finances

In the medium term, we must restore the health of the public finances.

For in a downturn, tax revenues usually fall and the rate of government spending goes up as welfare costs rise.

These so-called automatic stabilisers help to smooth demand in the economy. But the process works in reverse, so revenues automatically rise when the economy is growing above trend.

Economic stability demands that you save in the good times so that government can afford to help recovery in the bad times.

And after fifteen years of global growth, our public finances should be in a healthy state. Most other countries finances are.

But instead both the OECD and the European Commission estimate that we have the largest structural budget deficit in Europe, a deficit that is more the twice the size of the EU average.

In boom years, when it would have been prudent to save, this Prime Minister borrowed.
In fact over the last five years, he has borrowed over £100 billion more than he originally planned. That's more than we spent on the entire NHS last year.
And despite the Government's recent promises of tighter spending controls, despite the months of uncertainty over the economic outlook, borrowing still continues to rise.
In March 2006 Gordon Brown said he would borrow £30 billion this financial year. Over the last twenty months that estimate has risen steadily.
First it was increased to £34 billion and then £38 billion and now the Institute of Fiscal Studies predicts that borrowing could be £42 billion.
And for the coming year the OECD is forecasting that borrowing could reach almost £50 billion.
The truth is that, thanks to Gordon Brown's economic incompetence, Britain has run out of money.
This is the real reason why, for example, the government is seeking to put some breaks on public sector pay after years of huge increases. Of course, pay restraint is necessary.
However, the Prime Minister said in his press conference at the beginning of this week "the single purpose of this [restraint] is keeping inflation under control."
Prime Minister, that is either wilfully misleading or woefully ignorant.
It harks back to the failed logic of the pay policies of the 1970s.

Of course controlling inflation is crucial for maintaining economic stability. And I note that inflation is higher now than when Gordon Brown entered the Treasury. But the contribution of the pay rounds of the 20% of the workforce who are in the public sector is tiny compared to energy and food prices, or the rising costs of imports from China, or the impact of a falling pound.
Yesterday Capital Economic argued that the inflationary risk "is fairly limited. They conclude: "the truth is that [the Government] simply does not have the money to give away."
So let's try and get some economic literacy into the debate. The reason why Gordon Brown is giving public servants pay rises below the cost of living is because he hasn't got any money spare despite fifteen years of growth.
So with little room for manoeuvre, with no money put aside for a rainy day, what is the solution?
Well as the old adage goes: the time to fix the roof is when the sun's shining.
Savage spending cuts now to deal with the budget deficit would not make economic sense.
It's too late to make sure that the public finances are properly prepared for this coming downturn - and Gordon Brown must face the consequences for that failure.

In the medium term, we can all now see the benefits of our policy of sharing the proceeds of growth so that government spending will grow more slowly than the economy over an economic cycle.

By spending within our means - after a decade of doing the opposite - the public finances will in time be returned to health as government revenues grow more quickly than government spending.
We must also ensure that the economic incompetence of a Chancellor never again leaves the British economy in such a vulnerable position. Never again should we be able to borrow in the boom.
Of course, the situation we find ourselves in is exactly the fiscal rules trumpeted by Gordon Brown when he was doing my job were meant to prevent.

They have clearly failed.

We have already seen that when the golden rule started to bite, the then Chancellor was able to move both the start and end dates of the economic cycle in order to buy more room for manoeuvre. It was like making the defendant the judge and jury in their own trial.

As a result the fiscal rules have failed to ensure prudent fiscal management.

Gordon Brown said last weekend that serious academics support his use of the golden rule. In fact, the exact opposite is true. No serious economic commentator now uses them as an indicator of the health of the public finances.

That is why I have pledged that we will hand the dating of the economic cycle and the verification of fiscal rules to an independent body - so that credibility is restored.

Chancellors will no longer be judge and jury of the very rules that are meant to constrain them.

It is a key part, along with and independent Bank and independent statistics, of the triple lock on economic stability that David Cameron and I set out more than two years ago.

For by restoring trust in the fiscal framework we will ensure that never again will a Chancellor be able to borrow in a boom and leave our economy so exposed to a downturn.

Supply side

Not only must we prepare the economy with immediate reform of our banking institutions and restore the health of the public finances over the medium term, but we also need to make the long term changes that will make our economy stronger, more flexible and more competitive.

A competitive economy is far better prepared to weather a storm than an inflexible and uncompetitive one.

Alan Greenspan puts it: "if we cannot forecast these bubbles or these expansions or even a standard old-fashioned recession, which we can't, it is important that we have a flexible system so that it absorbs the adjustment."

Over the last decade the evidence of our increasing inflexibility has been overwhelming.

Gordon Brown's employment legislation; his £56 billion of additional regulations; his failure to provide the skills and supply the infrastructure we need have each in turn made Britain's economy less flexible. That's before the effects of Alistair Darling's proposed tax rise on entrepreneurs.

And the result?

Our productivity growth- what Gordon Brown rightly called the "fundamental yardstick" of economic performance - has fallen while in the US it has almost doubled.

Take home pay is down, real living standards have fallen, the tax burden is up, and business investment is down. We have fallen down every league table of competitiveness

While a benign global economy shielded Britain from the malign influence of the Brown Treasury, like rocks under a falling tide, the problems are now emerging all too clearly.

In the 1980s, Margaret Thatcher's programme of deregulation and business tax reductions freed Britain to compete. She liberated the supply side and let demand follow.

We have been living off the benefits of that revolution.

But a supply side revolution is not just a one-off that happened twenty years ago. To compete in the new global economy, we need constant reform to attract business from abroad and help domestic companies to grow.

Recent visits to Eastern Europe, Ireland, India and China have reinforced my belief that we need a second supply side revolution to once again catch up, build the environment for enterprise, and become the best place to do business in the world.

We have put forward a radical programme of school and welfare reform, because improving skills and ending dependency are crucial economic tasks in the modern world.

The report of our Economic Policy group last year set out proposals for far-reaching deregulation.

The independent Tax Reform Commission I established showed how we can simplify our business taxes, and we are working with PWC and Grant Thornton on how we achieve that.

These are the long term reforms to our economy that we will make and I will want to be judged on.

My ambition is nothing less than to make Britain the most competitive major economy in the world so that the benefits of globalisation are felt by every citizen, and we see living standards in our country rise not fall.

That, in the end, is the best defence against adversity and instability.

Conclusion

Two years ago David Cameron and I put economic stability right at the core of conservative economic policy, above all else. There were some who attacked us for it.

I believe that recent events have totally vindicated our decision to put stability first.

But stability means more than reciting a mantra.

It means a financial oversight regime that works. It means a strong and independent Bank of England. It means not borrowing in a boom. It means long term reforms to make our economy competitive. It means using the fat years to prepare for the lean years.

Gordon Brown has failed to prepare. That is economic incompetence. And now we must face the consequences."