*Mark Field MP*

# The Road to Recovery?

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# Foreword

The past year has been a fascinating period for observers of both global economics and UK politics.

This collection of articles and parliamentary speeches provides a snapshot of my views as MP for the Cities of London and Westminster during the climactic months of the Labour government and after this May's inconclusive General Election outcome. As a remorseless critic of government debt and Treasury complacency over the deficit during the past half-decade, I supported wholeheartedly the Conservative policy shift towards an austerity narrative during the latter months of 2009.

As the election approached we shied away from a robust message on the economy that sadly ran counter to a general sense that 'the recession is happening to someone else'.

Yet having failed to secure a conventional Party majority and needing to cobble together a coalition, the government has thankfully been emboldened to promote a decisive programme of deficit reduction once more. This is where we are now.

Soon the phoney war will be over and collectively we shall begin to see the impact of the tough decision-making that politicians have failed to confront over the last decade. But those events are the preserve of a future booklet. The past year has been fascinating enough - I hope you find the views I have set out here thought provoking, and that you may perhaps even agree with some of them!

**MARK FIELD**
October 2010

# The Future Landscape of Global Finance

## 18 November 2009

Such colossal sums of global taxpayers' money have been spent and immense government guarantees continue to underpin the financial system that it is remarkable how little agreement exists to what constitutes the point at which the banking industry can be said to be fixed. Less still is there any emerging consensus as to the ideal future landscape of the financial services world.

This is no mere academic issue. The imperative to start repaying borrowing at the earliest opportunity cannot be overstated. Yet commercial lending is unlikely to return to anything like normal until the second half of 2011 as toxic assets are gradually removed from bank balance streets. The credit crunch will be with small and medium sized businesses for some time to come.

Meanwhile this year UK taxpayers are consuming over £4 in government spending for every £3 raised in taxation. This unprecedented burden of borrowing will have to be repaid by future generations in the form of reduced living standards; the UK situation being especially acute as our public finances were already in a dire state as we went into the credit crisis.

To extend beyond £200 billion of Quantitative Easing puts at great risk our medium-term economic prospects: so when can the Bank of England and the Treasury call time on their short-term fixes? Amidst the euphoria of a narrative suggesting recovery is within sight and a FTSE back above 5000 I fear that we are in truth some way from being out of the woods. I have written before that the root causes of the global imbalances brought about by the West's financial calamity were the credit/debt bubble along with the East's aggressive desire to build market share in global trade. China's policy of suppressing its currency to soak up the West's debt in the bond markets further helped hold down interest rates. Yet the resultant over-investment, excess capacity and vast structural debt in the West remains in place. The underlying causes of the crisis have not gone away.

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Notwithstanding the ruinously expensive bailouts and capital raising, the losses incurred by banks are probably still not even halfway recovered. Indeed the government's insurance of toxic assets has provided a dangerously false dawn. There is no incentive – or currently requirement – for banks to crystallise non-performing loans because they could not then ignore the losses on their balance sheet. Lloyds Banking Group, for example, with a huge property portfolio courtesy of its disastrous HBOS merger, sits on an enormous pile of assets worth a fraction of their book value at their boom time purchase.

The collapse in public confidence in financial institutions and their more esoteric products has met with a strong-armed, opportunistic political response. Put simply, we need to ensure that management in banks are able to summarise in simple terms the financial products they wish to sell. If a derivatives product cannot be explained on two sides of A4 then frankly it should not be marketed.

Naturally an unworkably complicated regulatory framework risks seriously hitting the future viability and profitability of the entire industry.

Instead, the wellbeing of the institutions in this sector – not to mention its customers – depends upon the development of a workable regulatory system based on commercial principles which pass muster over the decades to come. How else can we persuade those in their twenties to commence a lifetime of prudent saving as a prelude to a financially comfortable retirement? It all comes down to trust. This is an ingredient that no amount of regulation or 'consumer protection' will rapidly restore.

Alongside the promotion of open competition (an end to the heresy that a bank might be 'too big or interconnected to fail') the best government can do is to advance a culture of mutuality. In short, inculcate a sense of accountability between individual policyholders and a diverse range of financial institutions. For this reason, Conservatives should welcome the potential of Northern Rock returning to building society status once it has been stabilised financially. Promotion of as diverse as possible a financial services ecosystem ought to be a goal of future Conservative policy in this area. In future we need ethical values to come from individuals rather than resulting from a hostility which, inevitably, will be mounted against an all-powerful regulator. We should not expect too much from regulation. The buck must stop with all of us as consumers.

Regulation creates barriers to entry and promotes the large and bureaucratic over the small and innovative. A competitive free market can only be promoted by the reestablishment of less concentration amongst all institutions in the financial sphere and ultimately means allowing companies – even huge players like Lehman Brothers – to fail. The interests of depositors and retail investors should rightly be protected from such an eventuality.

A healthy, competitive and innovative capitalist system requires risk-taking, which is why shareholders and bondholders should not naturally expect such blanket protection. The trouble is that too much of the current debate on banking regulation has focused on how we should have stopped the last crash. This has not been helped by a government whose recent economic policy pronouncements are governed less by the national interest and more by a 'scorched-earth' approach designed to limit the room for manoeuvre for years to come of any incoming Conservative administration.

We would be better turning our attention to how best to create a future global financial system that will be trusted by today's children investing in the decades ahead in anticipation of a long, secure retirement income.

# Reforming the City

## 2 December 2009

Collectively our nation was lulled into a false sense of security by the clement economic conditions that prevailed for a decade from the mid-1990s, alongside a delusional sense that the good times would be here forever.

In this sense at least, government has been in tune with public sentiment. There is an almost primeval human urge to avoid confronting the unpalatable in the hope that today's problems will simply fix themselves. 'Something will turn up' – the watchword of the cheerily optimistic and insanely reckless alike.

One of the underlying characteristics of the deep financial and debt crisis in which we find ourselves is that continuing state of denial. Part of this is understandable. Two years of grim daily news on the financial crisis has not been matched – except for those who have lost their jobs – by any sense of financial sacrifice. This continues as the government pumps more money into the economy. The time of reckoning will soon be upon us.

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 continued stimulus dies off probably just after the General Election. 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 in the 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 £45.5 billion bailout. But it is only the extent of the economic downturn, not its cause that is so very different.

Arguably it is the credit/debt bubble along with the China's aggressive desire to build market share in global trade rather than inadequate regulation that have been the cause of the economic calamity that has beset the global monetary system. 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 combination of inflation, rising unemployment, weak growth and diminished competitiveness.

This 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 expedient way of helping bring down the level of public debt. Moreover, inflation provides a convenient route to enhancing the tax take as fiscal drag is allowed to run its course. The inflationary pressures brought about by the fiscal stimulus and quantitative easing may in any event make this path difficult to avoid in the years to come.

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.

The billions being borrowed now by the government 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 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 UK political administration.

Only the Conservatives have truly begun to wake up to the enormity and seriousness of the debt crisis that will underpin domestic politics for much of the decade to come. In essence this is why, with our Party riding high in the opinion polls, the bond and currency markets have been calmed into quiet confidence about the nation's economic prospects as we look to the General Election. For it is certainly not some miraculous solving of our dire public finances that has soothed the markets over the past few months. Indeed the IMF has calculated that over the course of the next decade, the UK government should ideally impose a fiscal tightening of 12.8% simply to restore the national debt to pre-crisis levels – an option considered by most to be so extreme that it would prove politically impossible to implement.

The prospect of a hung parliament and further delay to the required radical decision making, pending a second election, risks tipping sterling and the gilts market into a catastrophic state. Nothing would be more damaging to our economic outlook than for a layer of political uncertainty to be added to our economic uncertainty. The markets have factored in firm action in the near future and risk being tipped over the edge if further delay results from an inconclusive election result. Just imagine the unseemly horsetrading that would result from a hung parliament simply to form a government.

In the absence of firm political decision making about expenditure or tax, market activity would certainly fill the void. The currency and bond markets would probably turn sour; there is a substantial risk of a sterling crisis; long term interest rates would soar and the nation's essential triple-A gilts credit rating might even face a downgrading. If political leaders – concerned only in gaining tactical advantage - showed themselves unwilling to face up to the stark facts of this long march back to fiscal balance and economic recovery it could even prove necessary to bring in the IMF. A political class unwilling or unable to take responsibility or court unpopularity may in this way be forced to bring in such a neutral umpire to administer the really tough decisions on public spending.

So how to bring about the decisive

leadership on the economy that the country so desperately needs?

Opposition parties have spent the past few months systematically discrediting the government's record for economic management. This has been an unqualified success. The Conservatives in particular have also been upfront about the collective task that lies ahead and we have made some difficult statements about the need to pare back public spending. But there remains a fundamental disconnect with the public – as well as a lingering sense of fear - that could well prove the difference between a working majority and a hung parliament. Any party aspiring to govern now requires a sweeping, positive, uplifting vision to counteract the dismal deficit of aspiration in today's Britain.

From now on politicians need to promote a consistent and well articulated case for sustained economic growth. The truth is that rapid action to correct the deficit will be the quickest route to the promotion of growth and recovery. A well thought out timetable to sort out the public finances boosts confidence and – as all the international evidence shows – promotes more rapid recovery. Note too that nothing will choke future growth more conclusively than tax rises. Cuts in public expenditure, rather than additional taxes, especially those on income, are more likely to result in economic expansion.

Above all let us not forget that the opportunity this financial crisis lends any party hoping to govern is incredibly exciting. Far more enthralling than the prospect of holding office during the past decade. Success in the battle of 2010 has the potential to provide the victor with explicit consent to reshape the entire country, redefining the government's role in Britain and Britain's role in the world. Politicians must now articulate that sense of excitement as to the challenges ahead. For sure, the public needs to know the scale of our problems and have a taste for the solutions. It now falls to me and my colleagues to give our fellow Britons something to believe in.

# Battle of the Bonuses

## 4 December 2009

I appreciate the bewilderment of the general public at the rapid return to huge bonuses in those parts of the City (including the 70% state-owned RBS) which seemed so close to collapse only a year ago.

However, amidst the anger and dismay we need to realise that this is a highly mobile, global business. The only way to introduce an effective cap on banking bonuses would be by a binding, international agreement to cover London, New York, Hong Kong, Singapore, Tokyo et al. This is NOT going to happen.

Conservatives rightly support calls for restraint throughout the financial sector and in order to open up lines of credit to small businesses it was our suggestion last month that this year's bonuses should ideally be paid in shares, which would only vest in future years.

The government is all at sea on this issue. It should now stop grandstanding with its "for the many, not the few" line and lead public opinion with a frank explanation of a practical way forward on bonuses.

The real question for the future is this: how can the UK taxpayer get best value for its colossal investments in both RBS and the Lloyds Banking Group?

For sure we can impose stringent rules on bonuses being awarded by those banks which are majority state-owned. But the truth is that the brightest and best will simply leave and join other banks where they will not be subject to a restriction on their bonus and earning capacity.

If we are to repay these nationalised banks' debts and sell off the stakes we own as rapidly and for as much value as possible, how can it be in the national interest to constrain these banks from maximising their financial performance?

# The Economic Perils of Political Uncertainty

### 14 December 2009

The relentlessly breathless press coverage of the financial crisis over the past two years may have persuaded the electorate that we have already been through the worst of the recession. The truth is that such optimism is dangerously unwarranted. The economic reckoning for the general public has yet to begin.

The relative calm and stability in the bond and currency markets owes more to the imminence of a General Election and the markets' confidence that an incoming administration will put politics to one side and administer the tough economic medicine the UK so desperately needs. For it is certainly not some miraculous solving of our dire public finances that has soothed the markets over the past few months. Indeed the IMF has calculated that over the course of the next decade, the UK government should ideally impose a fiscal tightening of 12.8% simply to restore the national debt to pre-crisis levels – an option considered by most to be so extreme that it would prove politically impossible to implement.

As we saw in last week's Autumn Statement it is only the Conservatives who have begun to wake up to the enormity and seriousness of the debt crisis that will underpin domestic politics for much of the decade to come. In essence this is why, with our Party riding high in the opinion polls, the markets are calmly assessing the nation's economic prospects.

The prospect of a hung parliament and further delay to the required radical decision making, pending a second election, risks tipping sterling and the gilts market into a catastrophic state. I repeat - the general public has spent the past two years believing they are living through a financial crisis without having to start paying the price. The effect of the current government's pumping money into the economy (however economically orthodox such a strategy may have been) has been to deceive the electorate into thinking this period has represented the worst of the economic downturn. It is one of the biggest indictments of this government that it has continued to borrow recklessly whilst failing to educate the public as to the medium and long term consequences of such policies.

Understandably the public remains reluctant to have the comfort blanket pulled away. I totally support Conservatives unashamedly levelling now with the voters and making the case for an urgent restoration of stability to the public finances. For the colossal scale of this debt crisis brings with it the urgent need for fundamental rethinking as to the extent of the State's empire. Unarguably this comes at some potential cost at the ballot box.

Nothing would be more damaging to our economic prospects than for a layer of political uncertainty to be added to our economic uncertainty. The markets have factored in firm action in the near future. Even as the sands of electoral time move inexorably towards next spring, the sterling and gilt markets risk being tipped over the edge if further delay results from an inconclusive election result. Just imagine the unseemly horsetrading that would result from a hung parliament simply to form a government.

In the absence of firm political decision-making about public spending and tax, market activity would certainly fill the void. The currency and bond markets would probably turn sour; there is a substantial risk of a sterling crisis; long term interest rates would soar and the nation's essential triple-A gilts credit rating might even face a downgrading. If political leaders – concerned only in gaining tactical advantage - showed themselves unwilling to face up to the stark facts of this long march back to fiscal balance and economic recovery it could even prove necessary to bring in the IMF. A political class unwilling or unable to take responsibility or court unpopularity may in this way be forced to bring in such a neutral umpire to administer the really tough decisions on public spending.

Nor should anyone rule out the prospect of inflation being allowed to run riot as the most politically palatable way to assist in running down the debt burden. Moreover, a dose of inflation provides the expedient route to enhancing the tax take as fiscal drag is allowed to run its course. The inflationary pressures brought about by the fiscal stimulus and quantitative easing may in any event make this path difficult to avoid in the years to come.

So how to bring about the decisive leadership on the economy that the country so desperately needs?

We have spent the past few months systematically discrediting the government's record for economic management. This has been an unqualified success. We have also been upfront about the collective task that lies ahead and we have made some difficult statements about the need to pare back public spending. But there remains a fundamental disconnect with the public – as well as a lingering sense of fear - that could well prove the difference between a working majority and a hung parliament. Rather than to continue to define ourselves in terms of negatives, I believe we now require a sweeping, positive, uplifting vision to counteract the dismal deficit of aspiration in today's Britain.

From now on Conservatives need to promote a consistent and well articulated case for sustained economic growth. The truth is that rapid action to correct the deficit will be the quickest route to the promotion of growth and recovery. A rigorously thought-out timetable to sort out the public finances boosts confidence and – as all the international evidence shows – promotes more rapid recovery. Note too that nothing risks choking future growth more conclusively than tax rises. Cuts in public expenditure, rather than additional taxes, especially those on income, are more likely to result in economic expansion.

Above all let us not forget that the opportunity this financial crisis lends us is incredibly exciting. Far more enthralling than the prospect of holding office during the placid past decade. Victory in the battle of 2010 has the potential to provide Conservatives with explicit consent to reshape the entire country, redefining the government's role in the domestic economy and Britain's role in the world. Let us now articulate that sense of excitement as to the challenges ahead. For sure, the public needs to know the scale of our problems and have a taste for the solutions. Once again it falls to us as Conservatives to give our fellow Britons something to believe in.

# Uneasy Calm Settles Over the Financial Markets

## 4 February 2010

Over recent months, global financial markets have been enveloped by an eerie stillness. The fear remains that this calm is unlikely to last – our fundamental economic imbalances have not been solved, merely parked. The recent indication from the Chinese government that it is to put a firm break on bank lending to ameliorate the effect of speculation is just one sign that points towards the likely return of market turbulence. The most negative effects of the crisis may well be most painfully felt in the stagnant aftermath of statistical recession.

As things stand, the global economic patient lies in an induced coma. Over the past eighteen months we have had near zero interest rates and governments worldwide have gone on an unprecedented spending spree – whether through quantitative easing, car scrappage schemes or bank bailouts - that has filled the gap left by the ailing private sector. The absence of an immediate market reaction to this, and the lag from credit ratings agencies in adjusting their assessments, has given rise (with the exception of Iceland, Greece and Ireland) to unwarranted complacency. But past economic experience reminds us that the State is not infallible to debt crises of its own. Sovereign default may not be the outlandish prospect we believe and the notion that huge deficits can be racked up without any medium term implications as to the cost and availability of credit may prove desperately naïve.

Remove the measures taken by governments to stem the downward spiral and our economic fundamentals do not look too smart going forward. There remain deep structural problems that may see our economic woes become harder to deal with once induced low interest rates, quantitative easing and enthusiastic investment in government bonds are removed from the equation.

For one, Britain's labour market is looking sickly. This recession has been characterised by graduate and youth unemployment and experience suggests that prolonged unemployment early in ones career risks longer term productivity. Not only that, but I have long feared that our nation's much-vaunted 'skills training' is failing to deliver a flexible and competitive workforce to face up to the challenge of competition from the millions of young Chinese and Indians graduating into the global marketplace.

In this post-crisis period, the temptation towards protectionism is likely to rear its head in the guise of demands for employment creation and retention schemes – the uproar over the Cadbury takeover will be just the beginning. Politicians need to make the case that any short term gains from this activity would inevitably involve longer term loss. Let us not forget that Britain has benefited significantly from the inflows of foreign capital over the past two decades.

We also face an increasingly powerful anti-capitalist sentiment. In every recession, a society inevitably wishes to punish those who have apparently precipitated the economic downfall. In our case, it is the banker. I understand the appetite for revenge but we must separate sensible measures to curb excess and risk to the taxpayer with punitive measures designed only to twist the

knife. Amidst this feverish pre-election political atmosphere, let us not ignore the case for the UK's imperative, competitive advantage in financial services. To be frank, we may wish in future for a 'more balanced economy' but no other sector will be a world beater any time soon on the scale of banking for UK plc. Nor should we forget the complementary industries of law, insurance, retail and entertainment – to name but a few – which all benefit massively from this sector when it thrives.

In this respect, I believe there is an urgent need for reliable, qualitative and quantitative evidence about the exodus from the City of London and the impact on London's financial markets following the imposition of a 50% higher rate income tax band from April this year. The Mayor of London has understandably taken it upon himself to defend the Capital's key role as a global financial centre. He, like me, has received plenty of anecdotal evidence in recent months of individuals and institutions already leaving these shores at the mere prospect of higher marginal rates of income tax.

Nevertheless, it is equally important that politicians refrain from bandying around figures in a way that can all too easily be regarded as hysterical. Indeed it can all too often be seen as special pleading from an industry that wishes to exempt itself from any form of restraint yet, in spite of the colossal sums of taxpayers' money spent to underpin, gives little indication of how the landscape of financial services should look in the future. Whilst recognising the potential for catastrophe if we delay the review of these matters until tax cuts are politically palatable, similarly little would be more undermining for the place of financial services in London as to be seen to be crying wolf about the numbers leaving. A robust case needs to be made and only reliable empirical evidence proving the effects of changes in tax rates can support it. For my part, as the MP for the City, I shall be working with the City of London Corporation to amass such evidence in advance of this autumn's pre-budget statement.

President Obama's attack on Wall Street excess comes at an especially dangerous time. The astonishingly rapid bounce-back in profitability this year for those banks still operating is a function of a diminution in competition in much of the sector and the effect of low-to-zero interest rates as easy government money has lubricated the system. These factors will be unsustainable even in the short term, so it is unwise to construct the terms of trade in global banking on the basis of this unusual period of super profits.

Nevertheless, the Conservatives here are right to press for a global accord to ensure that banks are no longer too big or interconnected to fail. Historically the City of London has benefited from arbitrage with Wall Street from withholding tax under President Kennedy (which precipitated the creation of the Eurodollar and Eurobond markets) to Big Bang in the mid-1980s and the effects of Sarbanes-Oxley (2002) in the aftermath of the Enron and Worldcom scandals. This time we must have an international agreement on the future landscape of the financial services world.

As I have written before, the rise of hedge funds owed much to stricter regulations post-Enron to control off-balance-sheet activity. Hedge funds were often the special purpose vehicle of choice created to bypass the culture of stifling regulation which always favours existing institutional players. Whilst asset management (whether hedge funds or private equity) has not been directly implicated in this global financial crisis, I believe that Obama's proposals may as an unintended consequence help promote a further explosion in less regulated

investment, which may prove the cause of the next financial crisis. As ever, too much political and regulatory energy tends to be expended in solving the last crisis rather than looking far enough ahead into the future.

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For this reason, Conservatives must continue to impress upon the nation that the end of the recession will not inevitably herald the beginning of recovery. This is not the Opposition talking Britain down. We are merely facing up to the reality that the avoidance of bitter economic medicine for some years to come is not an option. To coin a phrase, when it comes to the recovery, and repaying the nation's vast collective debt burden, the Conservatives at least will not stand by as the Do Nothing Party.

# Still the Biggest Game in Town

## 21 February 2010

Since time immemorial, the City of London has enjoyed an international reputation as a bastion of commercial certainty and reliability. It has promoted financial innovation, provided an international market to global merchants and in commercial affairs has rightly been seen as a watchword for justice, neutrality and fairness. As a result London has emerged as the global financial centre.

But this priceless asset to the UK economy is now being scrutinised as never before. The financial crisis has painfully highlighted our economic dependence on the City and our collective exposure to the risks taken by the banking sector. As we contemplate our future in the new, post-crisis economic landscape, many now suggest that it is time to wean ourselves off the City's false riches by diversifying our economy. But is this a realistic or desirable goal?

That failure in any single sector of the economy overexposes the domestic taxpayer seems unwise. The City's dominance over the past decade has also had wide-ranging social consequences. For a large proportion of British people working outside the gilded corridors of the financial services industry, the growth of the City's power simply increased the cost of living and reduced to a wistful dream any prospect of getting on the housing ladder (except via colossal personal debt). It could also be argued that the City precipitated a brain drain from other professions and industries, with our brightest and best graduates tempted away by the unrivalled starting salaries in banking jobs.

Framed in these terms, the desirability of a movement away from over-reliance on the financial sector seems sound. But when we talk of reducing our economic dependence on the City, are we sure that the UK offers similarly strong sectors to take its place? My fear is that many desire a smaller City, not out of pragmatism but rather an ideological distaste for financial services. In this feverish political atmosphere, let us not forget why - on the whole - a thriving City makes for a successful Britain.

It is not just banks that benefit from our financial sector but complementary industries such as law, insurance, retail and entertainment. So too do top flight universities and the arts and social charitable sector gain, the latter two from cultural funds or corporate responsibility grants often provided by the City's top banks and bankers. The presence of our large financial sector gives London the critical mass to attract the best professionals from across the globe.

The banking bailouts notwithstanding, the City contributes massively to the Treasury's coffers in terms of tax revenues and employment. It also plays a critical role in supporting business, whether that be in drawing huge inward flows of foreign capital to help build our infrastructure and prop up our companies or in providing British companies access to diversified sources of capital to enable them to invest and expand.

Even if opposition to City dominance is practical not ideological, I suspect that not only is it unlikely that any other sector will be a world beater anytime soon but that London's population is insufficiently equipped to deal with significant growth in new industries. Few people realise that at 9%, London has one of the highest levels of

regional unemployment in the UK. With Britain wedded to a model of high housing and employment benefits, those living in the Capital need to earn considerably more than the minimum wage to make it worth their while to work. As a corollary, it has been far easier in recent years to encourage hard working migrants to fill the jobs that Londoners have been unwilling or unable to take up themselves. We now have a large proportion of the indigenous working-age population without the skills or inclination to fill jobs of any description.

A nation of only sixty million people should be grateful to have one world-beating industry that is, in normal times, incredibly lucrative and feeds a panoply of other sectors. By all means, we should build up other sectors if we can and reduce the exposure of the taxpayer to risk. But economic diversification will be no easy option and should not lead to the neglect or diminution of the City – indeed if it does, the task of diversification will be far harder. Global businesses and their highly-skilled work forces do not necessarily have an innate loyalty to the UK. They will go where the legal, fiscal, regulatory, physical and social environment works best for them.

In this respect, more pressing than diversification must be the need to make the UK a place of possibilities, enterprise and entrepreneurship. I shall be working with the City of London Corporation in advance of next autumn's Pre-Budget Statement to amass reliable, qualitative and quantitative evidence about the exodus of companies and high net worth individuals away from the UK following the imposition of a 50% higher rate income tax band. It should be the priority of politicians of all colours to get that most important of messages out: that the UK welcomes business, whether in the financial services sector or indeed any other industry.

# Our Broken Infrastructure

## 22 February 2010

On the morrow of her 1987 election triumph, Margaret Thatcher pledged that the Conservatives would devote themselves to transforming Britain's inner cities. The urgent regeneration task for an incoming Conservative administration this year will involve transforming our increasingly shabby suburbs at a time of dire constraints on the public finances.

The regeneration of the centres of cities like Glasgow, Manchester, Liverpool and Manchester – to name but a few – has been one of the triumphs of the past twenty-five years. These areas have become attractive places to work and live. Even in my own central London seat I never cease to be amazed at the number of people in their fifties and sixties who choose to downsize from the Home Counties and move into a city centre apartment where they can benefit from an excellent retail, health, transport and entertainment offering. Alongside a more diverse and mobile younger population, they help provide a social glue that ensures many inner city areas now thrive.

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Unfortunately the same cannot be said of our suburbs. One of my not-quite-so-secret pastimes is exploring the streets of suburban London on foot in an almost Betjeman-like way. Beyond the seven square miles of my constituency, I travel by tube or overground about once a month to a farflung suburb and wend my back home through areas of the capital that very few outsiders ever see. It is rare that anyone takes a leisure trip to the Barkings, Crayfords or Dollis Hills of this world, but the furthest tentacles of our tireless capital can tell the visitor so much about modern British life.

For one, the pace of demographic change since the turn of the century in London's suburbs has been staggering. As life in the centre has become ever more expensive, it has been the outskirts of London that have absorbed those pushed further out and borne the brunt of the large waves of immigration over the past decade. While authorities such as Westminster City Council have a long history in dealing with some of the challenges of a hyperdiverse, hypermobile population – providing health-care, schooling, language services and housing quickly to new arrivals in the area – local councils unaccustomed to an unstable and diverse mix of residents are finding their areas' fast-changing population difficult to cope with. On top of logistical challenges come huge financial pressures. With government grants to local authorities calculated according to inaccurate population estimates, councils often find themselves servicing large 'hidden' populations alongside registered residents.

My walks also reveal neglected, rather shabby surburban districts that appear to have been passed over by the glitzy visions of urban planners keen to revive more central areas of the capital. Potholed roads and pavements and tatty looking street furniture make way for scruffy high streets, where the credit crunch leaves many shop units empty.

This bleak picture will be exacerbated by the grim economic outlook revealed in December's Pre-Budget Report. Following the General Election, any government will have to slam on the spending breaks. Nowhere will this be more profound than in infrastructure projects - yet this is precisely where a track record of patchy investment

has left the public realm in some areas falling apart at the seams.

Limited investment in infrastructure in the 1980s and 1990s was understandably identified as a political opportunity by Labour in the run up to the 1997 election. However, their grand building projects since, notably of schools and hospitals, have proved desperately poor value to the taxpayer, present and future.

Gordon Brown's diversionary tactic over the past thirteen years 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 public sector investment. As I have pointed out the cost the taxpayer will have to meet for PFI projects agreed over the past few years will amount to a huge ongoing additional burden on public expenditure typically over the next twenty-five years. Indeed the taxpayer is now firmly locked into making annual repayments for some 650 or so schools, hospital and other public sector programmes at a total liability so far stands at £262 billion, some of which will not be paid off until 2047.

Remember too that the capital value of these PFI contracts was only £55 billion – the vastly higher sum reflects the huge mark-up costs of lengthy long term contracts. Needless to say this comes at a time when public spending will already be under extreme constraint.

Yet the future political fallout of financially unravelling PFI schemes means that the room for manoeuvre open to any future Conservative government in the areas of public expenditure and taxation will be considerably limited – a fact acknowledged by Alistair Darling when in opposition he said of PFI, 'apparent savings now could be countered by the formidable commitment on revenue expenditure in years to come'.

The Treasury's response to concerns over PFI has always been robust and disingenuous – this means of long term funding was set up by the previous Conservative administration and the current government simply adopted the same rules but allegedly to tighter accounting standards. However, the principle underpinning PFI of private firms building schools, hospitals, prisons, bridges or roads has enabled the public sector to be charged often for decades ahead, leaving a generation-long legacy of debt. Broader public criticism has been muted because of the sheer number of private sector operators, contractors, consultants, lawyers and accountants who have all made hay over the past decade as advisers in a process that has proved extremely lucrative.

The true cost of accounting the future presents the sternest of challenges for Conservatives at a national level. But it will also fall to a group of relatively inexperienced senior Conservative council leaders to fight desperately to keep control of their districts at a time when infrastructure investment will by necessity have to be slashed.

Explaining to the public that this is a result of the extravagant costs and poor value of infrastructure projects already in the frame will be tough. Employ the acronyms PFI or PPP and the public switches off. It is the size of Sir Fred Goodwin's pension and the moats and bell towers of MPs that capture the public's imagination, not the couple of hundred billion pounds indiscriminately, incompetently splurged on PFI.

Conservatives face the challenge of reviving our suburbs and transport infrastructure amidst this depressing indifference to the true costs of Labour's decade-long spending spree. The risk is further decline of these

outer districts continuing alongside ballooning youth unemployment and increasingly fractious community relations. A serious situation risks being worsened by the systematic understating of population figures unless urgent attention is paid to the methodology of next year's nationwide census.

So much of local government in England is now Conservative run that we confront the sternest challenge in the face of a populist Labour campaign in the years ahead. Our task will be to reverse the waste of the past decade and reassert values of both economy and community in our suburbs.

# Warnings for the Road Ahead

## 1 April 2010

Now that the dust has settled on a highly political Budget, it has become ever clearer that our nation desperately requires strong Conservative governance to put our national finances back in order. Whatever the remedies within our reach should we secure office at the imminent election, we will also have to keep a close watch on events in the global economy which will surely have a significant bearing on the British economy in the years to come. There are already some worrying signals about the pitfalls ahead:-

1. If their governments are to be believed, the only way out of these economic troubles for all Western nations will be 'export-led' growth. I am afraid this begs the obvious question of just who will be doing the importing?

When the financial crisis hit, China acted earlier and more aggressively to forestall a serious downturn than any other large economy by engaging in massive fiscal and monetary stimulus. However, as most countries now agonise over how to keep their barely reviving economies growing, China is already looking to slam on the brakes. With policy makers becoming more concerned about containing inflationary expectations and managing the risk of asset price bubbles as a result of last year's aggressive expansion of credit, China's central bank has now moved to reduce lending to companies and individuals by, among other measures, requiring large commercial banks to increase the amount of cash they put in the central bank.

This is just one sign that points towards the likely return of market turbulence. If China brakes too hard, it risks slowing global growth overall and throwing other countries, including the United States, back into recession. Indeed when China announced its policy, share prices were sent sliding across Europe and America now that China's commercial banks have become ever more important lenders to the rest of the world following the contraction of lending by US banks. It is perhaps for this reason that despite the significant devaluation of sterling, widely expected to revive exports, a majority of British companies have reported that their export order books remain below normal.

2. We should also beware the looming threat of protectionism. Lessons from the crash of the 1930s over trade protectionism appear, to date, to have been learned. However, 'beggar thy neighbour' sentiments may manifest themselves in monetary policy (especially exchange rate). In the UK we have already seen the benefits of devaluation by some 25% over the past two years which may help alleviate the worst economic ravages in the months to come but we should not assume that this competitive advantage will persist. Indeed we may be losers as other currencies devalue in the years ahead; China, to name but one economic rival, also seems determined to use monetary policy to avoid what many would regard as a realistic revaluation of its own currency. The impending US legal judgment over alleged unfair competition might also result in tariffs being levied against Chinese imports. Clearly this would represent a dangerous escalation in economic tensions.

3. Finally, the global imbalances that were the underlying cause of the financial downturn have not been solved, only parked. Unless there is a smooth transition away from the racking up of huge trade deficits

and currency surpluses, the risk is that we simply repeat the policy mistakes culminating in a further crisis by the end of this decade with even greater imbalances.

We can no doubt take a positive hold of a large part of our economic destiny but it will inevitably involve a great deal of pain, a reappraisal of our expectations and a cold dose of reality over the degree to which we are at the mercy of global events (which will likely be primarily influenced by the way in which China handles its economic policy in the years ahead).

Our goal upon emerging from the economic gloom must be a fundamental rebalancing of the economy in favour of the wealth-creating sector, not a further public spending splurge. It is for this reason we should take little heart from the recent fall in unemployment, caused primarily by a growth only in public sector jobs. What we truly require is a proper strategy for growth, low taxes and a smaller state as a choice apart from this activist, intrusive government.

Sadly, in addressing precious few of our national challenges, the Budget perfectly illustrated the legacy of an administration that any objective observer must sincerely trust is now in its dying days.

It offered woefully little hope and inspiration to our young people, who are now beset by the ravages of an unprecedented growth in graduate and youth unemployment. If our nation continues to believe that 'Big Government' is the answer to all our travails and marginalises enterprise and entrepreneurship small wonder that many of our most promising youngsters will conclude that their future lies elsewhere.

A little over two decades ago I left university convinced that the UK was a place of infinite possibilities. I set up my first business as an undergraduate, got myself professionally qualified, sold my business, set up a second enterprise – all by the age of 29 and all here in the UK. Today's most talented young Britons will graduate with average debts in excess of £20 000 and the twin prospects of uncompetitive, high tax when they find work and collectively needing to repay the debts that my generation and my parents' generation have racked up over the past decade.

Essentially we are telling them that the price of British citizenship is to clear up the financially catastrophic economic complacency of this Labour government and foot the bill for over-consumption by our generation.

Unless we can contrive to present our brightest and best youngsters with a more attractive financial proposition we should not be surprised if they leave these shores. Some have highly globally mobile skills and we urgently need to convince them that this nation offers the exciting opportunities and limitless potential. If we do not, it is they who will vote with their feet.

# Winning the Battle of Ideas

## 12 April 2010

In the weeks ahead we can be sure that commentators will be ever eager to draw comparisons between today's domestic political scene and that of 1979 when the Conservatives were last swept to office.

Contrary to the myth that has since grown up, at that momentous General Election Margaret Thatcher presented a distinctive and radical offering to the electorate. I was a fourteen year old schoolboy at the time and recall the keen consensus that this was a crossroads election which had the potential to change not just political personnel of the day but our entire national direction.

We all fervently hope for a similar, sweeping victory after polling day. Indeed I passionately believe that a convincing result is not only what our Party needs but is essential for our nation's future well-being. However, I fear that this time the political backdrop is markedly different.

For one, the economic backdrop in 2010 is considerably more serious. Three decades ago we inherited a rocky economy, for sure. But we should remember that by the time we took control of the public purse, the country had been subject to monetarist policies for two-and-a-half years, courtesy of the IMF. In essence, the toughest decisions on public spending had already been made.

Second, the public was ready to embrace change in 1979. Today it seems the electorate has still to grasp the seriousness of our national economic situation. The hyperbolic media coverage of the past two years, charting dramatic stock market swings, house price crashes and global turbulence, has probably convinced many that the worst is behind us without the headlines having ever truly translated to the situation on the ground. This makes it all the more difficult to persuade a complacent public that an era of financial reckoning lies ahead.

Finally, the spirit of this age is uncompromisingly ugly for those of us who instinctively support capitalism, free markets and global trade. There is open hostility to banks, bankers, big business, the wealthy, private education, private health and the profit motive. This is in stark contrast to 1979 when the case for empowering people, the smaller state and individual responsibility had already been made.

Today, we are poised for electoral success without having needed to convince the public of the superiority of our case. Indeed domestic politics continues largely to be defined by New Labour's rhetoric, with our commitment to cutting public spending sold on the grounds of necessity rather than our natural instincts for a smaller, more efficient state. Conservatives have yet to challenge conclusively the contention that a government which devotes huge swathes of taxpayer cash to tackling 'social inequality' through a lumbering welfare system is more caring than one which believes in empowering the individual. Nor have we sufficiently defended ourselves against our opponents' class war politics. We acquiesce in higher taxes on the wealthy without making clear the very practical reasons why, in an age of global mobility, the brightest and best of our young people will simply leave these shores if their plans to create wealth and promote enterprise are stifled. As the election approaches, we must now make the political weather, dictate the terms of debate

and set out a distinct, positive pathway to a prosperous future. The tough times that lie ahead are sure to be infinitely more hazardous without such an underpinning.

To be tempted into a tussle for the centre ground is to rob the electorate of choice - which in part explains the sense of so-called apathy that continues to beset political debate in spite of our living in such tumultuous times. The floating vote slips with the tide and our task as Conservatives is to seek to influence the flow of that tide. If, as we widely believe, the electorate is repulsed by the politics of spin and illusion, then surely I am right in suggesting that authenticity and candour are the most effective weapons in the Conservative armoury?

Going along with the consensus that public spending and current living standards were sustainable even before the financial crisis took hold also robs the young of hope. Let us be clear: the political class has managed to avoid conflict over the past decade with older voters, home owners and those using unreformed welfare services only by consuming today and borrowing against future generations of taxpayers. A failure to grasp this nettle and secure an explicit mandate for the rapid administering of strong economic medicine, risks conflict and public disorder of a sort not seen on Britain's streets for a generation.

This is more than a mere academic debate. The global economic and political outlook is shifting so fast that any incoming Conservative government will need also to strike out urgently with a distinctive and convincing vision of the UK's place in the world in the decades ahead.

Let us be under no illusion, by the end of this tumultuous decade it is quite conceivable that our status internationally will have diminished considerably. First, our reduced military capability means we may soon no longer enjoy the prestige of a permanent seat on the UN Security Council. Moreover, as the geopolitical shift to the East gathers pace, the UK may find itself excluded from the top table of economic nations. The Centre for Economic and Business Research recently suggested that Britain may no longer be one of the world's top ten economies by 2015 and even if we do maintain our relative position amongst European nations, by 2050 we shall account for just 2.5% of global output (roughly where Benelux stands today in world rankings). Who is to say that in the coming years a G5 or so of the largest economies will not be instituted, with the UK's role confined to appearing as a bit-part player at occasional G20 summits? This readjustment will have a deep psychological effect on us all. No doubt it will reshape the way in which we look at the UK's multilateral obligations and should certainly inform a Conservative view on the forthcoming Strategic Defence Review.

I do not say these things to be unremittingly gloomy, merely to underline the importance of Conservatives having a consistent, resolute plan for the forthcoming election. The consequences of the political decisions taken in the next few years for the future prospects of our country cannot be overstated. We must make the UK a place of possibilities, enterprise and entrepreneurship; a place that inspires young, bright people, not drives them away.

Let us not lull the electorate into thinking that their choice in this election is not an important one, just a matter of swapping one lot for the other. No, this is a defining moment for our nation.

The forthcoming election must not be framed simply as a clash of personalities. It is far too important for that - it must be a battle of ideas.

# Capital Gains Tax

## 17 June 2010

We now know for sure that the nation faces a huge hole in its public finances. So amidst an economic crisis that has opened wider the social divide between the haves and have nots, a rise in capital gains tax to 40% seems to be an especially easy sell. After all this levy on second homeowners and rampant speculators is designed to fund a laudable income tax cut for the lowest earners. However taxing capital gains and income differently is not an anomaly.

Like many MPs, I have received an avalanche of letters and emails from angry and perplexed constituents since the rise in CGT was floated. These do not come from the ranks of the super wealthy or short-term City speculators.

Instead my anxious correspondents are predominantly people who have 'done the right thing' – those who have worked to build a business up, employees who invested in their company; workers close to retirement who have painstakingly acquired small share portfolios or those who, having lost trust in the pensions system, turned to property as a safe haven for their retirement fund. In short, rather than representing a neat redistributive tax from rich to poor, the proposed rise in CGT risks squeezing those caught in the middle and stifling aspiration and self-reliance to boot.

Capital gains tax is a levy on the gain or profit you make when you sell or otherwise dispose of an asset, such as shares or property. In addition to an annual CGT allowance (currently £10,000) and Entrepreneur's Relief, in the past taper relief (which modifies the levy according to the length an asset has been held) and indexation (the taking into account of inflation) have offset some of the burden placed upon individuals.

Capital gains have hitherto been taxed at a different rate from income for good reason. They come from investment and those investments inevitably involve risk - risk that does not necessarily deliver a return. Indeed given the current state of the economy, there is no guarantee that investing in shares or property will prove as beneficial in the future as it has been. Reduce further the incentives to make those investments in the first place, therefore, and you will find there are some unwelcome knock-on effects.

First, strong and growing economies depend upon high levels of investment. These have to be financed out of savings and the existing pool of capital. The UK has a serious problem already in this respect because our savings ratio has slumped to around 5%, compared to 35% in fast growing economies such as China and India. Accordingly in the UK we will have to depend on our current pool of savings and inward investments (which will result in ever more dividends and interest being sent overseas to the detriment of our own living standards). Higher levels of Capital Gains Tax will only serve to reduce further the pool of savings available for future capital investment.

Second, capital is highly mobile. For that reason economic competitors of the UK's such as Australia, New Zealand, Switzerland and the Netherlands, have abolished capital gains tax. All these countries recognise that high capital gains tax rates discourage investment. CGT also clogs up the capital markets. Nobody is compelled to sell an asset so uncompetitive rates of CGT will simply encourage those who do not need to

realise their gains to switch into other assets or securities. As such, there is a real risk that any sharp rise in the rates of CGT will produce a precipitate drop in the government's tax take from this source.

Moreover, high rates of CGT reduce turnover and liquidity levels in the stock market. In turn the most successful growing companies will find it more difficult and expensive to raise capital to the detriment of the UK economy as a whole. Naturally this also applies to foreign companies who have traditionally looked to the City of London to raise money for expansion.

Having been overwhelmed by individual respondents, I convened a meeting in parliament last week with representatives from the Institute of Directors, National Landlords' Association and the UK Shareholders' Association to test the breadth of concern over capital tax rises. Nearly every representative accepted the inevitability in the current economic plight of an uplift to CGT, but raised wide-ranging worries - the general competitiveness of the UK economy and the problems of uncertainty in the financial environment; the constraining effect on the private rented sector that stands to affect young renters and social housing tenants; the penalising of the small investor; the impact on company share schemes and mobile talent; the perverse message being sent out to pensioners and those saving for retirement.

If the headline rate is to remain, all representatives pushed for softeners, namely the reintroduction of taper relief or a return to indexation. This may be the only way yet seems contrary to the laudable aim of simplification in our tax system. In his famous 1988 Budget the then Chancellor, Nigel Lawson, brought into line the level of CGT with basic and higher rates of income tax. This was achieved at a time of aggressive reductions in the latter. Similarly two years ago Alistair Darling introduced a flat rate of 18% by removing indexation and taper relief.

Restoring a complicated regime of allowances and reliefs to take account of the effects of inflation and length of time over which chargeable assets has been owned sadly might prove an unavoidable compromise to part-protect the interests of the prudent and the elderly, long-term investor.

While we are assured by Business Secretary, Vince Cable, that the changes are designed at 'essentially private capital gains, financial capital gains and second homes,' he perhaps fails to appreciate fully that many second home owners have sought to save in such an asset as a consequence of the widespread lack of trust in pensions over the past couple of decades.

Similarly, the disproportionate impact higher rates on property will have on Londoners and those in the Home Counties seems not to have been taken into account. Many people who buy a second home outside the capital in addition to a small London base do so not because they are enormously wealthy but precisely because they are not. It is virtually impossible for many to trade up the property ladder in the Capital. For those with growing families, the only option is often to buy a second house outside London.

Above all, an increase in the rate of capital gains may in the event generate neither fairness nor additional revenue. Our nation more than ever needs to be able to repay its debts by wealth creation and selling our skills, products and expertise in a highly competitive global market. This cannot be done by disincentivising small businesses and entrepreneurs with higher tax for risk and investment now or by punishing those who have done the right thing by saving for their future.

# Budget Speech

## 24 June 2010

The first Budget of any new administration is a momentous event. Invariably it sets the scene for much of what will follow economically. This is a ground breaking and brave statement which has expressly changed the terms of trade. The case has robustly been made for a future for this nation underwritten by the success of business and enterprise.

It is only the third time in over three decades that such a Budget has been delivered. In the infinitely more clement economic weather of 1997 the then Chancellor, whilst ostensibly sticking to his predecessor's spending plans, announced fatefully his intention to restrict private pension tax breaks. At a stroke the culture of personal savings was undermined and a distinct shift from individual responsibility to collective, state provision was flagged up. It has perhaps taken a full thirteen years to appreciate the true implications of what many then regarded as a technical manoeuvre, borne largely out of a need to secure an easily available pool of cash to spend on pet projects, a state of affairs necessitated by making an orthodox manifesto pledge.

In the emergency Budget of 1979 the incoming Conservative government signalled a desire to unleash the power of the free market from the state's grip and promote free trade after a characteristic spell of Labour mismanagement. Indeed in the run up to the General Election this year, it became the pastime of many political commentators to draw comparisons between the momentous election of 1979 with the political and economic landscape of Britain in 2010.

Yet this simplistic analysis ignores the significant differences between these episodes. When the Conservative government took control of the public purse in the final year of the 1970s, our nation had been subject to monetarist policies for two-and-a-half years, courtesy of the IMF. In essence, the toughest decisions on public spending had already been made. In contrast this year, while there was a superficial acceptance that the best economic times were over, the sheer gravity of our massive economic problems was lightly skated over during the campaign skirmishes.

Indeed it served the expedient interests of all three main political parties to confine any economic discussions to a fatuous battle over public spending cuts of £6 billion – a sum we know has been borrowed by government every fortnight over the past year, and in the year to come.

The public was ready to embrace change in 1979. Today the electorate has seemed unwilling to grasp the seriousness of our national economic situation. The breathless, relentless media coverage of the past two years, charting dramatic stock market swings, house price crashes and global turbulence, has convinced many that the worst is behind us without the headlines having ever truly translated to the situation on the ground. This made it all the more difficult to persuade a complacent public that an era of financial reckoning lies ahead.

Finally, the spirit of the past couple of years has been uncompromisingly ugly for those of us who instinctively support capitalism, free markets and global trade. Once again today I am delighted that this budget starts to make the case for empowering people, the smaller state and individual responsibility.

The election now behind us, I remain concerned that our coalition government lacks the critical explicit mandate to make the tough economic decisions required as a matter of urgency to get the public finances back on track. For this parliament, indeed quite probably this entire decade, stands to be dominated domestically by the need to take a firm grip of the public finances. This year's budget deficit of around £155 billion represents 11% of GDP and means that we continue to borrow fully £1 in every £4 that we spend. And make no mistake this colossal living beyond our means is made up of consumption rather than investment in any meaningful sense. Correcting this imbalance will necessitate diminished living standards for the generation of taxpayers yet to enter the workplace. In large measure this must mean taking an axe to public expenditure - a remarkably rare event.

Whilst I am delighted at the generally positive media response to the Budget we should not forget that the pain of tax rises accounts for only 23% of its measures. Details of adjustments to public expenditure will be hammered in the month to come and only become fully apparent in 2011 and 2012. This is where the real logistical and political tests will come in the months ahead.

There is much to learn from history about those few previous episodes when there has been a need to make substantial public spending cuts. The single most significant period of efficiencies and reduction in public spending came in the aftermath of the First World War – and perhaps significantly during a period of peacetime Conservative-Liberal coalition government under Lloyd George.

The wartime economy had been characterised by huge, unprecedented state control. So much so that once the conflict was over, there was a massive upswing in the economy as pent-up demand, wartime savings and the removal of wartime controls caused a boom. However the first peacetime Budget actually led to a budget deficit of 6% of GDP after the then Chancellor concentrated more on building Homes Fit for Heroes and embarking on an ambitious social programme than balancing the books.

Hot on the boom's heels, however, was a grim slump. Having been one of the world's largest overseas investors before the war, Britain became one of its biggest debtors with interest payments taking up 40% of all government spending. The value of the pound depressed yet the anticipated export boom failed to materialise. Even preceding the slump there had been a public outcry at government extravagance. As the economic gloom descended and taxes increased, the outcry against government waste became a thundering clamour.

It was against this background of public pressure and economic misery that Lloyd George appointed Sir Eric Geddes to chair an independent review of central government spending in the bitter year of 1921, its aim to cut spending drastically by eliminating waste. The Geddes Committee was to become the most thorough and rigorous outside investigation of public expenditure ever conducted in Britain. It was also, of course, highly controversial, being composed of a single MP and five unelected business leaders. While lauded by the world of commerce, Conservatives and taxpayers, it was attacked equally by Liberals, Labour and the trade unions.

In the end, Geddes sliced £54 million off government expenditure on supply services for 1922-23, a ten per cent reduction. We should soberly remember that once ringfencing is accounted for, today the departmental cuts required are likely to be around 25% next year. Back in the 1920s a clear message was sent to ministers, Whitehall and the public that spending in

any form would be closely scrutinised like never before. The Committee's work was to mark a crucial turning point in the rebalancing of the public finances from a distorted war basis to a peace time basis.

So what can we learn from this? The Committee's success in rapidly achieving its goal was due to a number of factors:- professional and respected Committee members; unstinting support from the Prime Minister and Chancellor; working to a swift timescale; enjoying widespread public support for its aims; and also a willingness to compromise on those proposals that proved to be politically unfeasible. The experience of nine decades past also demonstrated that while politically difficult, public expenditure cutbacks are far from the impossible task often claimed.

Today above all we need desperately to achieve public support. The experience of the 1920s showed that while voters may agree in general with cuts, they almost never agree specifically with cuts affecting them directly. To put it simply, public spending reductions need to be fair, focused and effective.

History provides important perspective and pointers to the future. Wisely the coalition government has an even more recent precedent in mind. The Canadian model of deficit reduction in the first half of the 1990s took place in an era of global growth and plenty. We should not underestimate how much easier that made the painful readjustment that saw one-quarter of public sector employees lose their jobs. By contrast, today's reduction in headcount will be tomorrow's unemployment rise. In Canada the government had already levelled with the voters over a period of time; it then proceeded to provide clear evidence of year-by-year achievement in gains as expenditure was reduced. It also made the moral case that future generations of taxpayers should not see their living standards diminished as they pick up the tab for consumption and debts of current taxpayers. This is crucial.

This has been a brave Budget from the Chancellor. The fact is that despite the contrived anger from those on the benches opposite, the people who will most suffer are likely to be Middle England voters, the very people the Conservative Party relies upon for electoral support. The Budget's promise to be tough but fair is largely borne out, especially in its protection for the poorest and most vulnerable in society – indeed I have been saying for some years that I support the removal of our very lowest earners from income tax altogether and I am pleased by the steps forward in this regard.

I sound only one note of caution, however, and that is for the very real risk of serious sovereign default in the Eurozone. I in part accept the Opposition's view that there is a significant element of risk in this Budget, with many of the toughest measures coming in next year when the coldest winds may well be sweeping cruelly across the continent. However, for the sake of this nation's economic welfare, I believe this gamble is well worth taking. Given that debt, denial and delay are in part the problem, I cannot see that they can for any longer be our ultimate solution.

# The Next Financial Crisis May Already Be Upon Us

**5 July 2010**

I fear that the acute financial woes in Greece are but a side-show to a much more serious sovereign debt crisis that threatens to engulf the Eurozone in the months ahead.

The lesson of this week's global stock market jitters is that the UK, whilst proudly standing outside the Eurozone, will not be immune to its political and economic impact.

The coalition government's Budget set out a determined programme of decisive action to deal with the domestic deficit. Inconveniently this long-overdue transfer from stimulus to austerity is being faithfully emulated by many other EU nations, led by a German government constrained by a constitutional requirement to move to a balanced budget. This battening down of the hatches in key EU nations augurs ill for prolonged evidence of consistent renewed economic growth in mainland Europe. The twin worries of an unrequited policy of 'export-led' growth and monetary protectionism which I wrote about here after Labour's last gasp Budget in late March, now look very real indeed.

The main concern for the near term is of contagion - to Portugal, Spain (an economy four times the size of Greece) and even to Italy (two times the size again). Leading City figures working in European banks tell me that they are increasingly alarmed at the prospect of sovereign default by the turn of the year, especially as much of the debt of many of the struggling Eurozone countries – unlike the UK – will need to be refinanced over the next two or three years.

The more optimistic view is that some of the weakest economies can be persuaded 'voluntarily' to leave the Euro. These nations would take with them huge write-offs and guarantees on existing debt obligations, although it is difficult to see how such countries would ever again be able to finance their debt by selling bonds in the global capital markets. The lack of a mechanism to expel recalcitrant nations from the Euro may persuade the worst offenders simply to soak up support from the emergency fund for the European currency. Alternatively a two-tier Euro may enable Germany, France and others to draw away from the worst excesses of the currency crisis.

But make no mistake, the UK will be caught up as this drama unfolds even though we smugly sit outside the Eurozone. Some 55% of our external trade is with the countries that make up the Eurozone and our exports are already becoming considerably less competitive as the Euro depreciates against sterling.

Moreover, the fiscal and economic squeeze now underway in Europe designed to correct the sovereign debt crisis runs the real risk of promoting a renewed banking crisis. The truth is that in this low-to-zero interest rate environment (a deceptively benign state which provides a strong disincentive to foreclosure) many banks, both domestically and in mainland Europe, still have huge unquantifiable toxic 'assets' on their balance sheets. The interconnectedness of the global finance industry means that whilst British banks are not directly exposed to Greek debt, their German and French counterparts are. If Spain, Portugal or Italy falter then the exposure of our banks is more immediate

still. If this were to precipitate a renewed credit crunch, it is difficult to see how the British SME sector can play its crucial part in the export-led, private sector recovery on which all our hopes for economic growth are pinned.

Business expansion requires the smooth operation of a banking sector, willing and able to loan money freely.

It also requires confidence.

Sovereign default in the Eurozone in the next twelve months – if it happens – will have as profound an effect psychologically as it does economically. In truth the outcome many now regard as inevitable may prove every bit as seminal an event on global affairs as the collapse of Lehman Brothers in September 2008.

# Offshore Financial Centres

## 21 July 2010

As international organisations and major governments seek to understand the cause of the global financial crisis, small international financial centres (IFCs) have repeatedly endured political attacks and misguided criticism. From pejorative sniping about their being tax havens for avaricious bankers to allegations that they provide secrecy jurisdictions for shady figures in the international business community and are in part to blame for shortcomings in the financial markets, the debate over the role of small IFCs has been, to date, remarkably one-sided. This is unfortunate as it demonstrates a fundamental lack of understanding of their function and the benefits they provide to the wider global economy.

Before the UK and our international partners look to develop further international standards on financial regulation, it is critical that politicians and policymakers formulate and implement policy in an informed, consistent and balanced manner. As such, it is vital that we now take a dispassionate view of IFCs that looks sensibly at the benefits they can offer our nation as well as the broader global financial system.

The UK has a unique position in this debate. We have a constitutional relationship – through our Crown Dependences and Overseas Territories – with half of the top thirty offshore financial centres. With the Chinese government successfully lobbying the G20 to have both Macao and Hong Kong excluded from any OECD grey list on matters of tax transparency, it looks increasingly likely that the standards and regulations currently being formulated may well be imposed in some jurisdictions yet overlooked in others. Not only is this incompatible with the need to find a global response to the formation of new financial regulation but it risks undermining the UK's financial sector and the wider British economy which is a major recipient of investment capital raised through small IFCs.

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Small international financial centres, such as Jersey and Guernsey, are used by the global financial community for a variety of reasons. They include political stability and a favourable economic outlook; familiar legal systems often based on English common law; a very high quality of service providers; the ability to meet important investor requirements such as the legal infrastructure to sell shares; a lack of foreign exchange controls that remove restrictions on the payment of interest of dividends; tax neutrality (not to be confused with tax evasion) that enables investors from multiple jurisdictions to ensure they do not meet multiple layers of taxation as funds pass through the global financial system; and legal neutrality that ensures no one nationality is given special treatment.

It is for these reasons that there has been a mutually beneficial relationship between the City of London and many Crown Dependencies and Overseas Territories, demonstrated not only by the massive capital flows between the two which aid market liquidity and investment in the UK, but also legal and constitutional similarities and the transfer of skilled professionals. To give some idea of the scale of those capital flows, UK banks had net financing from Guernsey alone of $74.1 billion at the end of June 2009.

Unfortunately, because the public debate is largely myopic when it comes to IFCs, these benefits are often overlooked or conveniently ignored. This is in part as a result of small IFCs' relatively low profile, from, for instance, a lack of seats at the intergovernmental bodies which design global financial regulation.

There now needs to be a much greater understanding of the role and proven benefits provided by small international financial centres as part of the City of London's transaction chain. I therefore seek to dispel some of the popular myths surrounding such centres.

First, that IFCs have a negative impact on growth in the global economy. In reality, many small IFCs are able to offer a stable, well-regulated and neutral jurisdiction through which to facilitate international and cross-border business. Investment channelled into small IFCs will in turn provide much needed liquidity, further investment opportunities, competitiveness and access to capital markets for businesses and investors in both the major developed economies and emerging market countries.

Small IFCs play an important role in helping to allocate capital efficiently. To this end they act as important financial intermediaries which match the capital provided by savers in one country with the investment needs of borrowers in another. While this has led to concerns over 'round tripping' in which capital is recycled through an offshore centre in order to give it the appearance of foreign investment and attracting a more favourable tax treatment, the experience of China and India throws this into doubt – both countries have removed tax breaks for foreign investment during the past decade and both have seen inward investment continue to soar.

As a major net recipient of capital flows from small IFCs, it is possible that our firms may suffer if they were to find it more difficult to access capital via the international markets.

A second myth is that small IFCs played a part in causing the global financial crisis. While it is convenient to blame far off countries for causing the crisis, even those who work in the financial markets do not accept that small IFCs were a major cause. Last year, for instance, the Treasury Select Committee found that Guernsey did not contribute at all to global financial contagion. Indeed it could be argued that the liquidity provided by the small IFCs was significantly positive to the UK during the crisis.

Thirdly, that IFCs engage in harmful tax practices. The Foot Review suggested that the potential for tax leakage from so-called full tax jurisdictions such as the UK towards low-tax or zero-tax regimes is relatively limited. While the TUC has argued that the tax gap created in UK government tax receipts as a result of offshore centres is £25bn, the Deloitte Report, commissioned by the Treasury at the time of the Foot Report, showed that only £2bn is potentially lost in tax leakage per annum, with Foot concluding that the real figure could be even less than that.

Economic models vary country by country, and the adoption of a tax regime premised on the principles of lower tax burdens, efficient government and dynamic private sector activity is legitimate and some degree of tax competition should therefore be recognised as positive. Regardless of this, small IFCs have shown willingness to engage with the concerns raised over their tax regime and Guernsey, for example, is currently voluntarily undertaking a Corporate Tax Review to act within the spirit of the EU Tax Code of Conduct Group.

A fourth myth suggests that small IFCs have a negative impact on transparency,

regulation and information exchange. With the G20 placing tax transparency at the top of its agenda, small IFCs are actively participating in the expansion of the Global Forum on Transparency and Exchange of Information. Indeed an IMF review of Jersey's regulatory standards in September last year concluded that Jersey was in the "top division" of financial centres and gave it the highest ranking ever achieved by a financial centre in terms of its compliance with FATF recommendations.

Fifthly, it is often thought that small IFCs do not benefit developing countries. Small IFCs have been accused of supporting capital flight out of developing countries. Yet the Commonwealth Secretariat is publishing a new report this month illustrating how small IFCs often play an important role in aiding developing countries by enabling such nations effectively to 'rent' financial expertise from other countries while they develop financial centres of their own. Crucially, they also offer investors greater protection of their property rights against domestic political uncertainty. It is no exaggeration to say that without smaller offshore financial centres many developing countries would not secure key funding for project finance which makes a substantial contribution to the improved lives of the most vulnerable global citizens.

Furthermore, the Financial Action Taskforce gives many small IFCs a positive assessment in meeting its 49 recommendations on anti-money laundering and terrorism finance. In fact centres like the Channel Islands perform better in fighting financial crime when compared with major countries such as France, Italy, the US or even the UK.

Finally is the contention that the UK's Crown Dependencies are fiscally unsustainable. The debate within the UK government has naturally been framed by events surrounding the collapse of Iceland's banking system. When the Icelandic banks imploded in September 2008, it quickly became apparent that the contagion would spread to British savers and ultimately to the British taxpayer. Furthermore, the role of the Isle of Man as a core financial intermediary between British savers and Icelandic borrowers illustrated the UK's exposure to offshore centres.

However, the recent Treasury Review went some way to allaying the two main concerns. In particular, the worries over the fiscal sustainability of UK Crown Dependencies proved to be overstated. Throughout the past years IFCs like Gibraltar, the Isle of Man, Guernsey and Jersey have amassed large budget surpluses while diversifying their tax base as Foot recommended. Indeed the Foot Report commented on the fact that none of the Crown Dependencies have taken on significant levels of borrowing.

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The UK's Crown Dependencies also provide a platform from which to learn about and access the British economy. The Isle of Man, for instance, acts as the number one jurisdiction for the incorporation of Indian businesses listed in London and has been identified by a Chinese government economic unit as an important link in China's "Going Out" strategy in relation to Chinese businesses setting up in the EU.

The Isle of Man also plays an important and symbiotic role in London's shipping and insurance markets inter alia by having such a successful white listed ship registry as well as its fast growing aircraft registry. Similarly with satellite, space and film business, the Isle of Man brings into a British sphere of influence important strategic global business which could otherwise be drawn into a Singapore, Hong Kong or USA net. The Crown Dependencies are keen to continue acting on this hub and spoke basis with

the UK and to add value to Britain's international offering in a proper and transparent manner.

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To conclude, too few people who now seek to impose regulation on offshore jurisdictions truly understand how those jurisdictions actually operate, their positive rankings of compliance with major international regulatory standards or their beneficial role in promoting investment and growth in the wider global economy. While it is inevitable that governments attempt to prevent further financial crises occurring, and that this will result in the development of global standards which should have an impact on all jurisdictions, it is critical that politicians and policymakers do not depart from the need to formulate and implement policy in an informed, consistent and balanced manner. When it comes to our naked self-interest, it would be foolish of the UK to ignore the proven benefits provided by small international financial centres as part of the City of London's world class operation.

# Beware the Looming Threat of Protectionism

## 28 July 2010

'A Double Raid on UK Plc as Overseas Buyers Swoop' was how the Evening Standard fearfully described both a recent bid by a US-Canadian consortium to buy British manufacturing firm, Tomkins, and the revival of merger talks between France's GDF-Suez and the UK's International Power.

That news of either deal would have raised eyebrows in alarm a few years ago seems unlikely. And yet how the coalition government reacts to the selling of these British assets to foreign buyers is being watched with close interest.

With the furore over the hostile takeover of Cadbury by American giant, Kraft, the attacks by the Obama administration on British Petroleum, and worry over the number of companies being sold to buyers from the Middle East, China, Russia and India, the ownership of business has become increasingly politicised. Against a backdrop of rising unemployment and deep seated economic unease at home, any perceived failure by a government to stand up for the 'national interest' against ruthless foreign invaders risks domestic uproar.

Unfortunately, however, I fear these awkward collisions between the worlds of business and politics are merely the outward manifestations of an underlying trend towards protectionism that is beginning to infect the global economy. But why the urge to batten down the hatches and what does it augur for the future?

I would contend that growing protectionism is in reality only a symptom of a far deeper, more fundamental anxiety – that of the colossal trade imbalances that the financial crisis has so painfully exposed (and which were in truth one of its main causes). How these might be overcome and what the world will look like once they have been unravelled may eventually tell the story of the global economy in this century.

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Since the rapid unfurling of the global financial system in 2008, politicians have been anxious to avoid the policy mistakes that followed the banking crisis of the 1930s. Uncomfortably aware of the speed at which the Wall Street Crash of 1929 led to the Great Depression, focus has rested primarily on public spending. It is for this reason that we have been subject to the continual invocation of Keynesian economics when it comes to the bailing out of banks, quantitative easing and the maintenance of historically high levels of public spending.

Of rather less interest, however, seem to be the equally important lessons that the 1929-1933 era taught us about protectionism. As the global economy entered recession, the Smoot-Hawley Tariff Act of 1930 raised tariffs drastically on over 20 000 goods imported into the United States in a bid to protect American jobs from foreign competition. Initially the Act appeared a great success with domestic industrial production increasing sharply. However, while imports into the US dropped by 66% within only a few years, US exports also decreased markedly by 61% over the same period.

In essence this Act had sparked a domino effect amongst America's trading partners who were provoked into imposing similar measures to protect their own domestic economies. The result was a slump in world trade that decimated economic growth and caused unemployment to soar. We need not be reminded of the political upheaval and military conflict that followed hot on the heels of those deep economic troubles.

It is with an eye to this dark historical period that world leaders have continued to reassert their commitment to free trade at each meeting of the G20 since 2008's economic crisis. At the most recent summit in Toronto, further pledges to resist protectionism and avoid new barriers to investment and trade once again tripped easily off tongues. Yet these laudable promises disguised a rather less palatable reality that goes some way to explaining why the final declaration at the Canadian meeting reportedly dropped a promise to lift any protectionist measures that have been enacted since the economic crisis.

The truth is that since the global economy hit the skids, ailing nations have failed to resist domestic pressure to shield their own companies and workers from the coldest recessionary winds. Independent monitor, Global Trade Alert, has estimated that discriminatory measures applied worldwide since the beginning of the financial crisis now cover $1.6 trillion - a staggering 10% - of global trade. To reinforce this, a 2009 study by economists David Jacks, Christopher Meissner and Dennis Novy suggests that the costs and obstacles that exporters faced in 2008 and 2009 increased by almost the same scale as in the early 1930s.

Such costs and obstacles may not be the blatant protectionism of Smoot-Hawley, but they could still prove potent. Let us look at some specific examples.

First, the terms of the banking bailouts. When RBS was bailed out by the UK government, explicit clauses were inserted into the agreement that ensured that lending to domestic customers would be prioritised over businesses or individuals overseas. Similarly, in the United States foreign companies were restricted from accessing government bailout money and some important government contracts, and specific 'Buy American' clauses were inserted into the stimulus package. Granted, some of these measures were put in place to prevent leakage (in other words to guard against the drastic dilution of the stimulus effect in the event that government money was used to pay for cheap foreign imports or investment abroad). However, the provisions were palpably protectionism by the backdoor.

Turning to trade, the European Union has been putting ever more burdensome requirements on products and production processes that have been having an especially negative effect on developing countries' ability to export to EU nations. The new Renewable Energy Directive, for example, has been branded green protectionism for its use of environmentalism as a fig leaf in favouring French and Spanish rapeseed producers over cheaper foreign competitors in the production of biofuels.

Meanwhile a war of words has erupted between European business leaders and the Chinese government over access to China's domestic market. The President of the European Chamber of Commerce recently warned China that not enough is being done to create a level playing field for foreign businesses, a sentiment shared by the US Chamber of Commerce. New rules promoting 'indigenous innovation', for example, explicitly favour Chinese companies in government procurement and encourage the forced transfer of

technological know-how or intellectual property as the price of foreign companies doing business in that country.

Recent disputes between the Chinese and high profile global companies, Google and Rio Tinto, have served only to heighten tensions. The arrest of senior Rio Tinto executives for bribe-taking happened to coincide with tough negotiations with the Chinese over the price of iron ore as well as Rio's decision to pull out of a deal with a Chinese state-controlled firm. While the Rio Tinto employees have found themselves subject to a corruption trial, the Chinese felons have not been brought to book.

Eclipsing all these examples, however, is the increasingly fraught relationship between the United States and China. US politicians are under pressure domestically either to press vigorously for the revaluation of the yuan or else impose anti-dumping duties and countervailing tariffs on the cheap Chinese goods perceived to be undermining US exports and jobs. China, on the other hand, treats requests for currency revaluation and a reduction in protectionist measures as deeply distasteful. To their minds a nation so indebted is in no position to negotiate; nor should a nation that bails out its carmakers, enacts Buy American legislation or restricts Chinese companies from government contracts be regarded as being in any position to lecture others.

Perhaps alone none of these examples is critical. But in the event that nations across the world become convinced that others are retreating from free trade, the rush towards protectionism could prove highly contagious. We need only remind ourselves of the 1930s to grasp the economic and political implications.

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Such a rush would only be the symptom of a much more fundamental problem - the overarching struggle between nations with trade surpluses, on the one hand, and nations with trade deficits on the other.

Countries such as China and Germany have enjoyed for some time export-led growth that has allowed them to accrue vast reserves. This has, of course, been achieved in large part by the industry and enterprise of their people. Yet both have undeniably benefited from currency manipulation too. For some time the undervalued Chinese yuan has viciously undercut foreign competition. Meanwhile the adoption of fixed exchange rates within the Euro by Germany has kept that nation's relative labour costs competitively low. Both countries have also relied upon the willingness of neighbouring countries to buy their goods, lending vast sums to its trading partners if necessary to fund their imports.

Over the past decade or so these deficit countries - the United States and Britain, above all – have undoubtedly enjoyed the cheap goods and easy money. But when the financial crisis hit, the resulting indebtedness was sharply exposed. They have therefore spent the past two years uncomfortably realigning expectations and slowly coming to terms with a new reality of constrained spending. But they are also gradually beginning to ask why they should continue to provide a dumping ground for cheap exports and burden future generations with vast debt simply to provide Chinese and German jobs. It is these questions that are beginning to manifest themselves in the rhetoric of economic nationalism and the increasing allure of protectionism.

Having convinced themselves of occupying the moral high ground, however, surplus nations are asking questions too. Why should they relinquish economic power by unleashing some of their surplus and why

should they look again at currency revaluation at the risk of undermining export-led employment? As these issues are grappled with, so we see greater economic bullishness from the likes of China and an assertion of the right to protect jobs and favour companies domestically.

In truth, however, both predicaments reveal the mutual symbiosis of today's global trading relationships. By definition, not every country can have a trade surplus and those that do have now been made aware that any deep imbalance in their relationships with trading partners can leave the lender as vulnerable as the debtor.

The path ahead for the global economy therefore presents a choice – the massive trade imbalances can continue or somehow a healthier equilibrium has to be found. The first scenario is vulnerable to shocks, as we have seen. But the second inevitably entails the tense unravelling of trade imbalances.

In the face of such adjustment from both deficit and surplus nations, protectionism is deeply tempting. The combination of fear, anger, xenophobia, nationalism and anxiety over each country's role in an ever competitive world, could suck the global economy into a dark spiral that, in the worst case scenario, could prove the precursor to more physical conflict. Unfortunately the less immediately perceptible benefits of global trade are far harder for politicians to articulate to anxious countrymen than the emotional pulls of national pride and the easy political capital to be gained from standing up against foreign competition in the face of rising unemployment.

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It is for these reasons that it becomes ever more vital that the World Trade Organisation and national, political and business leaders make the case in the years ahead for the massive benefits of free trade. Efforts to roll back the protectionism of the past two years and break down the remaining barriers of all kinds to trade in goods and services must be redoubled. Only then will the path to prosperity become clearer for all.

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