Mark Field MP on

The Financial Crisis

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Foreword

For keen students of economic affairs, the past twelve months or so since the financial crisis took hold have been the most momentous in a lifetime. As the MP for the Cities of London and Westminster, I have enjoyed the opportunity of a ringside seat, delivering a distinctive analysis of the crisis without falling foul of slavish partisanship or simplistic, short-termist tactical considerations. This collection of essays begins with the text of a speech from a parliamentary debate I initiated entitled *Government Debt* in February 2007 which seems rather a long time ago, when the phrase 'credit crunch' had not been thought of, yet alone coined.

I hope that in the succeeding articles – posted online with national newspapers, political blogs and on my own website over the past year – you will see a distinctive thread to my outlook in what has been a fast moving and enthralling financial and economic crisis. Many of my opinions about the need to appeal for an explicit electoral mandate; the shift of power Eastwards; the need to restore competition rather than introduce rigid regulation in our financial services markets and the concern about large financial institutions being 'too big to fail' have played a small part in developing a modern Conservative analysis of the problems and their solutions.

I hope you find this booklet thought provoking (even if you do not agree with all that I have written) and will not remind me too loudly of those opinions I have made in the past year or so which already appear wide of the mark!

MARK FIELD
October 2009

Government Debt

20 February 2007

Politicians in this country are neither being open nor transparent about the state of the public finances. Too much government borrowing is being made to fund current consumption. We are in this way mortgaging the future and expecting subsequent working generations, some of whom have not yet been born, to foot the bill for the excessive costs of today's healthcare, education and pensions. This approach is neither prudent nor sustainable.

Unfortunately this cavalier outlook to public expenditure has a fairly long political tradition. In the aftermath of the Second World War, Britain frittered away its Marshall Aid on welfare consumption - in stark contrast, of course, with the Germans under Konrad Adenauer and Ludwig Erhard who invested the US-backed aid programme in rebuilding a world-beating, income-generating German industry.

I have to say that my own Party has also failed to address this fundamental problem. During several periods in recent decades, particularly in the early 1970s and early 1990s, the national debt rose as a result of an unwillingness to take difficult and unpopular political decisions to curb current public sector consumption.

The current Chancellor of the Exchequer's own diversionary tactic over the past decade has been to use the mechanism of the Private Finance Initiative (PFI) to remove from the public balance sheet a proportion of the capital costs associated with the government's much-vaunted investment in the public sector. The Treasury's response to criticism over PFI has always been robust. The Chancellor argues that the Private Finance Initiative was set up by the previous Conservative administration and the current government is simply adopting the same rules but under tighter accounting standards.

Unfortunately, however, this defence does not hold water. The concept of 'unitary payments'- the amalgamation of the capital and service costs of PFI projects - has been adopted as a supposedly simple method of allowing easy comparison between contractors during the PFI bidding process. However, so far as the public accounts are concerned, this means that a huge amount of current capital expenditure is transferred to future revenue. In short, PFI acts as a form of disguised borrowing, with repayment being postponed for as a long as twenty or thirty years.

In reality there is no economic difference between PFI projects and the raising of cash from issues of government debt: the principal and the interest need to be paid in both cases. The shrewd device of the unitary payment, therefore, simply gives rise to a misleading picture of future government financial commitments. In truth the obligation to repay principal sums under PFI projects should be accounted for as a government debt obligation, and unitary payments which contain a capital equivalent component should be accounted in the same way as ordinary government debt.

It is a little difficult to describe the workings of PFI projects without being beset with arcane or complex terminology. However in straightforward terms, my contention is this - the lack of transparency and use of off-balance-sheet funding would not be regarded as acceptable in the private sector. Any company, never mind its auditors, adopting such tactics would rightly be subject to critical scrutiny. The supporters of PFI frequently claim that one of its greatest benefits is the ability to transfer the risk of project or service failure to the private sector. Indeed this assertion is often used to justify the superficially generous deals that operators of PFI contracts appear to have won in the course of negotiation. However, the significant profit potential these contracts endow on operators – evidenced by the inflated share price of many companies who have won lucrative PFI contracts for school, transport system and hospital building here in London – comes at a real cost to future generations of taxpayers, who will be footing the bill for today's consumption.

In reality, all too often very little risk is transferred. I suspect that some of this is down to poor negotiation, with most operators - take for example the bus companies in London - running rings round their public sector counterparts in drawing up the repayment terms.

The Treasury admitted to the absence of risk transfer as long ago as July 2003 when it said in the document 'PFI: Meeting the Investment Challenge': 'It is impossible to predict with accuracy the percentage of PFI projects which may fail, but it is important to understand that in the extreme circumstances of failure the government will be prepared to terminate such contracts in accordance with its legal rights, even if at a loss to financial participants in the scheme. Where this happens it will also act within its legal right to ensure that public services will be maintained.'

On the one hand the government commits itself as the ultimate guarantor – and in truth many PFI projects cannot be allowed to fail if only for purely political reasons, as evidenced by the vast and unsustainable deficits accrued by many NHS Trusts. Yet on the other hand, there is often no sum representing that cost on the government's balance sheet.

Whilst admittedly some £20 billion of the capital value of PFI projects has actually been included on the current government balance sheet, estimated payments on the PFI contracts for the twenty five years until 2030 total £138 billion, leaving £118 billion of debt payments unaccounted for. This of course takes no account of those PFI contracts which are set to last beyond 2030. Most independent calculations suggest that at the very least an additional £25 billion should be added to the balance sheet by including a risk rated percentage of total liabilities arising from PFI. However, even this aggregate of £45 billion wildly understates the truth of the situation.

The fact is that the great majority of PFI projects are undertaken by local authorities, as my own constituents will soon discover to their horror when the financial implications of many contracts agreed to by the current Mayor of London become apparent. Worse still, there has never been any pretence about the balance of risk assessment being made for any of these projects and once again, given the vital social and political importance of the schemes, central government as the ultimate guarantor will have to cough up. We have already seen early skirmishes in a battle between the Treasury and the Mayor of London in relation to the budget of the 2012 Olympics which has, as some of us have always predicted, spiralled totally out of control. Clearly a guarantee from the Treasury would have immediately placed this entire project on the government balance sheet and would amount to public borrowing.

There is also a further category of debt which is classified as 'contingent liabilities' by the Office of National Statistics. The general rule here is quite plain – financial reporting should follow the substance of the commercial effect of a transaction, not the form in which it is dressed up. As a result, some £1.25 billion of bonds issued by London and Continental Railway – the body responsible for the Channel Tunnel rail link – were reclassified as government debt in August 2005, because the debt was ultimately guaranteed by the government and the bond holders were not deemed at risk from default. It had been hoped that the Statistics and Registration Services Bill, which has received its second reading in this House in January, would provide the opportunity to end the uncertainty surrounding the government's accounting.

Inevitably as some of our brightest investment banking brains create ever more complex financial instruments, the line between substance and form becomes ever more blurred. Transparency in these matters may not always be easy to achieve. However the case of Network Rail gives rise to strong suspicion that this government has deliberately manipulated the calculation of government debt.

Following the collapse of Railtrack five years ago, Network Rail was set up in such a way as to be legally independent of government. The management restructuring and the fiction that Network Rail was under the control of 'members' has helped masked the fact that some £18.2billion of debt has been run up by the company up until July 2006.

Just over two years ago the Office of National Statistics received advice from the Department of Transport that the government's support for Network Rail's borrowing was 'contingent liability of government' and was classified as such in the national accounts. Nevertheless, the government has guaranteed the debt, and the fact that Network Rail, a company limited by guarantee with almost £20billion of debt, is still regarded as having a credit rating of AAA gives rise to the presumption that the market at least recognises these debts are effectively owed by the government. It should therefore be on the public balance sheet.

One of the reasons that criticism of PFI has been so muted is that private sector operators, contractors, consultants, lawyers and accountants have all made hay over the past decade playing their part as advisers in a process which has proved to be extremely lucrative. It is incontrovertible that the explosion in PFI projects will vary from bad to appallingly bad value for the taxpayer, although as a means of avoiding upfront government debt, this device has also allowed for an almost unprecedented level of school and hospital building.

We need to stand back and face some harsh political facts. In the same way as privatisation under the Conservative government in the 1980s and early 1990s proved irreversible (even Labour's pledge to reverse rail privatisation in the final year of the Conservative administration had to be quietly dropped) so too will PFI. In many ways, from the Labour party's point of view, that is the great genius of the vast expansion of such projects that has taken place since it came to office. The cost the taxpayer will have to pay for PFI projects now agreed will amount to an ongoing additional burden on public expenditure over the next twenty five years or so. Yet the political fallout of trying to unravel PFI schemes in essential services means that the room for manoeuvre open to any future Conservative government in the areas of public expenditure and taxation will be considerably limited.

The economic fundamentals of this country do not look so smart going forward. We are simply kidding ourselves about the true costs of accounting the future. Ironically the Chancellor of the Exchequer recognised this expressly in his early justification for his 'golden rule' (that over the economic cycle, the government will borrow only to invest and not to fund current spending) when he stated that 'the government does not pass on the costs of services consumed today to the taxpayers of the future – each generation is expected to meet the current cost of the public services from which they benefit'.

I have spoken in this House before in relation to the principle of generational conflict. Nowhere is it more pronounced than in the area of pensions reform. Unfunded public pension liabilities mean that tomorrow's taxpayers will be obliged to fund today's ever-larger deficits. Alternatively those who have made their pensions contributions in good faith will see their entitlement collapse. Pensions payments are another example of deferred expenditure – or to put it another way, of government borrowing.

Another element of the unsung extent of government borrowing is in the field of public pensions. The government has claimed that its unfunded public pension liabilities were £460 billion as of 31 March 2004. However this figure was calculated on the basis of a discount rate of 3.5% which the government actuary's department has now revised downwards to 2.8%. In answer to parliamentary questions on this matter, the Treasury accept that the liability of unfunded public pensions amounts to £650 billion and the unfunded element of local government pensions scheme around £70 billion.

Once more there is no easy way out. In essence today's pensioners and those retiring in the near future will be able to rely upon considerably more generous benefits than those just entering the workplace who are paying for these liabilities. Given the fact that there are twice as many voters over the age of 55 as under the age of 35, and that they are twice as likely to vote, it is unrealistic to expect anyone in the political arena to state some bald facts about this matter. Nevertheless, in spite of the orchestrated campaigns, today's pensioners have never had it so good. The reason why many pensioners in their seventies and eighties believe they have so little is because they have failed to pay anything like enough into the system to warrant what they now expect to receive.

These unrealistic expectations have been created and are periodically raised by politicians across the spectrum. That somewhat unpalatable message plays no part in the policy prospectus of any major political party, perhaps for rather obvious reasons. The unspoken message of the political class to anyone under the age of thirty is that your generation will not only have to foot the unfunded cost of pensions for those who are older, but you will also need to significantly lower your financial expectations when it is time for you to retire.

I believe that we run the risk of quite serious social unrest in the decades ahead as the evidence of this appalling generational pyramid sales scam becomes evident. For there is little doubt that future government spending will have to be much higher, not least because there will be ever fewer people in the workforce having to subsidise an ever larger number of dependants, whilst the costs of the National Health Service, for example, continue to rise exponentially as the population ages.

This off-balance-sheet financing is delaying some very tough decisions that need to be made about the future of public spending. It also delays our debate on the way we need to manage public services in future to deliver equity and social cohesion as well as providing for the vulnerable and voiceless in our society. One of the more depressing prospects is that in the years ahead my generation will be seen as having had it easy. This era will be seen as the best of times.

In Defence of Capitalism

8 October 2008

These are dangerous times for capitalism and free markets. In the past few weeks we witnessed an unravelling of the global financial system at a speed so breathtaking that even seasoned financial experts have little certainty as to its eventual implications.

The political class is reeling. How best to balance the need for swift and decisive action to restore stability with concerns at the law of unintended consequences? How to protect depositors and maintain confidence in the markets without protecting and rewarding bankers for reckless risk taking? And how to convey security and certainty to a dismayed public whilst struggling to grasp how this financial turmoil will affect the real economy?

Supporters of free markets and globalisation have been dealt a sore blow. There is certainly a degree of truth to the notion that we are where we are as a result of untamed greed and we shall have to take stock.

But what we must not do is allow a narrative to develop which heralds the current crisis as the start of a new era of corporatism and ever more restrictive regulation. Capitalism, whilst wounded, has not been discredited. Indeed without the dynamism of free trade and markets, billions across the globe would not be enjoying (in many cases only starting to enjoy) the fruits of innovation, creativity and enterprise.

My constituency houses the City of London; hedge funds and alternative assets in Mayfair and St James; a residential population of wealthy global business folk and a service and entertainment sector in the West End which has blossomed from the disposable incomes of a busy London workforce. Capitalism has thrived here. But Conservatives have never shied from exposing some of the problems caused by this wealth explosion.

Last year, to the dismay of some of my wealthier international constituents, we articulated the importance of an equitable tax system for the non-domiciled in response to a growing sense of despair and resentment from hard-working Londoners. The debate on non-doms followed hot on the heels from that over the preferential tax rates enjoyed by those working in private equity. This was essentially a middle class revolt over the unequal rewards to labour. To their surprise, many highly educated professionals working outside the gilded corridors of the financial services sphere saw themselves losing out as the world became more integrated and interdependent.

It has come as no shock to me, therefore, that many people feel little sympathy for the current plight of the investment banker. For a large proportion of British workers, the growth of the City's power has simply increased the cost of living and reduced to a wistful dream any prospect of getting on the housing ladder. Now with a culture of two decades of financial services dominating the central London landscape since the 1986 Big Bang, the banking industry (previously keen to keep government interference or regulation to a minimum) asking for a public bailout has quite understandably been met with distaste. In such a climate, I am deeply worried that the centre of gravity of public sentiment on economic and financial matters has in recent weeks moved firmly to the left. The clamour for heavy regulation and government control in the financial services sphere will increase. So I was very encouraged to see at last week's Conservative Party Conference David Cameron and George Osborne take a brave stand on this issue. They made clear that whilst irresponsibility in banking must be curbed, populist and rushed measures designed to rein in City excess should be avoided.

In the current climate, it would have been all too easy to play to the gallery, a reckless temptation I fear the Prime Minister has failed to resist. As the Shadow Chancellor rightly pointed out, however, Gordon Brown has no place lecturing the City when he has played such a significant role in shaping the failed regulatory system and racking up colossal government debt whilst hubristically claiming to have 'ended boom and bust'.

Similarly, whilst it is easy for us all to target bankers as the most obvious recipients of the decade's boom, we must not forget that the racking up of over £1 trillion of personal debt was the responsibility of the public at large. Nor were the banking fraternity the sole beneficiaries of a house price explosion, which has seen many people accrue more profit from property inflation than they could ever have dreamed of earning over a similar period of time.

It must now be the role of politicians soberly to reflect that this crisis will affect not only the financial services world. The public needs to know that the economy as a whole now stands to be sorely tested in the years ahead as the combination of much diminished liquidity, historically high commodity prices and a weak currency begins to bite.

There is no easy short-term fix and I detect that the public are increasingly receptive to politicians who tell it as it is. We must accept that to a great extent, the housing bubble should be left to deflate. We should reconcile ourselves with the potential loss of some large banking and corporate institutions. At the same time, confidence needs to be restored to our markets through restructuring and recapitalising the financial system and the core of that system sustained – something which will require the determination of a strong government.

Demands for quick-fire solutions and superficially attractive regulation should not be indulged. The Sarbanes-Oxley legislation introduced in the United States after the Enron and Worldcom scandal has taught us two things. First, that recent additional regulation to protect consumers in that country did nothing to stave off the current crisis and second, that in a global economy, business will have no hesitation in relocating if regulation becomes too cumbersome. One positive now being discussed in the City is the possibility of mopping up in the years ahead should other countries, notably the US, be tempted to over-regulate again and further push business our way.

It is worth reflecting at this point that when financial institutions are described as 'too big to fail' implicitly we are also recognising they are 'too big to regulate' and are ultimately beyond the pale of prudential sanction. Perversely the recent set of defensive megamergers in the financial services world will make this worse since regulation is the strongest barrier to entry to the market. This in-built lack of competition will continue to result in a remuneration regime that means the rewards to investment banking employees are roughly seventeen times that of the general economy. The demand for robustly large balance sheets makes for unregulatable institutions, cushioned from competition and able to charge exorbitant fees. These new business opportunities will not be welcomed by the public unless we attempt to modify our own regulatory framework and make regulators more proactive and credible. This can be achieved without stifling financial innovation and flair or introducing unnecessary legislation.

Since 1997, we have had a three pronged system which divides responsibility between the Financial Services Authority (FSA), the Bank of England and the Treasury. After a decade of clement economic weather, the first time the system was tested saw the lack of accountability, division and conflict between each institution and the emergence of competition between regulators. Streamlining must now take place – perhaps through the merging of the FSA with the Bank of England – and the disparities between the regulators and the bankers should be evened up. The huge salary differences between the regulators (on civil service grades) and those they pursue mean that the brightest minds are consistently attracted to the banks, outwitting those who seek to check their excesses.

Banks themselves must in the future become more responsible. Huge success-driven bonuses have until now been based largely on short term results. Instead, reward should be pegged to share price performance (I accept this did not prevent the collapse of Lehman Brothers where employees were given generous shareholdings) and longer term profit goals. Furthermore, rules should be introduced to preside over banks' capital requirements to prevent what risks unravelling into excessive borrowing.

We should also look at the operation of credit agencies, the bodies which rate an organisation's ability to keep to their agreements, resulting in the advance of many billions of dollars a day. Currently, agencies are paid by the same companies having their credit rated, providing a clear incentive for an agency to produce a favourable result. A better system would see agencies either being paid by those lending the money or a general market levy to ensure neutrality.

It should be kept in mind that whilst mergers facilitated by the government can create short term stability, they are ultimately highly risky. Large banks cannot be allowed to fail and in the event of their faltering, financial meltdown quickly looms. As time passes, we must look to maintain smaller institutions which can keep alive an element of competition in the market place. This will be ever more crucial as consumers and businesses find themselves restricted by the offers available from money lenders.

Finally, the United States looks set to take on the greatest burden in sorting out the current mess. Rather than strive to deal with global financial problems, our focus should remain on sorting out our own house. Painfully, this may mean deepening a huge fiscal deficit but if this is to be done, it has to be vigorously and relentlessly driven down the moment the economy recovers.

A daunting task lies ahead and getting it right means resisting the emotional pressure of a public resentful of the money makers and fearful of what is in store. A large part of that pressure can be mollified if the public is made aware of the danger the wider economy is in, the pitfalls of poor regulation and the collective pain which we may all have to grit our teeth and get through.

Indulging in the bashing of bankers and global capitalism will prove tempting for many. As a defender of free markets, free trade and global capitalism, I am willing to bet that whilst government needs to play a crucial role in stabilising and revitalising our confidence-battered economy, it will eventually be hard work, enterprise and freedom in the market place which will ensure our economy thrives once again.

Power Moves Eastwards

9 October 2008

We can all be forgiven for being bewildered by the implications of the turmoil in the global financial markets. Over the past seven months most of the UK's biggest mortgage lenders – and all of the US investment banks – have ceased to exist as independent entities. We are witnessing the first signs of a seismic shift of power from the United States/Europe to China, Russia and the Gulf States.

I believe that the near collapse of the global banking industry will serve to accelerate trends which are already in play. Indeed the US economy may never recover its dominant position in global markets. With hindsight the current financial crisis may be as crucial to the undermining of US economic dominance as the outbreak of the First World War was to Britain's.

The erstwhile expectation that by the middle of this century China and India will have attained the standard of living and international power on a par with the US now needs revising.

I write these words at a time when US and European governments are desperately trying to underpin the global banking system. Amidst a doubling of US national debt as a percentage of GDP there has been a massive destruction of shareholder value. The much vaunted US $800 billion bailout is not only unaffordable but may fail to restore confidence to the financial sector let alone corporate Main Street America. For our part, government borrowing will spiral well beyond the predicted £43 billion this year and £38 billion next. The suggestion that next year's out-turn will see a public sector over-run of £90 billion plus no longer seems so fanciful.

In the midst of all the damage and destruction to the value of the West's financial resources, we also face a major loss of economic power and international prestige. The seriousness of the current situation is only just beginning to dawn on the public at large. In the year since queues snaked outside branches of Northern Rock, there has been a strange calm as if the travails of the financial services sector might somehow be ring-fenced from the 'real' economy. Everyone – whether they yet see it or not – is going to be affected by the seizing up of inter-bank lending. Most worrying is the possibility that the recapitalisation of the UK banking sector may not lead to a restoration of normal credit flows. This is already having a serious impact on future domestic economic growth and is unlikely to be ameliorated even by an aggressive strategy of interest rate cuts.

Whilst European governments try desperately to fix the system, there is a real danger that their co-ordinated long-term commitment of taxpayers' funds will be regarded as unfair both by domestic electorates and by key policymakers in trading partners outside the West. Unfortunately economic theory and public sentiment may pull in opposite directions – to be seen to reward greed and incompetence in the banking sector could prove fatal to any rescue programme.

To put it simply, money is power. Financial power and global political leadership go hand in hand. The bailout of US and European banks will essentially be underwritten by the flooding in the global capital markets of US and European government bonds which will be mopped up by cash-rich sovereign wealth funds in China, the Gulf and Russia. Their money will buy them power. This power will be used to exert more influence – in the case of China and Russia, backed by military force around its borders. Our entire model of democracy and free markets will be put to the test.

As we have seen in recent months, one of the few impediments to Russia exercising military power around its borders is the influence of an educated, wealthy and fast-growing domestic middle class. To date India and China (beyond Kashmir and Burma/Tibet) have shown relatively little interest in exercising their military muscle. As their global financial clout becomes more apparent, so too will their appetite for interference in world affairs.

The Islamic world will also see the West's ongoing economic crisis as an opportunity to exacerbate conflicts in its region. One has to ask who in the West will have the financial clout – or political will –to spend on policing any new flashpoints?

Having visited China three times over the past five years, I have seen with my own eyes the rapid pace of development there. If the US and Europe lose moral leadership in the management of global financial markets then there is little doubt that within a decade the West will be forced to accept China as an equal.

I have spoken several times over recent years in parliament about the impact of debt and have written on my own website about the current crisis. We have been living well beyond our means as individuals and collectively. The use by this government of PFI to fund capital projects is little more than a pyramid sales scam against future generations of taxpayers. The reckoning is upon us.

In short we have been mortgaging our future, expecting subsequent working generations to foot the bill for the cost of today's health care, education and pensions. Back in February 2007 I warned, 'As some of our brightest investment banking brains create ever more complex financial instruments, the line between substance and form becomes ever more blurred…This country's economic fundamentals do not look so smart going forward, and we are simply kidding ourselves about the true costs of accounting in the future'. Today's much vaunted recapitalisation of the banking sector is in essence more of the same – a further debt for future generations to repay.

For some years it has been clear to me that any incoming Conservative government's room for economic manoeuvre would be desperately limited. Now, on top of already historically high levels of government debt and off-balance sheet financing, we face having to grapple with the costs of sorting out the turbulence in the financial industry.

There will be no winners – at least on these shores. These momentous few weeks underpin an accelerated shift of global power eastward.

A Brave New World for Bankers

24 October 2008

Amidst the bewilderingly swift developments of recent weeks in the financial services sector, many in the City can be forgiven for failing to appreciate the extent of change in the landscape that lies before them. Some complacently regard the recent turmoil as a short-lived upheaval and that business will 'return to normal' before long. I fear this will prove wishful thinking.

The decision to launch a full-scale rescue of the domestic banking industry need not have required nationalisation. The enforced recapitalisation of a relatively healthy bank, Lloyds TSB, has – to date – met with only muted opposition from ordinary shareholders whose investment has been largely destroyed. Once the dust settles, pension funds, reliant upon dividends, are unlikely to be overjoyed by the government diktat that deprives them of this crucial source of income for up to five years.

One key area the government has failed properly to address is that of competition law. The extreme circumstances that prevailed in early October meant the Lloyds TSB buyout of HBOS was given the go ahead even though in less turbulent economic conditions it would have fallen foul of anti-trust legislation. In such extreme circumstances it appeared supportable. However by the time the government's bailout package was unveiled – seeing £37 billion of taxpayers' cash being pumped into RBS and the new Lloyds TSB/HBOS entity – it was no longer clear why it should be exempt from these considerations. Competition law is designed to protect the public - not as an extra layer of bureaucracy, but as a crucial guarantor of choice and diversity in the free market. Which begs the next question – whither the level-playing field? The US government in its decision to hose down the financial services market with vast sums of taxpayer cash has used the expedient of insisting that financial institutions such as Goldman Sachs and JP Morgan take government money even though, at this stage at least, it was neither needed nor requested.

In the UK, however, we face a potentially serious structural problem in the banking industry looking ahead. The government (courtesy of Lloyds TSB/HBOS, Northern Rock and Bradford & Bingley) now controls forty-five per cent of the UK mortgage market and it is difficult to see how innovation, flair and consumer choice can be enhanced by such an arrangement. Moreover, the two of the big four banks which have not taken public money, HSBC and Barclays, will almost certainly have good cause before long to complain that their products (without the foundation of a government guarantee) risk being less attractive to the consumer.

As a condition of giving banks public funds, the government have insisted that lending activity is kept on a par with that which existed when there was more clement economic weather. This is also dangerous territory – first, will this result in the creation of another credit bubble albeit with lower interest rates than we have experienced over the past decade? Second, with the government as a guarantor of last resort, might part-nationalised banks, in order to satisfy the government's demand for volume business, skew the market by selling their mortgage products at unsustainably attractive rates?

There is public distaste and anger for the banking fraternity which I fear has a long way to run. Indeed when the recession begins to bite hard in the 'real' economy there will doubtless be a vociferous demand (led by the tabloid press) that corporate UK should have a similar right to be bailed out as the banking industry. Indeed the Conservative announcements on small businesses in the last few days implicitly pre-empt this. I fear that there is a lot of complacency in the financial services world over the level of public anger still to come to the fore. Simply put – things cannot be the same. The adoption in the UK of rules, rather than as hitherto, principles based regulation system will now be the norm. Worse still so much of the banking industry is now in public hands there has to be a real concern about the place of the City of London within the ranking of globally competitive financial centres.

Unravelling these recapitalisation arrangements will not be a short term affair. I suspect that it will take many years – possibly as long as a decade. In truth the deal was done without full political scrutiny. The power of the executive in the UK and shorter term political considerations meant that effectively the government was presented with a blank cheque which it has brandished with relish. It is slowly dawning on the public that there has been a far more extensive nationalisation of banking assets than was envisaged when bipartisan support wasoffered.

An integral element of our ongoing scrutiny of the bailout must be a forensic analysis of the failings of the Bank of England and the Financial Services Authority. Our ambitious plans to encourage a process of Bank of England-led reconstruction in preference to financial services nationalisation requires respected and credible personnel at the highest ranks of the institution.

In short the bailout is far from being a 'done deal' and our role as an Opposition should be to side with the hapless taxpayer in holding the government to account. Looking forward we need to provide a compelling vision of global capitalism, free markets and a small, more effective state for the recovery stage of this economic cycle.

Time to Tell it as it is to the Electorate

10 November 2008

The state of the public finances is a national disgrace. Over eleven years of Labour administration too much government borrowing has funded current consumption. Instead of building a secure future we are borrowing from it and condemning future generations of Britons, some still to be born, to pick up the bill for the cost of current welfare, healthcare and pensions expenditure.

It is an approach which is neither prudent nor sustainable. It falls to Conservatives to condemn this cavalier approach to public expenditure and show the nation that there is a better way forward.

The recent banking bailout following the credit crisis has provided the government with an alibi for exorbitant levels of public debt which were already spiralling dangerously out of control. Public sector borrowing was due to reach £43 billion in the current financial year – we shall now be lucky to avoid doubling that sorry figure. Next year the total may well exceed £100 billion; that is around £300 million spending in excess of tax receipts each and every day of the year.

Just as it has been difficult for a bewildered public to grasp the true meaning of the wild fluctuations in the stock market in recent weeks, I fear that it will now be unaware of the seismic implications of the unprecedented level of government debt now locked into the system.

We must ringfence the billions accrued for the banking bailout from the enormous sums that were already on – and indeed off – the balance sheet. The new spirit of the age should be for value for money out of the public pursue – instead the idea of big government as an ever benevolent cash cow seems to be entrenching even further.

Remarkably, a narrative on the need for greater austerity has really not yet emerged. Whilst Conservatives no longer feel any pressure to match Labour's spending plans nor to 'share the proceeds of growth', the urgent questions we now face are whether we are to match government on massive, costly infrastructure projects – or better still to make the political weather perhaps by promoting a fiscal stimulus by means of a targeted tax cut to the less well off which will readily be recycled into consumer consumption.

In truth there remains an eerie sense of calm in the 'real' economy. But not for much longer. For now the tumultuous collapse of the finance sector appears to many an isolated incident which has now been contained. Whilst the newspapers might be littered with credit crunch tales – falling house prices, squeezed company profits – I just do not believe that this crisis has really bitten the public yet, as demonstrated by the crush of shoppers at London's new super shopping mall, Westfield, last weekend.

More worryingly this is coupled with a notion that however bad things get financially for the individual, the state will move to soften the blow, a perception that the government's intervention to protect depositors in Northern Rock, Icesave and others has only served to increase. Labour is returning to its comfort zone with an economic narrative of interference in the name of protecting the public through continued high spending. We saw the Prime Minister developing this idea last week in the House of Commons as he sought to exploit the outcome of the US election as evidence of an international mandate for big government. If there is a lesson to be learned from Barack Obama's success this should not be it.

For sure the world has changed but that is no reason for Conservatives to be bystanders – we must not be mesmerised by the tumultuous events into lacking the confidence to present a distinctive pathway forward. The era of cheap and easy money is now behind us yet too much government borrowing is targeted at short-term consumption rather than building for a better future. This was the case before the credit crisis and remains the case now. An increase in state intervention may soften the financial blow in the immediate term, but the looming level of interest payments alone on rising debt risks the lowering of living standards for decades to come.

It will soon dawn on younger voters that the unspoken message of the political class to anyone under thirty is that their generation will need to not only fund the cost of pensions for those who are older, but they will have to significantly lower their own financial expectations when the time comes for them to retire. The availability of cheap goods – clothes, technology, alcohol – has created a false sense of material wealth in the young. Unfortunately the longer term prospect of being able to pay off student debt, enjoy a standard of living as good as their parents, live on a decent pension for a retirement likely to last decades and expect a generous range of state benefits that those currently in retirement take for granted looks less rosy. Any failure by government rapidly to grasp this nettle risks serious social unrest in the decades ahead. Our society will otherwise be economically divided as never before between old and young; those working in the comparatively secure and well-pensioned public sector and those in private wealth creation; those with globally transferable opportunities and others in an increasing tail of low-skilled, chaotic lifestyles.

Conservatives need to connect these realities and provide a convincing financial and moral narrative as to the importance of balancing the collective books. Outside of wartime it is almost unique for any generation to conclude (as is the case today) that its children and grandchildren will most likely be worse off than it has been. Unless radical action is taken to halt and reverse these unsustainable levels of public sector borrowing and to re-educate people as to the economic realities of maintaining a cradle-to-grave welfare state, that will be the sorry fate to befall the future generations of Britons.

At the next election we can offer the electorate change and a distinctive agenda which shows we are ahead of the game. If the best of times are to lie ahead the Conservatives must make the case for a smaller, more efficient State and understand there is an untapped appetite amongst our fellow Britons for discipline and prudence. We should relish the real opportunity that comes with giving the bewildered general public a convincing narrative for the future based upon our enduring principles.

Procurement

A Route to Reducing Expenditure and Funding Tax Cuts?

20 November 2008

Public sector purchasing policy is not exactly a subject designed to make the pulse race. But perhaps it should. At a time when scrutiny of the public finances has never been greater, a prudent procurement policy offers a heaven-sent opportunity to rein in public expenditure.

The lack of visibility of so much of this spend means that the cost to the public purse risks spiralling out of control. There are straightforward disciplines which the public sector could adopt which can be taken from the private sector. Reduce the number of suppliers, manage those suppliers better, don't let them change the terms mid contract, negotiate well, bring transparency and disclosure to whom money is spent with.

In essence purchasing impacts the public sector more profoundly than you might imagine. Everything which is neither salary nor distributed as a grant or as welfare is regarded as public sector purchase. For this an estimated annual budget of £150 billion is up for grabs. Even a relatively modest ten per cent saving in this category would bring with it potential dividends.

Goods and services that the public sector purchases vary from IT systems (not noticeably good value in recent years), buildings, highly sophisticated defence equipment and stationery. Meanwhile services include the acquisition of childcare, consultants and call centres.

The science of sales is well known. It is certainly the somewhat sexier counterpart to purchasing. Top sales professionals are stars in the corporate world – their dark arts are the subject of an extensive body of learning and training. By contrast, the procurement industry is very much in its infancy – regarded as less easily understood or easy to define and its practitioners undervalued compared to sales staff. Moreover purchasing managers are rarely motivated to beat their suppliers down on price – this culture is especially common in the public sector.

Indeed it is estimated that there are some fifty times more professional sales people than trained procurement people and that procurement performance is rarely tracked in the way that sales are. The scale of public sector expenditure across a range of sectors is mind boggling. Grouped by department, Local Government (£39.8 billion), Health (£30.1 billion), Defence (£16.9 billion) and the devolved administrations (£15.4 billion) are the largest public sector purchasers. The goods and services purchased across departments include construction (£22.3 billion), pharmaceuticals (£8.9 billion) and the slightly more mundane transport (cars and business travel - £5.4 billion), telecommunications (radio and TV - £3.6 billion), IT services (£4.2 billion), down to food (£3.2 billion) and furniture (£1.2 billion).

The desire to 'cut waste' is one shared by opposition politicians across the world. The important thing surely is to drill down to determine the precise nature of the procurement and purchasing budget as well as examining why people are so bad at the science of buying.

In essence there are three variables – price, quantity and specification. When you buy a single good such as utilities, like electricity or water, there is a fixed price which hinges upon the quantity consumed. A poor purchasing deal is often done because of ignorance, lethargy, personal preference for a particular supplier or a misperception of the risk or product concerned. Whilst sales people are highly focused, all too often the purchaser of a single good fails to recognise the market is moving all the time and cannot keep up with these crucial changes.

By contrast, purchasing decisions over a multitude of items (such as stationery) involves pricing a basket of goods based on the volume of each item sold. In this model high value volume items should be less expensive. The total paid depends on the purchaser predicting the volume of each item and negotiating the price accordingly – get the prediction wrong and the high volume items will end up being rather more expensive.

There is a multitude of potential mistakes here: not assessing future volumes correctly (therefore paying more than is necessary); negotiating a discount to cover complexity, but failing to make the discount pay, or not noticing that the items being bought have changed and that the new products are not covered by the originally-negotiated contract.

Buying professional services can be trickier still. For example – something very close to my own heart – buying the services of a lawyer usually depends upon fixed day rates, quantity of consumption that can vary massively and a specification which is not visible at the time of purchase. The odds are typically firmly stacked against the purchaser when compared to the party making the sales. Mistakes include poor upfront thinking which can lead to an inadequate analysis of the specification and inefficient use of a supplier: using an overqualified and therefore more expensive professional for more mundane work or else agreeing to pay for the A Team but getting the less qualified and less efficient B Team for most of the assignment.

Buying services also involves a leap of faith – as a sales person it is easy to promise but hard to deliver. Defining and measuring of outputs and their quality can be so difficult that the entire process can be overly focused on inputs (such as time sheets for hours inefficiently spent undertaking the task at hand). Naturally the fee model can impact on behaviour by any supplier – day rates understandably encourage both prolonged and more complex work.

Even buying services over the longer term when many of the pitfalls should be foreseen can lead to problems. For example, the supplier may start cheaply and then charge overrun fees in the knowledge that the costs of changing supplier are prohibitive or would cause more delay to the process. Once locked in, the effective rate shoots up. Almost inevitably if a decision is made to pay the service on inputs then the project time (and expense) will extend. Similarly a supplier of long term service who may identify a problem may not also be that person delivering the answer. All of these factors make for a bad deal for a purchaser of services.

Then of course there is the problem that striking a deal is attractive but managing the subsequent process is far less so. All too many organisations – especially in the public sector – are notoriously bad at managing suppliers both commercially and operationally. Sales people, the suppliers in this context, are trained to be better at exploiting this.

It is also the case that the biggest savings often mean internal change. The easy part is to renegotiate the price of an existing supplier but changing to a new supplier (which may in the short term be more costly as well as inconvenient) is potentially the efficient way forward. If the buyer, whose job it is to determine the volume of services of goods being bought as well as the specification, is poor at managing the process of buying then costs will begin to spiral.

Unfortunately the public sector seems unusually susceptible to changing specifications as it goes along. As anyone who has employed a builder knows, this is not a good idea. The maxim here is straightforward – the better you plan, the better you buy. Much of this may sound like commonsense but it requires a meticulous approach. At the outset it is crucial that the individual charged with purchasing goods and services fully understands the objectives and payment around pre-determined delivery in the public sector.

This is an area of opportunity for the Conservatives to say something new by addressing ways of capturing value across a third of the public sector expenditure budget. At a time when the economic clouds are gathering and there are increasing pressures on the public purse, adopting a more systematic approach towards procurement should not detrimentally affect the services to the public.

Tales from the Front Line

5 January 2009

Few in the financial services industry will mourn the end of 2008, which will rank as its most tumultuous year certainly since 1974, or perhaps even 1931. Few wise men (or women) would dare predict how the year ahead will shape up. One thing seems for sure, however. The gloss on the Prime Minister's much-vaunted global recapitalisation of the banks is already wearing off.

As much as Gordon Brown has relished his portrayal as a grand Keynesian economic genius whose lead the United States and Europe follow, the political weather may be about to turn stormy for our Prime Minister. In his international showboating, he has sought to take the credit for the government's display of apparently bold and swift action to save the nation's economy. Household name banks have been provided with an injection of cash so colossal that the UK's already spiralling levels of debt seem like small change, allowing the Prime Minister to continue the conceit that he has been a steady hand on the economic tiller for the past debt-laden decade. No doubt he will try to elaborate a similar fantasy when the wheels come off the recapitalisation plan. The banks will offer a ready scapegoat.

For now as fear stalks the land, people are understandably desperate to believe the government has the answers. Indeed back in November I suggested that the broader economic crisis had not yet bitten and people viewed the implosion of the financial sector as a problem that had been contained. But sentiment is changing swiftly and in painting himself as an all-powerful global saviour, Gordon Brown will surely find it ever harder to escape blame when the fear turns to pain and then to anger. Now that the season of goodwill is behind us, harsh reality will assert itself. It will not be a pretty sight.

With a residential population of just under 70 000 but with a daily workforce close on one million, my constituency mailbag is filled every week with ever more letters from increasingly alarmed business folk. Most seem to boil down to the same question: given that the government has poured billions into propping up the banks, why will no one lend to my otherwise viable small business which is unable to access credit?

The first indication that the credit crunch would extend beyond inter-bank lending came a couple of months ago when a former lawyer at a leading international firm wrote to me outlining the problems he was having setting up a new solicitors' practice in the constituency. Despite fulfilling the criteria, he found it impossible to get a quotation for professional indemnity insurance. He could only suppose it was due to a lack of available capital in the insurance market and wrote, 'The Prime Minister has, to date, focused on the transparent costs of the credit crunch that fall on small businesses…it seems, however, little has been done to address the less transparent costs of the credit crunch on SMEs. I am told by my broker that the insurer has 'lost its appetite' for property-related risk. Very quickly, then, what was once a viable business could become unviable.'

Another company in the constituency informed me that under the DTI Small Firm Loan Guarantee Scheme they were given a loan of £50 000 of which they had spent £10 000. They requested that Lloyds TSB defer the capital repayments on the loan to maintain enough working capital for the business. The bank had refused, saying they were bound by the terms of the DTI guarantee. The letter concluded, 'The rhetoric the government is feeding us is not backed by any support in reality despite the billions of taxpayers' pounds served up to rescue the banks without our electoral consent'.

Another long-standing small business said 'Despite the massive efforts by the government to refinance the banks and to encourage a return to normal commercial practice, the facts on the ground remain dire, putting the life of our company at risk. In the past months we have seen our overdraft facilities cancelled, all merchant services provided by our bank subjected to huge cost increases and a strict refusal to envisage new terms for short-term loans or overdraft facilities. Ours is a seasonal business – without some financial flexibility, our cashflow fluctuations can quickly lead to difficulties'. I could provide further examples. In the meantime, rather curiously, a resident wrote to tell me that on going to his now partly-nationalised bank, he was offered a loan out of the blue and unsolicited of £27 000. He pondered whether the banks were seeking good risk customers to lend to so as to appear to meet the government's aims without involving themselves in intrinsically riskier loans to small business.

I suspect he is right and small wonder when one looks at the perverse incentives contained in the recapitalisation package. The banks are absolutely desperate to run down the capital they have been encouraged to take from the government as quickly as possible. Whereas the US Treasury has lent money to its banks at an interest rate of 5% and in Germany at between 5.5% and 8.5%, the British government demands a 12% coupon on its preference shares. As Eric Daniels, Chief Executive of Lloyds TSB said, 'In the case of the UK, the recapitalisation was done on pretty punitive terms, and that can cause the wrong behaviours'.

As the banks see it, the quickest and simplest way of reducing the size of its balance sheet and repaying the government is to stop lending new money. In the meantime, the government demands that lending continues to SMEs at rates far more favourable than those it has imposed upon the banks. Simultaneously it orders them to shore up their own balance sheets and buy government bonds to equip themselves better for future crises (and, conveniently, to fund the swelling national debt). To accuse the government of sending out mixed messages is an understatement.

Unfortunately the banks, all too aware of their grim public profile, are wary of publicly saying anything of their reservations. Speaking to a representative of RBS recently, I was told that the banks are prepared to act as fall guys in the short-term, but they are not fools: they realise that this narrative enables the government to deflect criticism for its own policy failures. For UK Plc this can only end in tears. It is not simply that confidence in our financial institutions has been shaken to its core – in truth, trust has been shattered and this will take a long time to restore.

In the year ahead we may well discover that our bashful, activist government has conjured up a fantastical rescue plan that has not only come at colossal cost to future generations of taxpayers but may not work on the ground. For the time being, the public has placed a conditional trust in the Prime Minister as someone who can best make sense of a fast moving and bewildering financial catastrophe. But be in no doubt. Before this year gets much older the public's fright and apprehension will turn to real pain and anger. The real question then will be whether trust will be corroded more in government or the workings of a free market economy. Neither outcome makes for a cheery prospect for the year ahead.

Time for Parliament to Lead

23 January 2009

Out in the real world beyond the Houses of Parliament there is growing alarm at the next tsunami threatening to engulf our beleaguered economy - the inequitable state of affairs between public and private pensions. Businesses faced with the prospect of lean times or liquidation are being forced to look upon their pensions obligations with a more discerning gaze. In December, the Pensions Protection Fund revealed that Britain's final salary schemes' pensions deficit increased to £195 billion as companies struggle to raise funds. Meanwhile this week it was reported that more than half of those defined benefit pension schemes still open to new members will be closed due to the current economic situation. This came hot on the heels of a warning from the National Association of Pension Funds that we may see final salary schemes closed even to existing members.

The scrapping of pensions benefits, falling equity and bond yields, lower interest rates, increasing life expectancy and even the risk of employers' default on pensions provisions all now combine to create a sobering economic outlook for those reliant upon occupational or private pensions. The government should take heed. For amidst all this private pension gloom, the taxpayers' bill for public sector pension provision seems to grow exponentially. People retiring from the wealth creating sector with inadequate, money purchase pensions – or in fact none at all from their failed employers – are not going to watch happily as folk from the public sector, whose wages they have paid over many years, retire on guaranteed index-linked final salary pensions. The greatest vitriol will no doubt be reserved for MPs whose gold-plated pension scheme will be even harder for people to stomach amidst private sector woe and further controversy over parliamentary expenses. Collectively the House of Commons has failed to show itself in a good light over allowances but we now have a real opportunity to display some leadership in these difficult times. As a matter of urgency we need to change the structure of our pensions and lead the way for the entire public sector. Failure to grasp this nettle risks serious social unrest – with society being economically divided as never before between those in the public and wealth creating sectors.

Pensions are vital to everyone's aspirations. But our expectations – especially in the public sector – must be made more realistic in the light of this country's financial plight. Now that public sector workers are paid on a par and often above private sector equivalent levels, the time when final salary schemes were seen as compensation for low levels of public sector pay are truly over.

MPs, whose pension arrangements are invariably regarded as the most generous of all, are the right people to show they are not immune from the turbulence of the British economy. For new entrants to the contributory parliamentary pensions scheme, there must be a defined contribution (not final salary) outcome. Existing MPs should set an example by voluntarily agreeing that future contributions should be on a 1/60th rather than a 1/40th basis (which means that MPs would have to make full contributions for forty, rather than only twenty-seven, years to qualify for a full pension). Only by agreeing to such a one-third reduction in the benefits of our generous pension scheme, can MPs look the rest of the public sector in the eye when asking for similar sacrifice.

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Where now for British banking?

3 February 2009

The dismal plight facing the UK economy naturally brings to mind rousing and inspirational Churchillian rhetoric. I am sad to report, however, that we are not even at the end of the beginning of this financial and economic crisis. Its impact on the fortunes of us all will be felt for many years to come. It is important not to heed some of the more outlandish predictions of our economic future (such as the so-called City expert opinion that the UK is now heading for bankruptcy) but a turbulent journey lies ahead. For in spite of the astonishing pace and extent of decline over the past twelve months there is no end in sight for the travails facing the banking sector.

The seven largest global investment banks have all lost their independence. One, Lehman Brothers, has gone bust. On these shores the government has spent or guaranteed unimaginably huge sums of public money trying to bring stability to the entire financial system on a scale that is barely able to be comprehended. Such is the price for the UK economy's unbalanced position as a truly global player only in the financial services sphere. Watching the second attempt by the Chancellor of the Exchequer at a definitive bailout my gloomy, but overriding, thought was this: how soon before the government returns for a third bite of the cherry?

The nagging doubt remains that the government lacks any real plan of what UK banking should look like once the worst is behind us. I believe we must soon see a robust vision for restoring free-market disciplines into this stricken sector. For whilst the spirit of the age may point an accusing finger at 'market failure', history teaches us that governments fail far more often. As I have written before, politicians of all parties must explain to the general public some unpalatable home truths – Britons have spent and borrowed far too much over recent times; moreover, too many of us lack the necessary skills to compete effectively as a high-wage player in the global economy. Unless these long-standing failures of government are addressed urgently the UK risks social unrest on an unprecedented scale.

As the financial crisis took hold last October there was a failure of government to send a clear message to the financial system about its priorities at such a difficult juncture. Those UK banks taking government money (RBS and Lloyds/HBOS) were ordered to resume lending at 2007 levels yet simultaneously constrained by an FSA decree to shore-up their balance sheets by increasing their capital reserves. The imposition of a 12% interest rate on government owned preference shares (roughly double what US or European banks were being charged in what was supposedly a co-ordinated international bailout) led to sheer confusion. Belatedly the UK government has recognised that part-nationalised banks' rational reaction to prioritise the repayment of government loans ran directly counter to its broader economic aims. As a result the government has transferred its preference shares into equity. But this policy confusion since October has cost the UK taxpayer dear.

By 19 January, the day of the second bailout, RBS's total market value had plunged to only £4.5 billion despite the bank having received over £20 billion at what we assumed was the lowest values last autumn. In these short months ownership of RBS shares has cost the UK taxpayer over £17 billion – greater than the UK's entire annual defence budget. Speaking to City professionals in recent weeks my clear understanding is that the problem facing the financial system is not simply one of lack of confidence: the biggest danger now is that trust in our entire financial system has been so eroded that there is a limit to what government action can achieve. In the eye of this storm the City's demise should not be exaggerated. Better times will return and our critical mass in this sector will stand the UK in good stead for the future. However, the reputational danger to both the City of London and New York means that both centres should expect a markedly smaller slice of the global financial services cake when the recovery comes.

How will this all play out? Whilst historically confidence can often be regained quite suddenly and seemingly without a trigger event, the restoration of trust in a failing system is much more difficult.

By the time the government has a third stab at a widescale banking industry rescue, RBS may well be fully nationalised. The Lloyds Banking Group and Barclays (notwithstanding the terms of its deal last autumn with Abu Dhabi investors) may well by then also have the government as a majority stakeholder. At which point given the imperative to protect the taxpayers' financial interests (an issue which seems to have been forgotten in all the turmoil to date) the competition implications may force even the final 'big bank' HSBC, to sacrifice its independence in the interests of a 'level playing field'. It would then be a short step from nationalising the banks to bringing large parts of UK industry and commerce under government influence, control or ownership. We already see the first signs of this in high-level discussions over what remains of the UK car industry. Indeed the fast deteriorating state of their corporate client portfolios represents the most serious short-term threat to the balance sheets of the UK banking sector. This scenario would also open the door to the creation of a 'toxic bank', a step which the government has so far resisted. Whilst the creation of a vehicle to take on all the toxic assets of the major banks should in theory free-up inter-bank lending and with it the credit markets, it comes at a tremendous risk. In these turbulent times it is almost impossible to set an accurate value to such toxic assets. Valued too low and the beleaguered banks stand to be crippled by their debts for years to come and unable to contemplate a return to private ownership. Value the toxic assets too highly (a more likely problem) and the taxpayer will foot an unfathomably large bill, further delaying the restoration of confidence and trust in the financial system.

This nation needs to go back to the enduring values of personal responsibility, thrift and enterprise. We must recognise that the debt-fuelled credit bubble of the past decade is little more than a pyramid sales scam against the young. Future generations of taxpayers will foot the ever increasing bill for the 'rescue', which fails to halt, yet alone reverse, the unsustainable levels of public sector borrowing. To pay for the years to come for present day consumption also makes it difficult to promote a savings culture.

The world of finance will look different. However, we have paid the price for short-termism, financial products being improperly understood and over-exuberant speculation in the past. This downturn is new only in its extent and the elusive ingredient, trust, will take a long time to restore. Above all, at this of all times politicians need to defend capitalism and free markets as the only bulwark against an all powerful State. For whilst government's role in stabilising our beleaguered economy cannot be denied, it will only be the hard work of our wealth-creators which will ensure that our economy rises again.

A Few Home Truths on Banking Bonuses

9 February 2009

Our nation needs a thriving financial services sector. The spiritual home of the UK's banking industry is in the City, but its importance as an employer and engine for economic growth extends throughout the land.

As the City's MP I regard with dismay the attempts by some in public life to make banks and bankers scapegoats for the recession. We should recognise that many thousands working in this sector have already lost their jobs; others, relatively modestly paid, are fearful for their futures in finance. The great majority of bank employees are caught up in events outside their control or influence and are as bewildered as the rest of us at the collapse in their sector.

This only adds to my disbelief at reports that the directors of RBS and Lloyds Banking Group, entities which survive courtesy of huge taxpayer loans and guarantees, now propose to pay billions of pounds in bonuses to reflect performance over the last year. The public outrage at this news is entirely justifiable. No bank which is in receipt of government bailout funding should be paying bonuses to staff this year. After all 2008 was for RBS, Lloyds and Northern Rock a year of catastrophic, monumental failure. This state of affairs (resulting in eye watering sums of government assistance and guarantees) cannot be compatible with a 'business as usual' approach on remuneration. I have sympathy for those hard-working RBS, Lloyds/HBOS and Northern Rock employees operating in profitable divisions, but the notion that they should be ringfenced from the disaster that has befallen their employers is absurd. Ditto those bankers on 'guaranteed' bonuses. For them, I am afraid, events since last October mean we are living in a very different world. My view is that any such salary guarantees are inapplicable to those banks reliant on government handouts.

It is high time that senior management in our leading financial institutions woke up to reality. What better case can they possibly provide to opponents of capitalism and free markets than obliviously to take unwarranted financial rewards when as a result of the credit crunch the UK economy finds itself in such dire straits?

Calling Time on Unsustainable Government Debt

25 February 2009

In such turbulent and volatile times it is tempting to suggest that Conservatives should concern themselves more with political positioning than making a cool assessment from economic first principles.

There is little doubt that for a few months around the turn of the year the 'do nothing Party' tag resonated with the public at large. No longer – it is fast dawning on a bewildered British public that frenetic government-by-daily-initiative is no substitute for sound judgement and longer-term thinking.

Whilst superficially the spirit of the age leans towards ever more government intervention and expenditure, so David Cameron's vision of a smaller state and promoting thrift (which all Conservatives should wholeheartedly support) carries short-term risks. In the medium and long-term it will be vindicated. Moreover, it is a clear sign that we are serious about the challenges ahead of government.

The next big question on the domestic economic agenda is quantitative easing – the printing of money by the Bank of England, necessary (or so we are told) to reflate the economy. An attractively easy option, but the wrong solution to our economic woes.

Because every other government initiative over the past five months has failed to get the economy moving does not mean we should resort to printing money without a crystal clear analysis of its dangers.

At the heart of the credit crunch afflicting the global economy is not the quantity of money, but the velocity with which it circulates through the financial system. Printing new money runs the risk of undermining further trust and confidence in the UK government in the bond markets with future inflationary consequences. The current level of government debt already baffles most of the general public. Amidst the mindblowing announcements that total public debt now stands at over £2 trillion, we need to educate the public to understand the plain truth.

In the past five short years we have added more to the national debt than we had previously borrowed in the 300 years since the UK was created. And this borrowing has not been investment at all, but for current consumption. For every £5 the government will spend in 2009, it will have raised only £4 in taxes. This is the lamentable legacy we pass on to future generations of taxpayers footing the bill for today's consumption. *[By the middle of 2009 this proved over-optimistic: government spending was £4 for every £3 raised in tax]*

Printing money now would simply represent more of the same. I fear it will lead this nation to fiscal and monetary ruin. Conservatives should not now shy away from making the case that enough is enough. After all, sticking closely to the financial orthodoxy of so-called banking industry experts over recent years has got us to this place. For the sake of future generations of taxpayers, Conservatives must now stand up and be counted. We must call time on unsustainable government debt.

The Unacceptable Face of Capitalism?

27 February 2009

On the day the Royal Bank of Scotland announced the largest annual loss in UK corporate history, paving the way for another huge cash injection by the government (bringing the taxpayers' investment in RBS to £45.5 billion since October), the story eclipsing all others is the size of the pension pot of RBS's Chief Executive, Sir Fred Goodwin. Let's face facts - this is a smokescreen to divert attention from the appallingly bad deal that government intervention in RBS represents to each and every one of us.

It is a sign of the times that the idea of a £24.1 billion annual loss fails to raise many eyebrows. Yet at a time when billion pound losses are being posted almost routinely, it is understandable that public anger rests on something easier to comprehend. On learning of the potential £16 million pension pot, we can all make a direct connection between the money we pay in tax and its destination – Sir Fred's bank account – and ponder the disparity between success and reward, the treatment of top bankers and ordinary workers, our own financial circumstances to the rewards for failure in the boardroom. This is why this story is so dangerous to capitalism.

I have some sympathy with Sir Fred's argument that he should keep his money if it is established that the government agreed to leave his pension arrangements intact in return for his sacrificing severance pay and options. I even have a sliver of admiration for his refusal to give in to a government whose self-righteous, politically calculating public face contrasts with its private desire to cut a deal without properly appraising itself of the implications. Indeed if there is one area of consistency from government over the past months, it has been in the blaming of bankers for all of our emerging economic woes.

But let us not forget that Sir Fred's stewardship of RBS has been a monumental failure – catastrophically the worst failure in this country's corporate history. Had the government not intervened to save this failed institution, Sir Fred would have had to rely on some sort of pension protection fund which no doubt would have capped his pension at around £20 000 per year.

I support capitalism. I believe in honouring contracts and recognise the importance of these concepts in our global economic relations. Incentives should rightly be offered for good performance. But the end result of this particular episode can only be utter distaste for politicians, bankers and – most damaging of all - capitalism. Far from upholding the free market values and the honour of the law of contract, those who support Sir Fred's entitlement as it was back in October will only help to undermine capitalism and all it does to create wealth.

For the truth is that we now know that the profits, bonuses and other emoluments for many banks and bankers over recent years have been massively overstated. If it is impractical to restate those earnings to reflect reality that has become apparent since last autumn, it is equally absurd to invoke the sanctity of contract law to prevent some move towards an equitable claw back for those unwarranted rewards.

Levelling with the Public About the Action Needed to Restore Britain to Economic Health

17 March 2009

"Anyone in management not planning to spend considerably less in the next year is living in cloud cuckoo land.' This was the bleak, yet candid, commercial assessment of a high profile businessman in my constituency.

Most people in the political world accept that the same strictures must apply to government. At some point, some unpalatable and politically difficult decisions will have to be made on public spending. But in the final year of this parliament, how open and honest should the political class be with the electorate about the scale of the troubles that lie ahead? Should we Conservatives be the first to tell some home truths about our nation's economic future?

I have long argued that we should tell it as it is to the electorate and believe we must continue to do so for one compelling reason: in the event that we are elected, it is crucial that we have a strong and clear mandate to do what is necessary to put the public finances back on track. After the next election it will not be enough simply to freeze or trim public expenditure. Instead more radical solutions will be necessary. Policymakers will need to re-evaluate where the State's empire should start and end.

I accept that this message is not an easy one to deliver. Indeed there are some sound political reasons to avoid even starting down such a path.

For a start, the extreme economic volatility of recent months is likely to continue well beyond the forthcoming election year. There can be few certainties about the state of the economy to be inherited by any incoming administration. Specific policy commitments are arguably unwise.

It is also worth reflecting that for many, this recession is still 'happening to someone else', with the real pain and anger being felt by only a minority. For those in (relatively) secure employment – including most in the public sector – the cost of living has fallen dramatically over the past year. Many with tracker mortgages are paying less than half the cost servicing housing debt than they were a year ago. Similarly a visit to the supermarket or filling station has become noticeably cheaper in recent months.

In these tumultuous times, the overwhelming emotion for many is utter bewilderment. Understandably most electors fail to grasp the magnitude of the current economic difficulties, when unfathomable levels of spending and debt running to hundreds of billions of pounds are routinely banded around in news coverage. Reducing departmental government expenditure by a few billion seems small beer when compared to the colossal sums expended in the banking bailout. So why try? In the run-up period to the general election, do we really need to rock the boat on public spending? It will be unpalatable to many that taxpayers' money can happily be spent bailing out banks and bankers whilst public services are cut back.

Similarly to the 750,000 more working in the public sector than twelve years ago, the prospect of public spending cuts is unlikely to appeal.

It is also conceivable that this state of denial will continue, especially as government continues to lead the public to believe that it will always be there to cushion the blow.

The Conservative leadership is mindful of the experience of the last two general election campaigns, when our proposals for what in the current situation seem like pathetically modest savings in government expenditure were misrepresented as 'severe public spending cuts' by our political opponents. Moreover, a bleak and uncompromising economic message runs counter to the positive, optimistic outlook that the Party has sought to project under David Cameron's leadership.

As a counter to the more general state of disillusionment with the political process, we must offer a positive programme that does not focus solely on the blame game. This requires avoiding an economic message that looks dangerously unappealingly in the face of unrealistic spending pledges made by a Labour Party with nothing to lose and a Liberal Democrat Party unlikely to be probed deeply.

Putting these concerns to one side, there is no doubt that an incoming Conservative government will have to be incredibly robust about the extent of the public sector's scope. Indeed matters are far more serious than in 1979. At least then we inherited an economy which, courtesy of the IMF, had been subjected to monetarist policies for two and a half years. Three decades ago the tough decisions on spending had already to a large extent been made.

Remember too that we are only at the early stages of the recession. Things will probably get much worse before there is any sign of global economic recovery. Today we must start to come to terms with the fact that there are entire areas of current central and local government activity that arguably should no longer qualify for public funding. The overall state of the public finances suggest that even in the areas of education, health and defence – which during more economically clement times the Party pledged to ringfence – further scrutiny will be necessary. Whilst there has been a marked improvement in school and hospital infrastructure over the past decade, much of this has been financed via the PFI, which will need to be paid off balance sheet for many years to come. Even here there will be no short-term public spending benefit to be derived from putting any future infrastructure commitments on hold.

I cannot accept that everything that government does today is essential. In a brighter economic climate we can be more expansive, but for the foreseeable future there are whole silos of expenditure that will have to be removed from the public purse. In truth, such radical plans can only really be carried out in the first weeks of a new government with a strong mandate. The planning must start now.

Whilst it is prudent to avoid overly detailed commitments along the lines of the James Review before the 2005 election, it may prove unexpectedly popular to the electorate if before the next election we display awareness of the seriousness of our nation's economic plight. In 1979, contrary to the myth that has since grown-up, we were clear with the public in advance of the election about the necessary medicine our economy required. It may be no coincidence that we were swept into office with the then biggest swing at a post-war election.

At a time when people are paring down personal and company budgets, the call for restraint by government will surely become even louder. I detect the public becoming weary of frenetic activity by political leaders, which yields little result other than to rack up yet greater national debt. Furthermore, a rather interesting phenomenon has revealed itself in my postbag in recent weeks. Constituents who are encountering the benefits system and Jobcentres for the very first time after being made redundant are finding that in spite of paying into the system for years, they either do not qualify for assistance or are bitterly disappointed with the help they do receive. Add them to the legions of pensioners dependent upon income from hard-earned savings and there may soon be significant demand for more value from a smaller, cheaper state by a hitherto silent majority.

A message of responsibility and thrift; the appeal of representing reinvigorated values of reward for work; the encouragement of innovation and flair; a choice apart from the activist, intrusive government that we are told is the essential response to this crisis – these are all positive things that can accompany our levelling with the public sooner rather than later.

The momentous change that Conservatives aspire to offer our nation requires an explicit mandate.

Which Way Now for Banking & the Economy?

23 April 2009

If there are any crumbs of comfort to be gained for the Chancellor in this week's Budget – and I suspect there are very few – no-one can accuse him of putting an overly bright face on our nation's bleak economic prospects.

It lacked any credible narrative of a pathway for economic recovery. Yet still the seriousness of the situation is only slowly dawning on the political class, let alone the general public.

Last year's budget predicted £40 billion public borrowing for 2009-10, by autumn the figures were £78 billion for last year, £118 billion this. Now we know that over the next two years aggregate borrowing will be around £350 billion. In short over the near term – whoever is in government – for every £4 that government spends, it will raise only £3 in tax. This overspend cannot possibly be described as 'investment' - it is purely spending to consume today what will need to be financed by a future generation. Remember too this is only if the government's figures - persistently over-optimistic - prove accurate.

There has been a precipitous collapse in tax receipts, especially from business. But this also applies to the government's slice of bonuses earned by the wealthiest in more clement economic times. No bonuses means no tax, which means as ever that it is predominately middle-income salary earners who will foot much of the future bill for the government's over-expenditure.

The government have flunked the really tough decisions on public spending that needed to be made. Instead action on this has been delayed until a General Election is behind us.

Attention is understandably moving away from financial institutions as the 'real' recession takes hold. But as the City's MP I would highlight some pressing issues that will emerge in the months ahead.

1. Two of the big four domestic banks are all but fully nationalised. One, Lloyds Banking Group, contains 'assets' from HBOS which engaged in a series of balance sheet boosting debt-for-equity deals during the boom years in the middle of this decade.

As a consequence, LBG has large holdings in a swathe of leading UK companies. Doubtlessly many such household names will require refinancing as the downturn proceeds. Such financial rescue will come from the taxpayers' coffers – in short, before long considerably large parts of mainstream corporate UK will be effectively nationalised.

2. Whilst the days of financial sector governance by blind form-filling may be numbered, it is wistful to imagine a return to the days of regulation by informal eyebrow raising from the Governor of the Bank of England. This will apply even if many of that institution's traditional powers are restored. However, we need to use smarter intelligence to nip regulatory problems in the bud. An enhanced role for the Bank of England must be accompanied by the appointment of high calibre, respected professionals in its top roles. I believe this

should be augmented by the emergence of prosecutors with US-style status in place of the discredited SFO. Nothing less will restore confidence from market professionals and trust from the public at large.

3. The banking bailouts have proved an expensive failure. No further nationalisation should be undertaken in this sector. The lesson we must learn is that any institution deemed too big to be allowed to fail will forever be prey to reckless risk-taking. If banks cannot fail, they cannot be effectively regulated, for regulation requires the eradication, not reward, of recklessness.

The operation of capitalism requires corporate failure. This is not 'market failure': it is a sign that capitalism is working properly. Instead the message that banks will not be allowed to fail only serves to make their effective regulation all but impossible. Regulation creates barriers to entry and favours large corporations over smaller start-ups. The wisest policy option should be to create smaller, more competitive financial institutions. Manifestly nationalisation takes us in precisely the wrong policy direction. The best form of regulation must be open competition; public ownership – other than on a strictly temporary basis – is anathema to this policy goal.

4. The conventional wisdom is that the heightened phase of the economic downturn since last autumn has come about as a result of the US government's decision to allow Lehman Brothers to collapse. But letting a leading bank like Lehman fail will in time, I suspect, not be regarded as a mistake at all.

For by nationalising banks, governments have protected not only depositors (unarguably essential in preserving trust in a market economy) but also bondholders. The latters' interests have been preserved at the expense of taxpayers, present and future.

Essentially this has been a political gambit – much of the banks' borrowing has been funded by insurance companies and other institutional investors and the risk of contagion in the event of their collapse was deemed too great. Yet bondholders, as lenders of capital, are supposed to take risks (and receive ample rewards by way of interest payments). In a "heads we win, tails you lose" inversion of classic capitalist practice when all has turned to dust they too have expected – and received – a taxpayer bailout.

5. The current consensus promoting Quantitative Easing will find less favour as the year wears on. With little evidence that the velocity of money within the economy is any less sluggish as the real recession takes hold, printing money in vast quantities increasingly seems like a desperate last throw of the governmental dice when nothing else has succeeded. Inflation is clearly not an immediate problem, but mark my words, this unprecedented pumping of money into the system is certain to be inflationary. History suggests that an unsustainable mini-boom will be on the cards by the end of next year, but stagflation (a toxic mix of inflation, rising unemployment and low growth/diminished competitiveness) will follow. Indeed the commodities and futures markets are already factoring this in when pricing for the early years of the next decade. I suspect the government has not seen the back of the problems it has recently experienced in trying to sell gilts as our national credit rating is hammered in the global capital markets.

6. This crisis – now that globalisation has taken hold - is certainly different in magnitude to those we have seen before. One of the grand old names of British banking, Barings, collapsed owing £780 million only

fourteen years ago: today RBS survives courtesy of a £26 billion bailout. However, there are clear lessons we can learn from the past. First, we need to restore the distinction between retail and investment banking which – in the US at least – existed for over six decades until the repeal of Glass-Steagall by the Clinton administration in 1999. The purpose of what was regarded as outdated 1930s throwback legislation is the protection of the ordinary depositor from high-risk, if innovative, banking practices. It now seems mighty apposite.

How then to deal with the toxic assets that banks still hold and find so difficult to quantify? Curiously enough, the UK has a template close at hand. The near collapse of Lloyds of London was avoided almost 20 years ago by the creation of a government-backed Equitas fund. This experience should be the starting point for consideration of any further large-scale government-backed rescue expenditure. In fairness the government has begun down such a path, although we should all be fearful of the ultimate overall cost to the taxpayer.

7. The nagging sense of insecurity amongst the majority of the UK workforce that the spoils of globalisation are being spread inequitably will grow and has the makings of serious social unrest.

The hollowing out of large swathes of 'traditional' UK industry as job employment has been exported to low-cost China and India has not even been accompanied by higher middle class professional earnings (at least for those outside the gilded world of financial and associated services until last year). Over the past decade the mirage of higher living standards was maintained only by the credit-fuelled residential property market. The sharp correction here has exposed the reality – international free-trade has done little to enrich personally the majority of our fellow countrymen in recent times. It is dawning on many middle class folk that the losers from free movement of labour and capital are not simply the unskilled forced to compete with ever large numbers of immigrant workers. It is also increasingly apparent that the generation about to join the workforce will probably be less well off than their parents, not least as they foot the bill for the economic unravelling that began last September. This phenomenon is almost unimaginable outside times of war – a shocking indictment for my generation of politicians.

8. So how will we know when the financial system has been fixed? In short, when can government stop pumping vast sums of taxpayers' cash into a system which so desperately needs confidence and trust restored? Surely the main purpose of regulation in this sphere for the taxpayer is the establishment of a system that makes long-term investment worthwhile.

High profile allegations of mis-selling of financial products from the early 1990s and the near collapse of Equitable Life a decade ago had already done great damage to public confidence well before the credit crunch. Ironically this led to property becoming the investment of choice, rather than savings with pensions. We all now know where this credit bubble has led. It is essential that individually and corporately, the UK reverts to a culture of savings and responsibility with less dependence on debt.

Make no mistake, this path will be a long slog. However, if the problem has been too much borrowing and excessive spending it is difficult to see how yet more government borrowing and a wilful, almost aggressive, determination to impose further public sector debt is the right way forward.

Tax and Tactics

28 April 2009

It comes as little surprise that early opinion polls suggest an overwhelming majority support the government's plans to impose a new higher tax band on those earning over £150,000. Our Party Leadership has correctly identified that this blatantly political gauntlet has been thrown down purely to embarrass us - after all it stands to raise negligible additional income. Accordingly we are entirely justified in declining to play to this discredited government's tune. The most urgent priority of any incoming Conservative government will be to stabilise the public finances.

As I have frequently observed there is an increasing sense of insecurity amongst an ever larger proportion of the UK workforce that the spoils of globalisation are being spread inequitably. This will grow especially amongst middle-class professionals outside the once gilded corridors of financial and associated services. However, the predictable truth of this imposition is that the super-rich will pay not a penny more of tax at all. They are either non-domiciled or in the privileged position of being able to characterise much of their income as capital gains (subject to an unchanged 18% tax rate). Additional revenue will come only from modestly successful entrepreneurs (who will have even less incentive or collateral to expand their enterprises) and salaried workers unable to avoid this increase and frequently earning sums not wildly in excess of the threshold, whose instincts to do the right thing on savings and pensions will be blunted as their disposable income falls.

Conservatives understand the critical importance to our national economic health of promoting small, start-up business. Competitive tax rates are essential to encourage entrepreneurs especially as we make our way out of this deepest of recessions. Conservatives appreciate that raising tax now even on the wealthiest in our communities risks prolonging the UK's economic downturn.

A decade or so ago the decision of the then Labour opposition to "stick to Tory tax and spending plans" was an explicit recognition that our economic strategy was right for this nation. This is in stark contrast to the situation today. Even in these turbulent times the public should not be taken for fools. No-one out there believes that the Labour government's recklessness with the public finances is worthy of emulation.

The US and China - A Fatal Dependency?

24 June 2009

The collapse of Lehman Brothers last September triggered an unravelling of the global economy so swift that its cause and scope was beyond the comprehension not only of a bewildered public but of most politicians and financiers too. Since that time, jobs have been junked, global trade has slumped spectacularly and governments across the globe have borrowed unimaginable sums to shore up our ailing economies. The implications are so colossal that we know not yet their true cost.

It is the crucial relationship between the world's biggest economy, the United States, and its eastern pretender, China, which we should examine if we are to understand the broader reasons why this unravelling has occurred. This relationship has for many years driven globalisation and has the potential now to wound that same project fatally. For a decade or more, the United States (along with the UK) has pursued a model of growth based on debt-fuelled consumption, the cash and cheap goods provided courtesy of China. Pursued to its limits, this relationship has become dangerously unbalanced, the myth of its sustainability brutally uncovered as the complicated financial mechanisms that hitherto propped it up, dramatically collapsed.

The consequences of this imbalance are not yet fully apparent. Their impact is still difficult to predict. What looks certain, however, is that the change will be profound and troubling. The West's position in the world may never be the same again. In the 1970s and 1980s, Wall Street received a number of breaks, beginning with the dollar's link with gold being broken by the Nixon Administration's repudiation of Bretton Woods. Later Ronald Reagan ended capital controls, the global bond market expanded and the US economy was liberalised, opening up America's savings and pensions. With US pension funds ballooning, Wall Street for the first time had access to a huge new source of finance which it sought to invest to maximum value. Corporations were encouraged to invest globally, exploit new markets and demand highest return for their shareholders – often the ordinary America pension holder.

Alongside this came a 'hollowing out' of US manufacturing industry as companies looked abroad for cheap goods and labour. Similar trends were afoot on these shores. By the middle of the 1980s, the American manufacturing sector was increasingly taking advantage of competitively priced, non-unionised foreign workers by moving production abroad. This process only accelerated once the end of the Cold War introduced millions more workers to the global economy. Whilst the working classes of America were invariably the losers of this deal, politicians made the case that the benefits to the US would outweigh their collective plight. New employment would be found in services, technology and the like, workers would be 're-skilled' and the vulnerable would be caught, short-term at least, by the welfare system.

China was poised and ready to take advantage of these developments. Following decades of economic darkness since the emergence of Chairman Mao, the more pragmatic regime of Deng Xiaoping adopted an 'Open Door' policy in the late 1970s. The country moved away from command socialism and concentrated on developing strategic industries with a global market in mind. The United States happily paved the way for further Chinese integration into the global economy, culminating in China's eventual admission to the World Trade Organisation in 2001. This final step was partially aimed at shrinking the trade deficit between the two countries. In reality, that deficit ballooned. Whilst China did liberalise and open certain sections of its economy, it kept the door to its domestic market firmly closed. By casting aside the established rules of free trade, China became the overwhelming beneficiary of globalisation, exploiting western markets whilst reinforcing its role at the centre of a powerful Asian market bloc. It simultaneously built up its own internal market and service sector, accrued vast reserves and began to secure stakes in strategically important commodity corporations and those which agreed to transfer technological know-how.

By the late 1990s, the income of the average US citizen had begun to stagnate as the hollowing out of Western economies continued apace. To disguise this unpalatable problem, politicians in the US (and here in the UK, its most closely related economic cousin) eagerly took advantage of the low inflationary environment provided by cheap Asian labour. They turned to a high consumption economic model fuelled by debt (often racked up against Chinese reserves) in the private and public sector. With easy credit and cheap mortgages, US and UK individuals were able to borrow cash as never before, the false perception of wealth embedded by access to cheap Chinese goods. Meanwhile financial services in the West thrived to manage the seemingly insatiable demand for new investment instruments.

For politicians in both America and China, the relationship between the two countries this seemed a classic case of win-win. In the US, citizens could enjoy cheap money and cheap goods. For China, the immature manufacturing sector boomed as hungry Western markets were exploited. For sure, even in the late 1990s there were nagging doubts about the sustainability of this arrangement. But to rectify them would cause short term economic difficulties and get politicians into hot water with angry voters. Furthermore, the United States was still in the driving seat. It would always be able to dictate the terms of its relationship with China…or so we thought.

Make no mistake, China will not emerge unscathed from this global recession. A slump in demand has already led to extensive Chinese unemployment. Social upheaval may follow. Given that China relies heavily on a healthy US consumer, it is conceivable that the unbalanced, but overly dependent relationship may yet develop into a tight economic alliance. Nevertheless, China remains on a growth trajectory that seems set to take its economy past that of the United States by 2050. The US Treasury and its ailing banks have been stabilised by Chinese loans. The US market remains dependent on cheap Chinese imports. It is hard not to conclude that in truth China holds almost all the cards when negotiating the terms of its bargain with America. What is more, its ascendancy – and that of near neighbour, India - may only just be beginning.

Last year, as the financial system collapsed at breathtaking rate, US and European banks and governments quickly borrowed colossal sums to shore up their operations. In large part that borrowing was funded by China's vast surplus. In this way, a trend that was already in motion – a shift of economic power eastwards – has been markedly accelerated.

The legitimacy of western capitalism has always been bound up in the idea that it can best deliver prosperity to the masses, offering many millions a route to middle income stability each year. But as jobs and money have been sucked eastwards, that mass prosperity – for the West at least – may no longer be guaranteed. The wealth of the past two decades is increasingly being regarded as an illusion and the competitive edge the US and Europe have over China and India in services, technological development and scientific research may just as easily be taken from us. China is churning out millions of industrious, well qualified engineering and technology graduates. As it controls stakes in so many western corporations, it is also able to transfer and copy intellectual wealth with ease. Soon the powerhouses of Asia could be undercutting western labour not only in manual but also white-collar and the most highly qualified management positions.

So what will China do with the strong hand it has engineered? Many naïvely assume that along the path towards economic superpower status, China will inevitably become more open, democratic and western. We assume (or perhaps hope) that it will abide by the western ideals which have shaped the world's international institutions and laws. It will play by our rules. But all these notions betray a fundamental misunderstanding of how China operates.

Westerners have confused the material wealth brought about by access to cheap credit and cheap goods as a physical demonstration of superiority over the world. However the debt that has been accrued by the West has come at a cost both in terms of future economic health and, more importantly, global influence. China has played – and continues to play - a patient game. Not for that country the quick fixes and instant gratification inevitably pushed for by western democracies. Instead a more patient strategy has been pursued, best illustrated by Deng Xiaoping's 'Twenty-Four Character Strategy' – observe calmly, secure our position, cope with affairs calmly, hide the extent of our capacities, bide our time, maintain an assiduously low profile, never claim leadership and make some contributions apparently from the sidelines.

It is inconceivable that China will not now seek to exercise its muscle on the international diplomatic and military stage as a result of the strong hand that has been quietly won. In fact that power is already manifesting itself. Take for instance China's refusal to condemn explicitly Iran and North Korea's nuclear ambitions; its military action in Tibet despite international outcries; the continued unease in Taiwan; the influence it exercises across large swathes of commodity rich Africa from the Sudan to Zimbabwe. Similarly from the Caribbean to the South Pacific, it is systematically buying up influence at the UN amongst its smallest sovereign nations. Even under Barack Obama's leadership, China is likely increasingly to reject US economic, military and humanitarian pressure. It will have greater success in any future competitions for resources and greater power to ignore the norms and rules of the 'international community'.

What does this all mean for the UK? Curiously, now that the price of our national profligacy has been put into sharp focus, policymakers seem determined to return to business as usual. Further borrowing and the maintenance of historically high levels of public expenditure seem the order of the day, as government remains reluctant to prepare voters for some very inconvenient truths. With typical impatience, the media is already beginning to ask when the recession will end as it hunts for green shoots in every dark corner.

In cold reality, we must accept that for too long now we have been living way beyond our means, riding on a wave of abundant credit, low inflation and inflated house prices which have combined to create a false hope of ever rising living standards. As a medium-sized economy primarily reliant on a hitherto booming financial services industry, we will remain vulnerable for some time to come. For those middle income folk outside the gilded corridors of finance who were unwilling to accrue wealth via (largely housing) debt, the economic stagnation had become ever clearer well before the recession. Average salaries and wages have stagnated for almost a decade, a fact that has been disguised by grossly inflated asset prices. For younger people in particular, merit and hard work were no longer translating into secure, well paid jobs and affordable homes. Despite this, the past fifteen years will soon be regarded as having been the very best of times.

The long hard slog of a slow recovery will be difficult to swallow for a nation used to assuming that its debts would never be called in. British employees are owed nothing more than the Asian sweatshop worker and even the graduate-level openings of tomorrow may equally be filled in the decades ahead by qualified and hard working twenty-somethings from the East. A rapid return to sustainable economic growth cannot be taken for granted. Complacent hopes of British exceptionalism may not see us through. We might not have the money to cushion this blow as we have in the past with a generous welfare system.

In the short term, we will have to take a long hard look at the books and sharply pare down spending commitments. In the long term we must make a strategic decision as to the direction of our economy; whether to gamble our future on the possible resurrection of our financial services industry; going it alone as a beacon of dynamism, or whether to diversify our economy and – implausible as it may sound today - tie our future more firmly to Europe in the hope that the strength in numbers approach will shield us from the stiffest of economic competition from the East.

The recent economic demise has never been outside the bounds of possibility. History is full of banking crises, burst bubbles, periods of economic darkness. But the breathtaking speed at which economic power will shift firmly to the east is new. The fundamental imbalance in the economic relationship between the United States and China will now either cause that relationship to implode or it will be prolonged and made more acute by a continued tsunami of debt. Either way, the coming decades will likely be shaped by the emergence of an increasingly confident China keen to flex its muscle economically, politically, culturally and in short order too, I suspect, militarily.

The West's hope that it can assume continued dominance in the 'knowledge economy' may prove optimistic. I suspect that within the next twenty years, it is quite likely that the intellectual property rights that have underpinned the West's competitive advantage (licensing, patents, copyright protection) are overdue for a radical, philosophical shake-up. An ever more assertive China will argue that traditional IP structures are no more than the West's attempt to impose its own form of protectionism to suit its particular demographic. We should not assume that the dominance of 'our' values in determining global trade will remain unchecked. If there is to be a longer-term price for our collective indebtedness, it will be for the UK to watch with increasing impotence as it becomes our turn to suffer as the rules of the global trading game are changed.

Farewell to a Wasted Decade

10 July 2009

Too few of my parliamentary colleagues have woken up to the enormity of the debt crisis that follows hot on the heels from the economic downturn. Yet the seriousness of what will follow cannot be long denied.

For sure, technically the worst of the economic recession may now be behind us although it would be premature to conclude that a 'double-dip' recession is not on the cards as the effect of the stimulus dies off in the New Year. Amidst some of the glib green-shoots commentary, we should also understand that the banking crisis represented nothing unusual. Indeed it signalled the end of another in a long line of boom/bust cycles (positively commonplace in the second half of the last century) caused by speculative euphoria and an excess of credit.

It is the Labour government's narrow interest to present this as being an entirely unprecedented type of downturn caused by modern financial alchemy gone wrong, failure by regulators or rank unforeseeable misfortune. This is not so. It is true that the global nature of the economic crisis has made things worse. But there are also clear lessons we can learn from the past. One of the grand old names of British banking, Barings, collapsed owing £780 million only fourteen years ago; today RBS survives courtesy of a £26 billion bailout. But it is only the extent of the economic downturn, not its cause that is so very different.

The UK economic downturn began when household debt and housing bubbles simultaneously burst. Our house prices rose 88.5% in the decade to 2007 – even in the sub-prime enhanced US this index rose by only 64.5%. Our average household debt leapt from 105% in 1997 to 177% of disposable income a decade later – in Europe and the US both the overall levels and increases during this period were significantly lower. The toleration and promotion of these debt bubbles alongside the growth in financial services and property industries was an integral part of the government's narrative of creating an economic miracle. It had long since given up on encouraging old-school manufacturing and needed to find favour amongst middle income Britain's to secure electoral support.

The first decade of the Labour administration seemed for so long like the best of times. However, in our complacency we planted the seeds of catastrophe. Consumer consumption in the US and Europe was maintained by unsustainable levels of public and private debt. The dotcom revolution was heralded as a 'new paradigm', so whilst almost imperceptibly the wages of middle income earners stagnated, consumption in a low inflation, low interest rate economy remained apparently robust. In truth – as we have seen – Gordon Brown's 'new' economy was sustained by an old-fashioned private debt bubble. Cheap mortgages remained eminently affordable by virtue of the deflationary effects of China and India's emergence on the global economic scene. The Clinton administration's deregulatory policies promoted a love affair with home ownership in the US previously seen only in the UK.

Millions of families – including latterly many of the sub-prime borrowers – were able to clamber for the first time onto the property ladder. For so long as the housing bubble inflated, this new breed of property owner was able to borrow yet more on the back of rising house prices. Naturally this also happened with a vengeance on these shores as became startlingly apparent with the demise of Northern Rock.

As the level of private debt reached dizzy heights the financial risk to the general taxpayer of widespread default suddenly got a whole lot more serious. As we now know there was good cause for retaining the distinction between retail and investment banking, which in the US at least existed for over six decades until the repeal of Glass-Steagall in 1999. Little did we know that the inherent risk of investment banking was to be transferred not to retail banking depositors but to global government balance sheets. Instinctively bankers understood this and once their institutions became too big to be allowed to fail, they had precisely zero incentive to minimise danger. On the contrary investment banking's short-termist bonus culture positively encouraged reckless risk taking.

The abiding lesson of the global banking bailouts is that in future no institution should be allowed to become so large that it cannot be allowed to fail. That way lies the madness of ever more public exposure to financial calamity. An effective regulatory regime requires the eradication of, rather than reward for, risk taking. It must avoid the creation of barriers to entry that favour large established corporations over entrepreneurial start-ups. Hence the Conservatives' support for a future banking industry made up of smaller, more competitive institutions.

However, there is an uneasy feeling that banking is fast returning to 'business as usual'. Public anger at the proposed £10 million bonus package for the new top team at RBS would perhaps be better directed towards ensuring that risk-taking in future is better managed. Indeed the crisis of the past nine months has seen those banks that have not collapsed, disappeared or been nationalised suddenly become markedly more profitable as competition has fallen away. Yet whilst money flows again into the hands of bankers the essential structure of the industry remains intact – in short, the taxpayer will be the lender of last resort if all goes wrong. Small wonder that even some Conservative commentators support the notion that banking as a sector whose failure threatens the entire economy must have some added costs and regulatory restraints imposed upon it. After all, the debt now facing future generations of taxpayers courtesy of this banking-led credit catastrophe is more than was ever racked up to fight two world wars. Let's not even speculate at the inflationary prospects ahead if Quantitative Easing proves overly effective.

I have written before about the colossal trade imbalances between the West and China which have spawned a fatal interdependency. This has been made worse by the ending over recent decades of both the gold standard and capital controls, the mechanisms by which trade imbalances were traditionally kept in check. Consequently since the late 1970s the UK and US have borrowed incrementally more and exported ever less whilst China, especially over the past decade and a half, has built up a huge current account surplus.

Arguably it is these imbalances rather than inadequate regulation that have been the cause of the economic calamity that has beset the global monetary system. A new international framework to secure stability in the management of global trade and the flow of money within the world economy is now overdue.

This economic downturn has been unique in its dramatic global effect. But the core causes are not so very different from what we have seen before. As a result the solutions do not require - whatever our government may tell us – a bewildering racking-up of unimaginable levels of debt for future generations of taxpayers. Indeed nothing will more certainly hinder our prospects of rapid economic recovery and a sustainable return to improved living standards.

The biggest threat in the years ahead is that the indiscriminate pumping of money by the Bank of England into the economy will bring with it an unsustainable mini-boom. Thereafter a combination of inflation, rising unemployment, weak growth and diminished competitiveness will produce a toxic mix of stagflation – truly a 'back to the 1970s' phenomenon. The worst case scenario here is that a future government may regard a sustained dose of inflation as the quickest and most politically convenient way of helping bring down the level of public debt.

In truth, any UK government that is regarded as popular in 2011 and 2012 is probably not administering effective economic medicine. To do the right thing on tax and expenditure in the years to come will not be seen as a politically easy option.

This year, if we follow the government's almost certainly optimistic predictions, we shall be borrowing – I repeat, borrowing, not spending - £450 million each and every day. As such for every £3 raised in taxes in 2009, the government is spending £4. None of this can remotely be regarded as investment - this is consumption plain and simple. The billions being borrowed now to ease the impact of the downturn for today's electors will be repaid by future generations in the form of higher spending, higher inflation and reduced living standards. Yet the true cost of all this will not become apparent in the months ahead. The government is desperately hoping these sands of time nor the patience and goodwill of an increasingly alarmed gilt and bonds market do not run out before it has to face the voters. Which makes talk of economic recovery now so very dangerous. Contrary to the Prime Minister's fatuous claims, this is not a simple, binary choice of 'Tory cuts' set against 'Labour investment'. There is a hard slog ahead for any administration.

If political leaders are unwilling to face up to the stark facts of this long march back to fiscal balance and economic recovery it may even be necessary to bring in the IMF. What better way to encapsulate the power of the quangocracy we have built up for a political class unwilling to take responsibility or court unpopularity than to bring in a neutral umpire to make the really tough decisions on public spending?

This is one of the reasons why the Conservative leadership feels inclined to give as few specific hostages to fortune as we head towards our day of destiny with the electorate. I am reminded of the incoming Labour government at the election of October 1964. Then Harold Wilson and his Chancellor, James Callaghan, had in Opposition consistently portrayed devaluation as an economic catastrophe to be avoided at all cost. As a result once in office they spent three ultimately fruitless years desperately trying to avoid this fate before succumbing to universal derision.

The lesson is plain – leave as many economic and fiscal options open before an election and act quickly once in office.

"Whilst government needs to play a crucial role in stabilising and revitalising our confidence-battered economy, it will eventually be hard work, enterprise and freedom in the market place which will ensure our economy thrives once again."

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