

## George Osborne: We need action

Last Updated Friday, 09 January 2009

George Osborne delivered a speech to Policy Exchange this morning, where he stepped up pressure on the government to adopt Conservative plans to free up banks' lending to businesses.

George said:

"I'd like to thank Policy Exchange for hosting this event today.

It's my first time here under your new Director Neil O'Brien, who is already taking Policy Exchange from strength to strength.

I come to speak to you about the economy at the end of another disturbing week.

The Bank of England has cut interest rates to the lowest levels in its three hundred year history.

The Nissan plant in Sunderland, which the Prime Minister was citing in interviews last weekend as a model for his government's employment policies in the recession, ended the week by dismissing a quarter of its workforce.

The country's largest retailers, from Marks & Spencer to Next, joined with former Labour Ministers to condemn the government's fiscal stimulus - the temporary VAT cut - an expensive failure.

And the Chancellor of the Exchequer not only attempted to wriggle out of the optimistic economic forecasts he made just a few weeks ago, but also encouraged open speculation that the Government was considering the desperate step of starting to print money.

That's just one week in the current life of the British economy.

Little

wonder, then, faced with weeks like this that academics, policy-makers, journalists and the general public continue to turn to the events of the 1930s for illumination and inspiration.

In doing

so, of course, much of the attention has focussed on the fiscal measures Roosevelt took with his New Deal, perhaps because they are the easiest to understand and explain.

What can get

overlooked are the monetary and banking policies which many historians and economists now believe were of far greater significance and impact.

For

example, the academic work of Professor Christina Romer, the Chair of Barack Obama's Council of Economic Advisers, has shown that nearly all of the observed recovery from the Great Depression was due to monetary expansion, mainly due to inflows of gold that reduced real interest rates and therefore encouraged investment spending.

As

she put it: "Monetary developments were a crucial source of the recovery of the U.S. economy from the Great Depression. Fiscal policy, in contrast, contributed almost nothing to the recovery before 1942."

Now

I am certainly not proposing to debate what are the right fiscal policies in the twenty first century for countries other than the United Kingdom.

Each country must consider its own

budgetary situation and reflect on what it needs to do to maintain international confidence in the sustainability of its public finances.

For

as John Lipsky, the First Deputy Managing Director of the IMF, has said, "fiscal action may not be advisable in countries with greater vulnerabilities, or those where debt sustainability is a major concern".

And

it is worth noting what President-Elect Obama said yesterday, "We cannot have a solid recovery if our people and our businesses don't have confidence that we're getting our fiscal house in order."

Today,

I want to argue that because of the state of Britain's parlous public finances, because we didn't fix the roof when the sun was shining, because there are now concerns about debt sustainability and because there can never again be any confidence that this Labour Government will put our fiscal house in order, the room for manoeuvre is limited in this country.

Tax reductions, which can be used to help the victims of the recession like pensioners and savers, have to be paid for.

And

it is monetary policy, and specifically action on credit, that will be the most effective way of reducing the length and severity of this recession.

Not least because at the heart of this recession is a credit crunch.

David Cameron and I have been making this argument for months now.

I argued in October last year that it was monetary policy not fiscal policy that should play the main role in stimulating demand in the recession.

And in November David Cameron said to the Prime Minister across the Dispatch Box in Parliament that action to get credit flowing was the absolute priority.

At the time, some wondered whether we weren't making an economic and political mistake when we warned about the dangers of further discretionary borrowing and said that the VAT cut would not work.

But

we trusted to our judgement and I believe as we enter the new year our consistent position has been vindicated by events - businesses continue to cite the lack of credit as their number one concern, and the Government's VAT cut is proving to be an expensive failure.

The

tragedy is that if the Government had followed our advice the national debt would be lower and, because credit would now be flowing to businesses, jobs could have been saved.

So today I want

to appeal again to Gordon Brown to take the action we recommend, before further jobs are lost, before further debts are heaped on the shoulders of our children and before the Government reaches for the desperate last resort of printing money with all the risks that involves.

We need action and action now.

To make the case for action we need to start with absolute clarity about where we are as a country today.

It suits Gordon Brown's political interests to present the economic downturn as though it were a crisis only a few weeks old.

But the credit markets seized up a year and a half ago.

The British economy stopped growing nine months ago.

The recession is now more than six months old.

And

yet despite the Government's repeated claims throughout the last year that each new summit or latest policy gimmick will hasten the end of the recession, those claims are demolished by the daily diet of economic data which suggest that things are getting worse, not better.

The

Government's economic forecasts in the PBR were optimistic even at the time - more than a percentage point of growth higher than the lowest independent forecasts for 2009, and even more for 2010.

And now just weeks later the Chancellor has told the Financial Times that Britain was "far from through" the recession and that his PBR forecasts were "based on the evidence we had at the time".

He clearly understands what every new piece of economic news confirms - that Labour's policies are not working

Everyone thinks there has been just one fiscal stimulus.  
In fact, there have been three.

In May the Chancellor announced a £2.7 billion fiscal giveaway before the Crewe and Nantwich by election that he claimed would boost spending, but the recession got steadily worse.

Then in September Gordon Brown announced the fiscal stimulus of a Stamp Duty holiday and said he would "keep the housing market moving forward", but house prices have continued to fall at record rates.

In fact, according to Halifax this week, house prices have fallen by 8 per cent - more than £14,000 - since the stamp duty holiday was introduced at the beginning of September.

And then in November came the third fiscal stimulus, and the biggest of all - that £12 billion temporary 2.5% reduction in the VAT rate.

When he announced it in the House of Commons, Alistair Darling said that "by encouraging spending, [it] will help stimulate growth"

Now it has been in place for more than a month I think the country is entitled to ask: what spending and what growth?

The Chief Executive of Next says it has been a waste of time and money.

The Chairman of Marks & Spencer says it "has not made a material difference to our sales."

Why aren't Labour's policies working?

The reason is clear.  
The policies fail to address the root problem of the recession - the lack of credit.

Instead,  
they have alarmed the public about our soaring national debt, alerted them to the tax rises needed to pay for it if Labour is re-elected, and so undermined confidence in the future.

As the President  
of the European Central Bank, Jean-Claude Trichet, put it, by borrowing more than you can afford "you can lose more with absence of confidence and loss of confidence than you would gain from the simple channelling of additional spending."

Gordon Brown should have known this would be the result.

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

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

Labour's policies are  
failing to tackle the problem that lies right at the heart of this recession - the rapid decline in the amount of credit available to British businesses.

As Richard Lambert, the Director General of the CBI put it earlier this week, the Government "must concentrate on the root cause of the problem, which is the shortage of credit flowing across the private sector".

The symptoms of this credit crisis can be seen in dramatic declines in the reported availability of lending.

The Bank of England stated just yesterday, "the availability of credit to both households and businesses has tightened further, pointing to the need for further measures to increase the flow of lending to the non-financial sector."

The symptoms can also be seen in the drying up of trade credit insurance cover, which - as my colleague Alan Duncan has highlighted - is undermining large sections of the economy and hitting small and medium sized businesses particularly hard.

So what exactly is happening?

After the events of last autumn, some banks have simply disappeared and others that survived are building up capital reserves to protect themselves.

The result is a sharp reduction in leverage.

This means a lack of access to working capital which is driving otherwise sound businesses to the wall.

It is inducing others to reduce employment levels in order to preserve precious cash flow.

And it is forcing others to sell off assets in order to raise cash, further depressing asset prices.

A shortage of credit is right at the heart of this feedback loop that has

cascading effects on unemployment, confidence and asset prices.

Without radical government action this vicious cycle will make the recession longer and deeper.

It's almost impossible to overstate how urgently this action is needed, but so far there is no sign that the Prime Minister or the Chancellor understand this.

David Frost, the Director General of the British Chambers of Commerce says he can detect "no sense of urgency", but that "as every day ticks by, companies are going to the wall because of lack of finance."

Well, there needs to be a sense of urgency.

We need urgent action in three areas - revising the terms of the bank recapitalisation, introducing a National Loan Guarantee Scheme, and introducing new liquidity support from the Bank of England for new business lending.

First, the terms of the bank recapitalisation.

This was supposed to get credit flowing again.

As Mervyn King said, "It was necessary to recapitalise the banking system so that it could continue lending to the real economy..."

But is clearly not working.

And it is hardly surprising.

Just think of the wholly contradictory things that the Government is asking the banks to do:

Pass

on rate cuts to borrowers while not passing them on to savers; relax their lending policies while meeting higher capital requirements from the regulator; pay the government 12% for its preference shares while their competitors pay their governments half that; pay off those preference shares while expanding their lending.

The policy on the banks betrays a complete muddle at the heart of government.

Simple revisions to the terms of the recapitalisation plan would go some way to correcting this failure.

That requires the Prime Minister to stop boasting about its success and started addressing the reasons for its failure.

He

needs to reduce the 12% coupon on the Government's preference shares - at its current level it actively discourages the banks from lending at low interest rates.

The equivalent rate in the US is 5%, while in France and Germany it is around 8%.

We

also need to reduce the cost of the inter-bank guarantees, which are still higher than similar schemes in other countries even after the Treasury followed our advice and reduced them last month from their initial levels.

And we need a clear and consistent strategy from the Government towards the banks that helps them rebuild their balance sheets, return to profitability and so be in a position to start lending again.

This is the first area of action.

Second,  
we urgently need to introduce the National Loan Guarantee Scheme that  
we Conservatives have been advocating since November.

This approach has been welcomed by the groups that represent both large and small businesses across the UK.

As  
Justin King, the Chief Executive of Sainsbury's said just yesterday:  
"if we're to get [banks] to lend more then that risk has to be managed  
through credit guarantees on prudent borrowing."

So how would it work?

Our scheme would provide guarantees - initially worth up to £50 billion - for new lending to businesses of all sizes.

This  
is far larger than the £1 billion Small Business Finance Scheme  
announced by the Chancellor in the PBR, which covers only 0.2% of all  
lending to businesses.

It also dwarves the 720 million euros of loans from the European Investment Bank that were announced yesterday.

The guarantees would be similar to the £250 billion of inter-bank guarantees announced as part of the bank rescue  
package.

Crucially these do not add to Government borrowing.

Guarantees for business lending would be provided for a fee to ensure that taxpayers are protected.

The  
resulting loans will still be affordable - businesses are prepared to  
pay for credit, the problem for many is that they can't get it at any  
price.

Indeed the interest rate charged on eligible loans would be capped at a margin above the Bank of England base rate, the level of which would be decided by the Board of the Scheme.

And crucially the guarantees would cover less than 100 per cent of the eligible loan, since it's important that banks at least take a share of the risk to prevent reckless lending.

This means that it will be the banks, not the Government, that will make decisions about which companies to lend to.

This is not about the government subsidising lending that would otherwise be unprofitable.

It is about using the government balance sheet to support lending that is expected to be profitable, but which is limited by a lack of capital.

The ultimate effect will be to allow the banks to lend more for a given amount of capital, because the guaranteed portion of any loan should be zero-weighted for the purposes of risk analysis.

As Professors Lucian Bebchuk and Itay Goldstein of Harvard and Wharton Business School have argued, lending by any one bank is more likely to be profitable if lending by other banks is supported by government guarantees.

As they describe the problem, "banks may not be lending because of their self-fulfilling expectations that other banks will not lend".

But if lending is supported by guarantees, then they argue that "with many companies expected to receive financing, banks' willingness to lend their own capital, which they might otherwise elect to hoard, would increase."

The result they point out is that "the programme's costs to the government would be limited, because the credit risks the government took upon itself would not materialise".

And for both taxpayers and for the businesses most in need of credit to survive and retain jobs - including car manufacturers - this approach is a much better alternative to the selective government bail outs for specific companies.

As the CBI have argued, a broad based system of guarantees "would be a lot better than reacting in an ad hoc fashion to the requests of particular businesses."

We must not return to the failed industrial strategy of the 1970s, however much it is disguised by new language - the Labour Government then was no good at picking winners then and it is no better today.

There is no reason why this approach could not be in place within a matter of weeks.

I can today announce that we have tabled an amendment to the Banking Bill in the House of Lords that would establish a National Loan Guarantee Scheme.

That Bill will be debated when Parliament returns next week and we will press our case.

It presents the Prime Minister with a clear choice.

He can support the radical action needed to limit the effects of the recession or he can continue to achieve nothing.

The most recent data show that the number of company liquidations has risen from 241 a week to 304 a week in the space of a year, and that's even

before taking the last few months into account.

That's almost 10 businesses a day going under because of the credit crunch.

Every day that Gordon Brown dithers, he is putting at risk people's jobs and livelihoods and futures.

That's why we need action and action now.

The third thing we need is more liquidity to fund business lending.

The National Loan Guarantee Scheme solves the problem of insufficient capital for lending to businesses.

But  
it does not directly solve the related problem of a lack of funding -  
the banks still need to raise the funds to lend to businesses.

In the US they are addressing this through direct lending by Government.

I  
have already said that this shouldn't be ruled out, but it is mainly  
appropriate for large companies due to the administrative requirements.

So  
as well as government guarantees, we urgently need to ensure that the  
Bank of England's liquidity operations include new lending to business.

The Special Liquidity Scheme is set to expire at the end of January.

And  
the Bank of England's remaining liquidity facilities, their 30 day  
discount window facilities and their long term repo facility, only  
accept the most senior corporate paper and triple A securitised loans.

Given the current economic uncertainty and ratings downgrades very few banks have collateral which meet these terms.

So banks aren't getting the liquidity they need to support businesses.

That's why we would ensure that any loan covered by the National Loan Guarantee Scheme would qualify for liquidity operations at the Bank of England.

In many ways this approach would be similar to the acceptance credit market that existed before the provision of liquidity was essentially privatised in the late 1990s.

This means that the scheme would both ensure that businesses get access to the capital they need, and that the banks can access the liquidity they need to lend.

These three things - new terms for the bank recapitalisation, a National Loan Guarantee Scheme, and more liquidity for new business lending - would transform the credit conditions facing British businesses.

As a result they would go straight to the heart of the current crisis in our economy - a dangerous shortage of credit.

And they would do far more than any fiscal stimulus to reduce the length and severity of the recession.

We should try these steps before considering any of the remaining reserve options, all of which carry far greater risks.

Another round of recapitalisation would expose taxpayers to even greater liabilities, and in any case the National Loan Guarantee Scheme should address the problem of insufficient capital.

A "bad bank" model, as was implemented in Sweden, shouldn't be ruled out but it would leave taxpayers holding the worst assets of all.

And quantitative easing - printing money by another name - is the last resort of desperate governments when all other policies have failed.

Of course it too can never be ruled out as a last resort in the fight against deflation.

A debt-deflationary spiral would be particularly damaging in a country with the highest levels of personal debt in the history of the developed world.

But in the end printing money risks losing control of inflation and all the economic problems that high inflation brings.

And for the Treasury to float the idea carelessly is irresponsible in the extreme as it could shake the confidence of international markets.

So instead of speculating about printing money, the Government should immediately take the radical action I have outlined to tackle the root cause of the recession.

New terms for the bank recapitalisation, so that the Government isn't demanding more lending while simultaneously creating incentives for less.

A National Loan Guarantee Scheme to significantly increase the amounts banks can lend for a given amount of capital.

And more liquidity for new business lending to remove the final barrier to getting credit moving again.

This

is a plan to end the recession that the Government could adopt today,  
and for the sake of our economy I sincerely hope that they will.

For as they said in the 1930s - we need action and action now."