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UK and the World Conference Transcript

The UK and the World: Rethinking the UK's International Ambitions and Choices

Session 2

The UK in the Global Economy – Still in the Top Tier?

13 July 2010

Vanessa Rossi

Thank you, I think we should begin the next session now and we will unfortunately have to finish quite promptly in part I would excuse in the beginning that Kitty's going to have to leave very promptly so if we see her nip off at the side here then that's probably our cue for leaving for lunch so, thank you, shortly after her.

In terms of the importance of the economy I think it's been clear from the first session how many people are stressing the inter relationship between the strength of the economy and what you're able to do in the world, how the UK's projected in the world, what its power and role in the world is. But also in our paper, the co-authored paper I've done with Professor Jim Rollo, who's here in the audience today as well, we're pointing out that of course the influence in the world is also important back to the state of our economy and I think we can... we've also pointed to this in terms of the way we're shown in this paper, the linkages in the scenarios between the strengths and the international side compared with the domestic issues. I particularly wanted to bring this out in this schematic form of the scenarios because I fear that there's probably rather a lot of emphasis placed in the UK itself on the probability curves, whether we're going to have a probability of achieving 2.1 growth or 2.5 growth or 1.8 growth and different probabilities attached rather than explaining to people perhaps what is thematically behind these different views, what are the key drivers that we're really looking for here to achieve a better growth performance in the coming years and so this is one of the reasons why we've developed this approach and why we're keen to persuade people of it particularly in these coming years we're going to be very dependent on growth in the rest of the world. We clearly have the message that growth at home's going to be perhaps somewhat restrained both by the consumer problems, the property market problems and probably then fiscal tightening too. All of these leaving you with slightly less opportunity than in the last decade for domestic growth. But we do believe that those opportunities are there out in the rest of the world and it's important to look for them and look at the strengths in the world economy.

Related to that I'll point you to the YouGov surveys that you all have available and one interesting facet of it which is that in terms of the public opinions expressed there the concerns that most people have about the international environment remain on areas such as terrorism with very little perception of the economic threat from potential disturbances in the international economy. I think in light of the fact that the economy is seen as such an important issue, even for international affairs, then it seems to be somewhat strange that the public hasn't yet got the message that the world economy and the risks in the world economy are also an important threat to the world. This seems to be much better understood by the elite than it is by the average voter. So, to some extent I think my point about trying to get economic scenarios into a more thematic form trying to explain the key drivers and importance of the world may be even more important to get these messages across to the wider public.

It also struck me doing this paper and because of another paper I've been asked to contribute to this latest paper is in relation to a joint article which will be published by a member of Sarkozy's cabinet looking at comparisons between the UK economy and France and it struck me both with that and with the paper we've just done that when you look at the performances of the UK economy compared with its neighbours actually there's very little difference between them. We seem to spend a lot of time comparing ourselves with Europe and worrying about our differences in policies, our differences in industry structures, for example, and yet if we look at this long term performance rating we have very little overall difference between us, certainly compared with the rest of the world. The big picture that's happening elsewhere is far more important in terms of industry trends, global trends than the nuances between the European countries.

That said there's one very important area in which there is a distinct difference and which I believe has made the single biggest contribution to the UK's economic performance actually being slightly better than its European neighbours over the decade up to the crisis and that is actually the UK's quite outstanding performance in the exports of services. This is quite unique. It's quite different from others. If you look at what pulls us apart from the rest of the pack it's not to do with declining industries, it's not to do with the share of services in domestic economy and all these things that we actually discuss so much within Europe. It's about the outside external world and the pattern of exports and in that contribution probably adding something like 15% to 20% to the overall growth in the UK economy since 1990 the role of exports of services cannot be underestimated and I think it's in that connection that perhaps we want to reflect about how the UK's moving forward its role in the world and how the rest of the world sees us.

Now the panel we have today I think is going to contribute of course to this discussion but I would like, firstly, to turn to Gerard Lyons, representing Standard Chartered Bank which of course has a very prominent position in the whole world economy with a clear understanding of how the UK's viewed and how the UK interacts with the world economy, and I think to give the first discussion followed then by Kitty Ussher and then by Danny Gabay, each talking for about ten to 15 minutes in order to start the discussion and we will then turn to questions from the floor and hopefully have a useful session answering the questions that you have in relation to this discussion. But firstly please let me turn to Gerry to kick off.

Gerard Lyons

Thank you Vanessa, it's a pleasure and honour to be here this morning. The question; is the UK economy still in the top tier? My view is yes but maybe the question should also be will it remain in the top tier? I would say yes but it's not guaranteed. This morning I'd like to focus on three areas to set the scene. First the global shift to touch on some of the big issues. Second, in terms of the current economic situation in the UK good economics is good politics, how good is the economy? And third and finally to touch on some of the areas I think we need to focus on if we are to succeed and maybe, in your view, make it into the top tier or in my view to stay in the top tier.

First globally I believe that we're seeing a shift in the balance of power. This view is now more widely accepted although in being more widely accepted I still don't feel that it's fully appreciated. Even though there is a shift in the balance of power it is a gradual shift. It's also likely to be a volatile shift and in my view, and in our view at Standard Chartered, the winners in this global shift will be countries that fit into one of three categories. They will be the countries with the financial resources such as say China or Qatar. They would be the countries with the natural resources including water, often overlooked, commodities and also some countries like India and its people and also third and finally the winners will be the countries that have the ability to adapt and change. So the countries that either have the cash, the commodities or the creativity.

Britain doesn't have the cash or the commodities as such so for us to succeed is about being creative, being able to adapt and change. To do that I think we really need to appreciate what is going on globally. Despite the prospect of a double dip in the UK and despite the uncertainty in the markets I believe that we are in a super growth cycle in the world economy. This has been characterised by a number of factors; an industrial revolution in China - I still personally don't think people in the West get it - the opening up of India. But this has led to some big trends which have already developed and are likely to continue, new trade corridors. World trade was hit hard by this global crisis. Global trade fell by about 20%. As a result the innocent suffered like the guilty. Countries that did not get carried away with financial shenanigans were hit by the slump in global trade. Global trade bottomed last May and even though it took a hit last month it's likely to return to pre-recession levels in the next month or two.

So basically three years after the peak global trade will be back to where it was. Normally after a recession it takes two years but in the early 80s it took four years for global trade to get back to its pre-recession peak. 18 months, 12 months ago people thought it would take six, seven even eight years. The reason it's rebounding quicker is because of new trade corridors. Asian or inter-Asian trade rising sharply, Asian-African trade, Asian-Latin American trade, Asian-Middle Eastern trade. China, for instance is Germany's biggest export market. On top of that demographic shifts have been mentioned. These... demographics is not destiny. Basically you still need to actually have the right tools in place but if more countries around the world, such as India and China, start to have the right policy tools and institutions in place learning from the UK then in our view we're likely to see an arc of growth over the next 40 years from China, which eventually has a demographic problem, to India, where half the population's under 25, even into Africa.

But for that to take place these countries need to actually receive the inward investment they require and there is an infrastructure boom underway around the world. Ahead of the World Cup there was a lot more focus on Africa. Journalists seemed to be surprised that not everything about Africa was pessimistic. In actual fact, as we can see from the last month, people by actually learning and seeing what's happening have taken a more positive view but we shouldn't underestimate how far there is to go. As a result there is a huge middle class out there that we in the UK need to sell into.

But there are other issues we need to be aware of. State capitalism is a big issue. I wrote an article in the FT about this in 2007. The role of the state and the rules of the game are different in some countries. In China we have state owned enterprises. We have sovereign wealth funds. We have different organisations around the world that possibly play by different rules. How will the UK cope with these in the future? These underlying shifts which I could talk for hours about are things that we need to be aware of but clearly in the near term we have to take into account the fact that the world economy is still heavily influenced by the West. So we still should not be complacent about some of the near term challenges as the deleveraging in the West unfolds.

But I think whilst we look at rates of growth we should also look at levels. A year... or ten years ago the world economy was $31 trillion in size, hard to picture. On the eve of the crisis the world economy was $61 trillion in size. It had experienced the biggest ever boom. Now some of that was driven by debt in the West but much of it was driven by the opening up of economies around the world hence on the eve of the crisis 900 million people had been brought out of poverty in the previous decade. Unfortunately 90 million went back into poverty but in level terms the world took a hit and fell about $3.3 trillion in the crisis. But we have a $58 trillion world economy. America is about $14.2 trillion. Then we have Japan 5 trillion, China 4.9 trillion. Germany is about $3.7 trillion. Then, I'm not going to go through every country, don't worry, but then Britain and France are about $2.7 trillion in size. So we are still pretty chunky. The West accounts for two thirds of the global economy so if the West is not booming, the world cannot boom. The West is not going to boom but the emerging economies are likely to outperform. Indeed since 2005 the emerging economies have accounted for more of global growth than the G7. On our forecast at Standard Chartered by 2014 the Asian economies outside of Japan will account for more global growth, the change, the delta than the West. So the balance of power is shifting and in our medium terms forecast by the end of 2014 the world economy will have risen to about $77 trillion in size. We need to make sure we think globally and we have a bigger slice of that cake.

That leads onto the second part, how is the UK economy doing? Well the key, in my view, is that the outlook wherever one sits the peon's on the same factors, the fundamentals, policy and confidence. We can never underestimate the importance of confidence. Economists tend to be very bad at predicting recoveries. Business people are actually worse but confidence at the bottom is naturally rock bottom. I often say Britain's biggest export is its pessimism but we shouldn't underestimate the confidence effect. But notwithstanding that the fundamentals here clearly need to be addressed and policy, in my view, is a potential negative in the near term. I call it the good, the bad and the ugly. The good is that Prime Minister Brown boosted the economy. The good is the Bank of England did things. The bad is they did not do it from a position of strength. We should have had budget surpluses in the good times and higher rates in the good times. The ugly is how we get out of this. Britain is not going to go bust, let's be quite frank about that. It does have a painful adjustment phase but what we need to make sure we do in the adjustment phase is try and achieve a balanced economy.

Just as it's a two speed world economy, the East doing well, the West not doing well even in the UK, we have two different characteristics. Those parts of the UK that are doing well are still doing very well. The challenge is to pull the bottom up. Let me just give you an idea. Manufacturing; we have the sixth biggest manufacturing industry in the world. Its share has declined but 12% of gross value added it compares with France and with America pretty similar. It's below Germany which is 25%. We have an increasing number of employees with tertiary education. 32% of our employees have tertiary education and it's rising. In America it's 40% and rising. In Germany it's 24% and static but whilst we do well on higher end skills we do terribly on lower end skills. 23% of school leavers apparently don't reach international standards in reading and counting. In Germany it does much better there, apprenticeships etc. Likewise UK share of research and development and our GDP... sorry, our share of R and D relation to GDP is very low, 1.8%. Finland is off the scale. Germany is 2.5%. But yet the companies that do invest very highly. Similarly in other areas.

Mandelson in the last year needs to be given credit for giving more emphasis to industry but we do have some strengths. Our science base is recognised as internationally competitive. We have high level skills. We're seen as being open to international competition. Despite the crisis we're also seen globally as being pretty good on regulation and competition and if you look at where we're seen as having potential growth areas in the future nanotechnology, advanced manufacturing, low carbon and life sciences. So it's not all broken.

That leads onto the third part; what do we need to do to position the UK for the future? Clearly we need to move up the value curve but everyone, everyone, everyone is moving up the value curve. For instance in Asia fiscal policy was relaxed in the crisis but whereas we threw the kitchen sink at the problem in countries across Asia there was a focus on positioning themselves for future growth markets. About three quarters of the fiscal boost in Korea, for instance, was aimed at making Korea the leader in fusion energy, green energy. These are quite interesting. Countries are moving up the value curve. We shouldn't overlook the importance of the City. The UK is seen as a leader in financial services. Clearly politicians need to play to the public gallery sometimes but they need to resist the public temptation to clobber the City all the time. Not everything in the City broke although parts of it clearly did, but we should recognise that is we are to achieve a more balanced global economy, which is vital for everyone, then the more balanced global economy not only means the West spending less and saving more, currencies adjusting. It also means economies like China, India, Brazil moving towards being bigger consumers. If that's to take place then they need deeper and broader capital markets and London is well positioned to benefit from that.

But overall I think we need to address longer terms issues. We need to invest in our infrastructure, the soft infrastructure, particularly skills and education, and as I say, we do that well but we don't do that well enough. Warwick University, where I'm on the council, for instance, has the only digi-lab in the world. You look at parts of UK university education and we are seen as world leaders but other people are funding their universities. We might not be doing that.

But we also need to get the heart infrastructure right. You talk to some big businesses they will not go and invest in the regions. That's why three quarters of employment increase in the regions in the last decade was in the public sector. We have abysmal infrastructure. I did some work for the business council for Britain a few years ago. I think we were on a par with Namibia, quite frankly I'm not joking. In road, rail and air infrastructure we were bottom of the scale.

I think we need to be innovative. I fully support the idea of airport in the Thames Estuary as a statement of intent that we can do infrastructure and also we need to start focusing that the future growth markets are in the East but we need to address these infrastructure issues and also maybe to conclude policy issues, policy fora. I'm not going to repeat what was said in the last panel but we need to play to our strengths at the UN permanent members status and the G20 and the other point is let's not overlook culture. We often overlook the importance of culture. The UK's cultural ambitions are pretty good. Our creative industries are playing a big role and to put it all together we are seeing a shift in the balance of power. The UK has remained very open. We've not said no to foreign money coming in. We've had checks and balances in place. We've had an independent competition authority that can block any takeover on competition grounds. We've had an independent regulatory authority that can block any takeover on regulatory grounds and we've had the Enterprise Act which safeguards sensitive areas such as media and defence. I think that's the right approach. Maybe we might need one or two better levels of defence given the way the world is changing but ultimately I think we need to remain open to attracting money in as well as sending money out.

So putting it all together is the UK doing well? Yes. Do we have challenges? Yes. Can we stay in the top tier? Yes, if we actually address some of the underlying issues, thank you.

Vanessa Rossi

Thank you, Kitty without more ado would you like to take the podium? Thank you.

Kitty Ussher

Thanks very much. It's a pleasure to be here. I'm Kitty Ussher recently stepped down as Member of Parliament for Burnley in the North West, former Economic Secretary to the Treasury at the beginning of the credit crunch so it's all my fault. It was fine until I became a Minister at the Treasury in June 2007. I spent the last nearly 20 years now working on various aspects of economic and industrial policy in and out of government and now Chief Economist at the think-tank Demos, which is a great place to survey the architecture in the UK at the moment.

I'm going to address my brief remarks to the top bullet point in the agenda in front of you and in particular how has the financial crisis affected the UK's place in the global economy. As you've heard from Gerard's excellent contribution and also from Vanessa and Jim Rollo's paper in your pack the position of the UK economy at the moment in the global ranking is sort of four, five, six-ish depending on which exchange rate you use and what assumptions you make and that's going to change over time anyway as the... particularly China and India catch up and rapidly overtake us in the next 10 to 20 years.

So the position of the UK in the global economic rankings is going to fall anyway and that's got nothing to do with the financial crisis. What I want to explore is what has been the impact of the financial crisis both economically but in particular in terms of economic policy. We're still very good at what we do. We've heard some of the sectors where we currently excel and are perceived to excel and will excel in the future; creative industries, bioscience, advanced manufacturing, things that require high skill levels and British brains to the application of common problems, hopefully low carbon and so on and, yes, still financial services and that won't change as a result of the financial crisis unless we have very bad policy making but we seem to have a consensus there.

The other reason why the financial crisis hasn't made a huge difference to our global ranking despite the fact that 10% of our GDP came from and has come from and hopefully will come from financial services in the future is that although the recession began with problems in the financial markets the effects on the real economy were pretty similar across the Western world at least and that's because... and we can debate this at length but my view is that the cause of the financial crisis was that all financial institutions suddenly became very leery about extending credit because they didn't know how much they were worth and how much their... because they didn't know the values of these toxic assets that they had on their books and even if they had pursued the most risk averse cautionary approach to credit derivatives and any other type of asset base, particularly in the US housing market when they had their housing boom and these toxic assets were created and disseminated around the globe, even if they didn't have any at all on their balance sheets which is practically unheard of... even those who didn't they did not know what the position was of their trading counterparties and since so much of the activities of the banking sector involves the wholesale markets on a daily if not hourly basis even the most risk averse institutions did not feel able to trade and felt uncertain in the heart attacks that took place in the financial markets in 2007 and then again in the Autumn of 2008 and so they didn't want to extend credit to consumers and to businesses and that applied regardless of whether they had a very strong financial services or a global financial services sector themselves. It applied equally to Italy as it did to the US or the UK even though Italy doesn't have a global financial centre on the New York, London scale. So that's why recession hit everyone. That's why we are not uniquely disadvantaged from the financial crisis in broad economic terms.

The other... and we know this because the work that is currently being done on the assessment of the output gap in the UK economy... that's the extent to which we are trading beneath our potential has recently been revised downwards but I think I'm right in saying that it's not because of the affect of the financial crisis. It's simply because the economists are now saying that it was estimated as being too high previously due to errors in the way that the numbers were interpreted and so there's nothing about the financial crisis of itself that means that we're going to be further down the rankings in the medium term. However, it may have made a big difference in our economic policy credibility globally because although having 10% of our GDP in the financial services sector may not have meant that our economy was worse off in the medium term as a result of this crisis obviously in policy terms the actions of government when the crisis hit was extremely important for the UK and a lot of the activity, not all of it, but a lot of the activity took place here.

When I became Treasury Minister in late June 2007 I think I'm now able to say that the Prime Minister, Gordon Brown, said to me, "Very important job Kitty, I'd like you to do Minister for the City, very important group of stakeholders in the City, very important to make sure they understand they have a strong voice in government" and he was right to say that. What he also said was "Not much policy in it, sorry about that".

Two years later are they the most important group of stakeholders to government? I think they are in economic terms but we've had a bit of banker bashing I've noticed since then and certainly in terms of policy it's been one of the fastest moving areas of government, not just here but around the entire world. So I should have said, "I beg to differ Prime Minister", but obviously of course I said, "Oh I'm very grateful, I'd love to do it!".

But what we were currently saying then, and this was a policy position that evolved, had evolved over the previous five to ten years is that we had light touch regulation in the City. We had principles based regulation as opposed to the box ticking line by line regulatory approach particularly on the European continent. It's what the City wanted us to say and we fundamentally believed it was a more intelligent way of regulating and perhaps it is. But the fact is that we've been saying that and then Northern Rock happened here before anything else happened anywhere else and I was right in the front line of the rest of the world going, "Ha ha thought you were really clever on city policy and on regulatory policy" and for those... for that six months or so from... I don't know, I guess it was September 2007 through into the New Year we lost credibility on economic policy because we had a run on a bank. That's embarrassing but we fixed it pretty quick and the market stabilised then but certainly the financial crisis did quite a lot of harm for us in terms of economic policy, credibility and that lessens our influence around the world.

Now a year later, October 2008, when Lehmans collapsed in the US and we had the next heart attack and crisis of credibility across the global markets the fact that the British government then stepped in fast, radically, was able to get out the cheque book and to a sufficient scale calm things down in a way that was then copied not just in the US but around the world restored some of that credibility. So we had gone down and then we started going up again and I think it was up all the way until I think this morning the previous session mentioned the G20 summit that took place in April 2009 where Gordon Brown was feted as having done the right thing in very difficult circumstances. So effect on the UK economic policy of the financial crisis down and then pretty much up again.

Now under the new government at this point in time we are again, I think, being seen as having a leadership role in our policies on reducing the deficit. The current Chancellor, George Osborne, wasn't I think listening to you when you said, Gerard, that we are not going to have a massive debt crisis and the UK's going to go bust because he is... it is suiting him because he wants to be seen as the Iron Chancellor to portray the UK as under risk of a sovereign debt crisis because that then justifies his extremely bold and ambitious plans to reduce the structural deficit within four years which was a harder line even than the Conservative manifesto and a harder line than the coalition document.

So at some point between May 6th and June 22nd when the budget happened... between the election and the budget George Osborne decided to introduce a deficit plan that went faster and further than he had previously said he wanted to do and this is very much in tune with what's happening in the periphery of Europe and as we also heard in this morning's session it now looks like the UK is at the front of the pack where the US is further behind in terms of economic policy which is all very well and good if it's the right policy. The UK... everyone will know that the sort of consensus forecast at the moment is that the economy will start... well it is tentatively starting to grow now and that it will stabilise at around 2% per year growth in the next couple of years but somebody earlier mentioned probability fan charts. It is more likely that that won't happen than it will happen according to most analyses but there is no other central forecast around at the moment.

The risks to the forecast are absolutely... two main ones and I'd agree with Gerard, is that confidence is the crucial thing. This government has said that it wants GDP growth to be driven slightly less by consumer demand, significantly less by government demand. The government is going to contract as a proportion of GDP and more by export led growth, by net exports and more by business demands. So business demand over household demand. Partly this is out of necessity because the budget position is such that the state has to contract. Partly it's out of a belief set that it is better for a smaller state and a larger private sector. Partly as a result of the credit crunch where they saw consumers getting overstretched, household demand getting overstretched as compared to business demand and they see no problem with a slight correction of that. That's all very well and good, they've reduced business taxation. That's been warmly welcomed.

However if consumers aren't buying the goods then it's not going to make much difference to companies that their corporation tax has gone down because they won't be making any profits at all and so the risk to all of this is that the climate of austerity, particularly if you happen to be a public sector worker earning £25,000... if you were a public sector worker earning £25,000 in Britain today knowing that your department was likely to face 40% cuts in

October and not knowing whether that was going to affect you would you decide to spend more or less on your summer holiday this year? Less and this confidence... negative confidence effect is beginning to spill through into the British economy. Nationwide consumer confidence survey a couple of weeks ago had us down. An EU wide confidence... consumer confidence survey had Britain down even more than other European countries despite the fact that we're not Greece facing that level of crisis. So far that has not spilt into reduced retail confidence and long may that last. But that is the one thing I would be watching to see whether the government's going to be able to pull off its trick and of course raising VAT, which is a tax on consumption, precisely at the time when some people might argue that they want consumption to rise may not play in the right direction but I don't want to get into political rows this morning. The other risk of course is that Europe, which is our main trading partner, starts to feel the squeeze to such a great extent that we are unable to devalue effectively against them because the Euro is falling so fast and since half our trade in goods is with the EU that may also present a risk to economic recovery. But at the moment the central scenario is that we'll be okay.

So we have two possibilities. We have the likely one which is that as a result of the financial crisis we are able in 2010/11/12 to demonstrate global leadership in economic policy in rebalancing the books in an audacious and fast way that not only solves the economic problem but also solves the government's political problem and they're going into the next election promising tax cuts from the surplus they have thereby created or we end up in a situation where by being so bold and audacious they actually manage to reduce confidence so far that that central forecast of 2%ish growth begins to drip downwards and downwards and downwards and then they can't even meet their budget deficit targets because of course there is no growth to provide tax receipts and to reduce the benefit bill. In that case the current strong position on the international economic stage will start to look rather foolish in retrospect on which point I shall end.

Vanessa Rossi

A slightly more gloomy note to finish on. Before I pass to Danny can I just interject with one question coming back to the years before the crisis and you mentioned your role then and perhaps issues that came out because of the crisis with that role. Did you feel that there was any inkling within government and international scene that this crisis was about to unfold? Had you any warning tremors at all before this all broke or are you saying that the Northern Rock events and so forth were a complete surprise?

Kitty Ussher

Northern Rock wasn't a surprise by the time it happened because there had been difficulties all over the summer. I think very few people in May, June, really understood the extent of the vulnerability and what could happen. I don't think anybody... I mean perhaps there are people in this room who can prove that they did. I don't think anyone anticipated that the wholesale financial markets would cease to work... have a heart attack because that is unheard of. A crisis by definition doesn't seem to have...

Vanessa Rossi

That part of it, yes, but thinking about the underlying economic problems which were part of it clearly when it broke out into that financial crisis it went beyond what I think anybody had really thought could happen. But in the early signs of difficulty with, for example, the US property market, the UK property market and so forth had there been no feeling that perhaps a recession could be brewing and therefore a little more prudence in fiscal affairs may have been suitable?

Kitty Ussher

I would disagree that fiscal affairs were imprudent because GDP... debt as a proportion of GDP was below 40% which is very low and we can prove it's low by the fact that in order to join the Euro European countries had to come down to 60 and we were at 40. With hindsight you could say that perhaps the structural deficit of 1:2 ratio GDP it would be better if it wasn't there but given that the estimates of the output gap can vary so widely anyway it wasn't seen as a cause of concern.

Of course there was concern about the US housing market absolutely and there was concern about the very low savings ratio in the UK and work was in hand to discuss that. But I think that one of the policy conclusions once the dust has settled that arises from all of this is that we don't have a very clear policy discussion about what you do in a situation where you have an asset price bubble with an independent central bank and both interest rates and inflation and inflation expectations are very low because in the old days if there was a housing bubble then you'd fiddle with interest rates because they were fiscally controlled and you could make those tradeoffs. I think it's absolutely right to have in independent central bank but there wasn't a conversation in the early days anyway about whether there are things you should do to the housing market in order... that should be done fiscally because the central bank wouldn't do it in order to try and calm a housing bubble and then during the recession they had been playing around with stamp duty which is one possible solution. But certainly if... what I would and what we're doing at Demos at the moment is looking at whether we should have a more open conversation about what you do when one bit of the economy's taking off and you've got in independent central bank.

Vanessa Rossi

A few too many problems and not enough leaders in a way.

Kitty Ussher

I think the leaders are there but they... because it was a new situation they hadn't been fully explored and discussed.

Vanessa Rossi

Sorry, I'll let you off the hook now for a moment. Danny please.

Danny Gabay

Thank you very much. I'm afraid I'm going to continue with a slightly more gloomy note and take what I would consider a bit more realistic view of the global situation and the UK's position within it but I hope to end on a more optimistic point. I'm going to make three basic points. The first is this crisis is not over. It's nowhere near over. Secondly, we're all in it together. Nobody's immune from this crisis, not geographically certainly, and thirdly on a more optimistic point I think there is a chance that Britain can emerge not only stronger but a winner from this financial crisis.

If we start from the crisis not being over this crisis was, is, remains and will continue to be a banking crisis. It is not a sovereign crisis. It never was about subprime. It's about too much money being lent against assets which fall in value. It is not a new story. We have 800 years, according to one book, of exactly the same story. It keeps happening over and over again except that every time we say it's going to be different.

The Greek state was not bailed out by Europe. The French banking system was bailed out by Europe. The question is not who borrowed the money but who lent them the money and if you keep tracing the money back according to the Bank of England we lent the French banks the money to lend to the Greeks. The Americans lent us the money to lend to the French to lend to the Greeks and the Chinese saver lent the American the money to lend to us to lend to the French to lend to the Greeks.

It was fashionable at the beginning of this crisis to call it a subprime crisis. It wasn't even going to be a mortgage market crisis. It was just going to affect people with no credit rating in Arkansas and there was lots of that nonsense. There were stories of 92 year old women being given 25 year mortgages which is optimistic at the best. It then became a US housing market problem but we were assured by the IMF and other noteworthy bodies that it would stay within the US housing market. It was contained, containable. Then it moved off the balance sheets of the SVs, the Special Vehicles onto the banks and the banks simply didn't have the capital to deal with the amount they'd lent out and ultimately the governments had to step in. But all that's happened here is that we've moved risk from one balance sheet to another balance sheet. Nothing's changed. The governments took the debt off the banks and now the governments need the banks to buy their debt. It's the same debt.

It was fashionable to talk about decoupling in 2007, 2008 as part of the it's all right, it's just an American problem. Not only was China going to decouple but so was Europe in some kind of fanciful imaginary world in which Europe had its own banking system which was immune to what goes on in America. This is in some ways very unpleasantly similar to the 1930s. We're all in it together now as we were then. We hear a lot about globalisation. It's very common to talk about globalisation and how trade is increasing and so on. If you look back in time the share of world shade as a share of world GDP today isn't much different from where it was before the First World War. It's not a new phenomenon. Different countries have ebbed and flowed. Global trade has always risen as a share of GDP in modern times.

Where I do take issue with some of the points made earlier is I think this particular crisis did affect the UK in a particularly hard manner. Not just the

UK but what you might call Anglo Saxon finance or Anglo Saxon financial industry. The point Keynes was making in the 1930s when he literally ran himself into the ground crisscrossing the Atlantic was that because we are all in this together it's pointless to think about sinners and repentants and who's morally obligated to help who out. The savers have saved too much and the debtors have borrowed too much and we need to rebalance. We all need to rebalance.

China's saving ratio on most estimates is about 25% of GDP. India's is over 30. In the US and the UK we got to zero. These are not sustainable positions but this is at the heart... the global imbalance is at the heart of the financial crisis and I do take issue with the view that nobody could see it coming. It was very obviously coming and a number of people were pointing it out but the global imbalances had a very strong chance of correcting themselves abruptly and that is unfortunately what tends to happen. The housing boom in the UK did not cause the crisis. That isn't how it works. The analogy I often use with clients is if it's of a drunk man walking along the edge of a cliff. You're vulnerable to any gust of wind. You shouldn't be that drunk on the edge of a cliff. The UK was very very drunk as was Ireland as was America. When the gust came we weren't able to cope with it. That's going to have to change and that's going to mean the UK has to change fundamentally as an economy and as a way we think of our economy.

Eddie George when he was governor was fond of a phrase in the early parts of the previous decade that two speeds are better than none. We actively went out to encourage consumers to borrow money. They deliberately pushed down interest rates in order to get consumers to raise their borrowing to offset the perceived global shock which was a fall in the NASDAQ. Not only was that shock much smaller than they anticipated but they were very slow to raise interest rates. You may or may not need more levers but the levers that were available were not used and that's why we got into the situation that we're in. The government borrowed too much. The household sector borrowed too much and it's payback time now.

I'm not quite as confident that the UK won't lose its credit rating. I don't think we'll go bust but we're vulnerable and I think the new government have done exactly the right thing in recognising that vulnerability. There are three constituencies that they have to work to. The first is the coalition and it's not going to be easy holding the coalition together. The second is the markets; convincing the markets that they're doing the right thing so that our credit rating doesn't deteriorate and that the cost of our debt doesn't go up, and the third is the electorate; convincing the people that this is for our own good in the long run, that we can't continue to live in a situation which the UK household sector owes more than 160% of its annual disposable income. That number really needs to sink in. In 1990 we thought we'd had a boom when it reached 90%. It's 160%. If we all saved every penny that we earned it would take us nearly a year and a half to pay off the debt collectively and most of it is backed by housing. That has to change. That attitude has to change for the economy to move forward. The household saving ratio has started to rise and that is a good thing.

What I would say in the long run then in terms of the position that the UK finds itself in we do have a fortunate position, not just because of the language, because of our position at the United Nations or because of our role as thought leaders in terms of economics and as well as the perceived role that we played in helping to resolve the crisis but the future's going to depend on the UK's ability to harness what it can actually achieve and to live within its means and to show others that that can be done. The way I think Britain could be stronger is by tackling the problem head on by trying to reduce the government's debt position and the household sector also. Now this is where we get very tricky because, as Keynes also pointed out, everybody tries to save we very quickly find ourselves in a hole.

There is one sector that we haven't talked about which is sitting on a very large pile of cash and that's the hope. That's the corporate sector. The cash balance of the corporate sector is historically high at the moment. Gross operating surplus is very strong. That money can be used for investment and it can be used for employment. Now there is a big debate in the UK which will be replicated across the world where Obama does... President Obama, excuse me, does stand out somewhat on his own in believing that the stimulus is still required. I really do question the extent to which governments actually stimulated the economies. Even on the Treasury's own numbers the amount of fiscal loosening that actually went to the economy was less than 1% and the economy fell by over six. I really do wonder where that money has gone and how much of it is directly supporting activity. We have examples in the past and I think the UK could show again that if done correctly reducing the size of the state and particularly the size of its employment can crowd in private sector investment. It's popular... I hear it all the time on Radio 4 that Canada only managed to do it because America was booming. It is not true. Net trade did not make a meaningful contribution to Canada's growth in the 1990s. It was private sector business investment because when you see government spending coming down you can look forward to taxes following them and that's what businesses need to see. When you see government spending going up the opposite is true.

So the hope is that this can be achieved, that private sector businesses will be given the confidence to invest to create a more competitive economy because despite everything that Gordon Brown said, and I have... in my previous life I used to sit in the House of Commons as a speech writer. I used to listen to Gordon Brown talking over and over again about Britain's productivity problem and I would say his analysis was absolutely spot on but nothing happened. Productivity growth did not go up between 97 and 2010. If anything it went backwards and productivity ultimately is the source of wealth and that I think we need to focus on whether that's from schools upwards or within businesses themselves.

The final thing I would say is the thing we must avoid... it has always failed us in the past and will fail us again we must avoid the siren call of lower sterling. The belief that continuously depreciating your currency by making yourself poorer relative to the rest of the world somehow is the way out it's just false. We don't produce the kind of goods that compete on price. We're not going to compete with China no matter how low sterling goes for those kinds of goods. We're at the other end of the scale on services which are less sensitive to sterling. All sterling falling will do is add to inflation and force the Bank of England to push up interest rates more aggressively or quicker than they need to making the overall position much worse.

So my final point is on this crisis something major broke. The belief in markets broke, the belief in markets always being right broke but there's a real danger with what's going on from France to the rest of Europe that we're in danger of throwing the baby out with the bath water. There was a massive boom globally in 1870 following the movement out of railways to the US, a massive global boom which led to a massive global depression including deflation but no-one thought then and rightly ripping up the railways was the right way to go. We need to preserve what worked and that's what Britain can really trade on, thank you.

Vanessa Rossi

Thank you, varying views here about the UK economy and its place in the world. Before I open the floor perhaps I could just direct another question back to Gerry please following on from the previous discussions of how the UK is recovering or whether its financial sector is perceived to have played a role in the crisis and therefore is somehow blamed by the rest of the world you're travelling in and talking about economies which are growing at very rapid growth rates in Asia, the emerging market economies. Do they feel that there has been really such a bad event even? Do they feel that this is something the UK's blamed for or do they see this as a blip that was a problem for the US and Europe?

Gerard Lyons

Across Asia but not just Asia the crisis hit not directly through the financial sector. It hit more through the trade aspect which is my comment about the innocent suffering. You had very open economies hit very hard but at the time it was very much seen as a western financial crisis. But I think there's a recognition everywhere that imbalances caused the crisis. They question is where the solution lies. When the Chinese premier visited... Wen Jibao visited London and Davos last year it was just in the wake of both the British and the Americans saying China was to blame for the crisis because of their excess savings and Wen Jibao said why is it in the West everyone talks about Adam Smith's invisible hand, the role of the markets, no-one talks about Adam Smith's visible hand, which he wrote about in the Theory of Moral Sentiments, which is the importance of morals and ethics. So it says something when it requires the Chinese premier to come to the West to talk about morals and ethics. So there is an underlying view in the East that we need to sort our greed out. I always say the crisis was caused by Greenspan, Glass-Steagall and greed and the incentive structure in the West needs to be addressed.

But what we need to get to in terms of a balanced global economy is accepted at G20 South Korea, at the French with Sarkozy next year might be more confrontational and there are three aspects to that. One is the West needs to spend less, save more, so periods of austerity. Second is currency adjustments and the Chinese now blatantly are accepting that although not fully. But the third aspect is the real difficult one. It's the idea that savers need to spend more. I think there is an acceptance in Asia, particularly China and a lesser extent India, that they do need to boost their domestic economies but for their own good. The challenge is the likes of Germany. You go to Germany, and I was in Germany two weeks ago, and the comment put back to me was "Why should the good become like the bad?". So getting to a global balanced economy is a challenge and in answer to your question I think there is an acceptance that there needs to be a balanced global economy but in Asia the feeling is the West needs to sort itself out more than the East needs to sort itself out.

Vanessa Rossi

But in terms of targeting the UK it's not as specific as that.

Gerard Lyons

No, the UK is held in different light around the world. I think the challenge I feel going to Asia is that in Asia people understand the US. The US speaks with one voice. The US is one homogenous market. Europe comes, speaks with one voice as Europe and then everyone comes and talks about their own country. So almost we talk regionally but act nationally. So Asia can't come to terms with the European angle but Europe... I don't think Britain should become too entrenched in Europe. I think we should stay outside the EU, sorry outside the Eurozone, sorry, but as part of the EU. But Europe is Asia's biggest trading partner, it's China's biggest trading partner so Europe needs to actually realise it can punch its weight.

Vanessa Rossi

Yes, I appreciate the comment about the German picture, for example. I had a comment recently from somebody on the issue of German export performances so it's clearly... apart from our own super performance in terms of exports of services the only other one that stands out across Europe is actually the German ability to sell manufactured goods and as somebody put it in this meeting at the EEC was "Well why are you criticising us?". We had the Lisbon agenda which set the view that we had to be the most competitive countries in the world. Germany went out and did it what happened to the rest? So I think there's a feeling of a little bit of fighting back going on here over some of these issues and positions which is quite interesting.

But, sorry, anyway to come back to the other point, the last question and I'll come back to Danny on this one I think it's illuminating to come back round again to these imbalances issues and the view that savers are somehow at fault as well. In other contexts though this really... this seriously concerns me in the sense that it wasn't the problem of having cheap money it was the problem that it was invested badly and unfortunately I think this is the link to

Danny's comment about repeats of crises is that repeats of crises usually occur because money is not invested well and something goes wrong and it doesn't matter whether it's the government that's been leading that investment or whether it's the private sector or financial markets there always seems to be some point in time at which this goes wrong and unfortunately we hit one here. If that cheap money over the previous decade had been spent wisely we wouldn't have had those problems.

Now I know the riposte from financial markets has tended to be, yes, we could have done a better job but actually governments and nations colluded in creating problems as to why this money was funnelled too much into US mortgages, for example, and not enough into things like other infrastructure investment, energy investment and so forth. So there's some game plan going on here and a standoff over these blame games. So thinking of Danny's point about this pool of corporate money which could now be invested and help to restart growth, and it's perfectly true that is an important opportunity I think the US has been talking about this as well as the UK, do you feel that this is a danger that's been overcome or that it's for the moment disappeared and may resurface in ten years time?

Danny Gabay

Sorry, the danger being...

Vanessa Rossi

The investment problem, will this money be invested well is the question? Yes, we can get the investment going again it will give more growth in the economy but will it be any better quality investment than we had before?

Danny Gabay

Yes, I think it axiomatically will be. The issue you highlighted is fairly clear. Productive Chinese savings were put into non-productive US assets. Housing doesn't give you anything. It doesn't improve the economy in any sense but it was a form of savings because there was no financial intermediation to recycle those Chinese savings closer to home. Businesses aren't going to be investing in housing. I don't think anybody's going to be investing in housing for the foreseeable future. The question is whether or not businesses can have the confidence that the government is putting its house in order to invest that money in a non defensive way. A large amount of the corporate cash balance is due to complete unprecedented slashing of inventory and arithmetically that's what's causing profits to go up. The question is when will they have the confidence to rebuild those inventories and then go beyond that to actually expand the economy and I don't think we're there yet and I think governments do have a role to play in providing that base.

Vanessa Rossi

Thank you, now open to the floor. Can we take questions? Could I suggest that we start over this side with the... no, hands are going up here quickly as soon as I said it. The right hand side gets it. Your hands went faster. If we start a sweep please with the microphone from over this side I think guys there would you...?

Andrew Fraser

Andrew Fraser council member at Chatham House. Just picking up on business investment one of the facets none of the panel have referred to is almost unique about the British economy among large economies is that virtually half of it is owned by foreigners and notwithstanding the last much lamented Industry Secretary's determination to keep our chocolate pure and British managed what's the panel's view about the strategic competitiveness of the UK? The last number's 48.5% of GDP is foreign owned. Are we going to continue to attract foreign capital given that Europe is a very uninteresting place to do business in terms of growth as we've heard, compared with other regions of the world, particularly Asia, and, secondly, does it matter that foreigners own so much of our industry? For example, we talk of low carbon growth and so on and new energy industries. Westing House, which the British taxpayer used to own is now owned by a Japanese corporation which looks at its investment decisions on a very different basis. Does it matter, for example, in terms of energy security if a company....? I don't know, one could pick BP for example... whether a company like BP is continued to be headquartered in the United Kingdom, does that matter?

Vanessa Rossi

Thank you, should we take a couple of questions just there by you firstly and then we'll come back to another area of the room please.

Dominic Dyer

Dominic Dyer, member Chatham House. Just coming back to the housing issue because this big inflationary bubble that we've seen occur in housing in this country over the last ten or 15 years it's not gone away has it? We live in a country of millions of people that are seeking a limited amount of property to live in and if you look at where the government's cutting back on expenditure at the moment some of it will be in social affordable housing. How do we get that balance right? Because if you're a young person at the moment you're having to put more and more money away to get that deposit to get that home and we're all living at the expectation that will rise in value and then we can sell it on. Do we have to change that viewpoint at the public level and how can government play a role in that? Because otherwise I just can't see that we're going to avoid just repeating the same mistakes again in our economy.

Vanessa Rossi

One more question and then I'll give it back to the panel.

Hans-Josef Beth

Hans-Josef Beth, I'm from the German Embassy and of course I'm a little worried looking at your perspectives in ten years time we should be par with Britain if it comes to the GDP so I just want to ask you I mean forget the financial sector of course but where's your... actually if it comes to those sectors which were mentioned by you, for example, about the innovative industries and so on, low carbon industry, nanotechnology and stuff looking at your situation if it comes to research expenses, if it comes to vocational and training in situations in Britain what makes you so optimistic?

Vanessa Rossi

Gerry would you like to start?

Gerard Lyons

The Germans are... Germany played very well in the World Cup, I'll give them that. The reality here in the UK is that we're very good at lots of things but we don't have the strength in depth. The financial sector is pretty damn good and we shouldn't throw the baby out with the bath water, as Danny was saying. But, yes, what's going to get the UK? I do think we need to invest more. The gentleman at the back talked about repeating the same old problems. We've had the Maudlin boom and bust, the Barber boom and bust, the Lawson boom and bust and the Brown boom and bust. I think we need to have more strategic thinking. Immigration, for instance, is seen as a positive for the UK. We're... the Office of National Statistics expects to see 10.1 million more people in the UK in the next 20 years. They're all expected to be in England. Given that there's a lack of infrastructure in the rest of the country they're all likely to be in the South East of England. We're not allowing new homes to be built in the green belts so should we be surprised that there's a housing shortage each year and therefore housing markets are going to go up. What we need to have in answer to your question, the previous question, is more strategic thinking. We actually can show that we can do it. We are cutting edge in terms of pharmaceuticals, telecoms, nanotechnology. Give you an idea three years ago I chaired the UK Hong Kong business partnership so the City needed a little room at the Foreign Office. From the Hong Kong side which was basically the Beijing side they were... they came to talk about areas where they saw Britain as being at the cutting edge and they talked about Britain being at the cutting edge in creative industries, ICT and environmental areas. Areas we don't take as important maybe or we tend not to sing our praises, small medium firms in those areas.

So in answer to your question quite frankly I wouldn't be so smug if I was sitting in Germany. Germany has a lot going for it but Germany went through a big problem. But Germany can't just export infrastructure goods forever. China will pick up in the future. I think Britain and Germany... I think we would be very positive. We can learn from Germany in the fact that we don't have the property booms and bust. We can learn from Germany in the fact the education levels are at the bottom end of very good. You have apprenticeships at the top end and I think we're pretty good. I think we can learn from one another and hopefully work with one another because Germany is the powerhouse of Europe but Britain also in many respects is pretty powerful as well and maybe, just to conclude, about should we remain open? Absolutely, I think we should aim for level playing fields.

At the moment, as I was saying in my talk, we block takeovers on competition grounds, on regulatory grounds and we safeguard certain areas. My big worry about how things have changed is state capitalism has become a big issue and states might play to different rules, strategic not commercial and therefore we need... the challenge is to make sure more investment if it comes in goes to the grass roots. Football is a classic example. Foreign ownership comes in it stays at the premiership and English premier league clubs spend a less percentage of their income on grass roots football than in the German Bundesliga. So we need to make sure foreign money does come in. We need to make sure there are level playing fields in that we can access particularly the financial sector, the markets in India and in China, but maybe we need to get more money going into the grass roots to invest on our skills, our education. Germany does that very well and I think we could learn from them.

Vanessa Rossi

Danny.

Danny Gabay

I would agree in relation to Germany that there's a big difference. There's one very neat way of seeing the German performance of the last decade and the UK performance. We've had a massive decline in the real exchange rate. It's entirely due in Britain's case to the nominal exchange rate, the cash value falling. In Germany's case it's entirely due to unit labour costs falling which would make Germany an incredibly competitive economy if it wasn't saddled with the rest of the Eurozone. The other aspect of my view that this isn't a crisis which is over and that nobody's alone Germany has locked itself in , in one sense, with the Eurozone but it also captured and kept hold of a captive export market. One quarter of Germany's trade surplus goes to the so called... is accounted for by the so called PIGS. They account for 48% of all of the domestic demand in Europe over the last decade. That tap just got switched off and if Germany isn't going to step up then Europe as a whole is going to start to look like a soufflé once again that's collapsing on itself. We can't all export. My problem with this optimistic view that there is... China's exporting, Germany's exporting, Japan's exporting, to whom? Who's importing? Who's doing the demanding? And those savers countries need to turn things around. So I don't... I'm not an industry specialist but I wouldn't dismiss the financial industry just like that. I think it's... in a world in which China doesn't have a banking system, India has a fledgling one if London's competing with Dubai I would back London to win that particular battle.

In terms of the housing market I used to work in a hedge fund and I was continuously... every time I wrote that the housing market was going to burst I'd be told by one bright trader or another that you're born short of housing which is one of those hedge fund statements which sounds really clever but means nothing. We weren't born short of housing in any other way. All those demographic arguments and so on all of those have been in play for a long time. It's when the Bank of England started cutting interest rates in 2001 the housing market took off. It's not a very complicated story. There is maybe excess demand in some parts of the country. That's what government policy should do. We've had incredibly low levels of building. New completions have fallen to post war lows. All of that can be addressed without necessarily trying to convince everybody that it's some kind of a birthright to own a house. In the same way as the subprime mortgages' meltdown was partly because people who couldn't pay back the debt were given credit and if everybody lived within their means renting is not such a terrible alternative. We don't have a rental market much outside of London.

So I think the housing market has been our Achilles heel in all of the booms that Gerard mentioned it's the same story, the Lawson boom, the Brown boom, always housing because that's what we borrow money against. It's not housing per se, it's just that's the asset that we hold and then final question about whether we should remain open, of course. It's the only way that we can trade and particularly if we want to become a major financial hub the only way to be able to do that is to be involved in the global trade business and the UK needs to be able to perform that role.

Does it matter that nearly half of the economy is owned by foreigners? I don't think so. I don't see why nationality matters. It can matter as it seems to matter for British Petroleum but otherwise, no, I don't think it matters.

Kitty Ussher

I agree, I don't think ownership should matter. The most important thing is creating good jobs and wealth and I don't mind who comes and does that. They're all very welcome even if they take over so called British companies in order to provide good management and do it better than was previously done. I think that is to be welcomed. In the long run the more open we are the greater competitive forces we experience and the higher our productivity and so the greater our wealth in the long run although it can be quite dislocating for some people in the short term.

I think... is it Dominic who talked about housing? I think this is a fantastic opportunity to have a look at housing policy more generally and I, like you, have been slightly disturbed by short term effects of current government decisions although they say that they will be ameliorated in the longer term when their new policies kick through. I'm developing a hate/ hate relationship with the editor of the Daily Mail because I've been going around saying that the government should be bold and introduce instead of, for example, VAT, capital gains tax on primary residences as a policy tool because that will... it's very easy to vary and that will enable us to get more money in when the housing market takes off. If the housing market takes off that's a leading indicator of a crash to come and so the government can increase the resources that it has as a result. I think we need far more building, far more innovative forms of ownership, a complete sorting out of the housing benefit market which is causing the government an absolute fortune and we're busy procuring for the most vulnerable people houses that are damp and don't meet the decent home standards and we should be doing some type of, God forbid, regulatory approach to perhaps turn those into long term leases at lower rents, for example, through social letting agencies and this is something that we started talking about at the end of the last government and will be anathema to the current government. So now is the time to have this questioned properly because we can see the damage... properly talked about because we can see the damage that it's caused by not getting it right but I think regulatory and fiscal tools to try and have a more continental style housing market would be a very good idea.

Vanessa Rossi

Could I just ask there though the Barker report was produced some years ago. Was there really much action that came from that essentially recommending that supply should be increased in the UK?

Kitty Ussher

It has been increased and some of the projects... I mean obviously they were the first to go in the credit crunch because the housing market collapsed and who was going to build more houses? But in the medium term the numbers have gone up and in the last two weeks those projects have started to be cancelled. But they need to move faster. I accept it needs to be faster.

Vanessa Rossi

The effects weren't overwhelming as it were.

Kitty Ussher

No, it needs to go faster.

Vanessa Rossi

A bit slow. Let me take a couple more questions before Kitty has to go and then we can... the gentleman over here, perhaps let's move over this side of the room.

Martin Bond

Thanks very much, Martin Bond visiting Professor at Royal Holloway. I've got a double question if I may. We've spoken briefly on the comparison between Germany and the UK. I wonder if the panel would just say something about the contrast between Greece and Germany, slightly outside our framework but the prospective solutions to the Euro issue at the moment would be... would have some implications for the UK I suggest and rather more general than that in the world scheme and our position in it don't you think that we're all moving towards a situation where the return on capital is likely to go up. Unit labour costs we were driving for them to go down and the disparities in our society look like getting wider rather than narrower.

Vanessa Rossi

Another gentleman over here and then the lady at the end and we'll wrap up those three questions.

Lionel Freeman

Lionel Freeman, member of the board of directors at Seversil [?]. No panellist has so far mentioned military expenditures and where they figure into the budget imbalances. Germany has for many years been a major supplier of military equipment to the Greeks. The Greeks now have a huge arsenal. Their expenditures on military equipment of all sorts, mainly from Germany, are way in excess of the average percentage of military expense across the EU. German banks lend the money to the Greeks so the Greeks can buy German submarines. Why do the Greeks buy German submarines? Because they're afraid of the Turks. Where do the Turks buy their equipment from? From Germany. Why? Because they're afraid of the Greeks. Who's lending the Turks the money? The German banks. How do these countries get so indebted? Because they are foolish and buy military equipment they don't need. When we ask them to reduce expenditures for across the common population we're really asking them to stop buying military equipment but the Germans do this because the Germans create jobs by keeping these shipyards occupied. These circularities occur all through the world economy and they have increased as we've exported jobs from high class countries where we live to the Chinese. Now why do the Chinese save so much? Is it because they are frugal and careful while we are foolish? No, there are no pension funds in China. It's the same thing in India. They have no future of financial stability unless they create it for themselves. We also provide a huge amount of our deficit through healthcare. It's one of those supplies for which the demand is infinite but the supply is rationed. At what point do we need to ration our own healthcare supply? Just a few questions for lunch, thank you.

Vanessa Rossi

Just a minor one and we'll take a question from the lady at the end there and perhaps we ought to have a buy back scheme on submarines. Would that help out?

Ngaire Woods

Yes, hello, Ngaire Woods from Oxford and my question's for Kitty who put a very clear argument to us about why the financial crisis has not more negatively impacted Britain. But I just wonder Kitty you mentioned that both in 2007 and in 2008 the government had to open its own cheque book and Danny and Gerard have given us a very clear story of a Britain that needs investment and that investment will depend on some quite intensive investment in infrastructure, in skills and so forth. To what extent did the opening of cheque books to deal with the financial crisis impede the government's capacity now to invest in the kinds of infrastructure that are prerequisites for growth and are you not underestimating that when you say it didn't impact on Britain's competitiveness?

Vanessa Rossi

I'll give Kitty the first turn to answer because I know you've got to go shortly.

Kitty Ussher

On that particular point if you look at where the debt to GDP ratios of all the big industrialised so called economies are expected to peak they're all going to be in roughly the same place. I haven't got the figures off the top of my head but it's at round about 85% of the [inaudible] in around about 2014ish and so there isn't a disproportionate impact overall on the UK. Has the fact that there's a deficit problem now for most people meant that there's going to be less capital expenditure in the next four years? Yes, of course capital expenditure plans were quite sharply cut in the last budget of the previous government in March and the new government has said they're going to keep to those plans but of course the... when the government bought bits of the financial services sector in time they are projected to be sold back again and will achieve a return. So the point that I was making is that in the medium term there is no obvious negative impact on the broad fundamentals of the UK's economic position in the world as a result of the fact that we had a larger financial services sector than some of our major competitors and I do think that that is the case.

Vanessa Rossi

Just to clarify I'm sorry I didn't mean to imply anything of the sort. We were given five minutes leeway because we started late so we can just take a little bit more question time. That's all but we understand if you have to go. I was just going to bring in one other question from my co-author over here, Jim Rollo. Sorry we haven't got the microphone down here to you before Jim and since you've co-authored the report with me I think we should let you get a word in before we pass to the rest of the panel.

Jim Rollo

Thanks very much Vanessa. It's very clear we're... there's an inevitable process of relative decline going on and a jolly good thing too in my view because it means other people are getting richer and better off and we can profit from that in the long term. To that extent what we need to do is somehow or other to project a successful economic policy stance and to maintain and taking all of Crispin's points about sustainability into this, a sparkling growth performance is the best way forward to look as if and to influence other people. So I want to ask the panel just given our current circumstances what would we do in the next three or four years? What are the two or three things you think that government should be doing to get our underlying sustainable growth rate up?

Vanessa Rossi

Would you like a chance to come in on that Kitty?

Kitty Ussher

Do nothing to jeopardise consumer demand until the recovery is well established and maybe some disagreement somewhere.

Vanessa Rossi

It's not established yet you mean.

Kitty Ussher

I don't think it is established yet. I think there are huge risks at the moment and then obviously prioritise everything that will raise productivity as we've spoken about before. That's what I'd do on which note thank you very much Vanessa.

Gerard Lyons

There's a whole host of questions. Shall I...?

Vanessa Rossi

The submarines please.

Gerard Lyons

In terms of what should a government do to link it into the budget deficit. What do we know about reducing the budget deficit? We know for certain that you need to have a medium term plan to reduce a budget deficit. Also what do we know? We know that interest rates have to remain low whilst you're reducing the budget deficit. What we don't know and why there is s big disagreement or uncertainty is the scale and the speed at which you reduce a budget deficit. That is a judgement call that has to be made on the basis of the economy. In some respects the Chancellor was damned if he did and damned if he didn't. Damned if he does cut aggressively because that will clearly impact growth in the regions. Damned if he doesn't because you will be penalised by the markets.

What would I be doing? I would be trying to ensure that the Bank of England keeps interest rates low. If I was on the Bank of England Monetary Policy Committee I would walk out tomorrow and say, look we need to reduce our debt. We need to get our balance sheets back into shape. For the next two to three years we're going to actually keep interest rates low. But then I would actually learn from India, China, Canada and Australia and have macro prudential measures. You don't just need to have one club, on instrument to control things. Macro prudential measures, well we had them in the UK in the early 80s, competition and credit control but basically other measures used successfully in those countries to stop them having the boom.

Also I would actually reverse... obviously you wouldn't do this if you were Chancellor but Alistair Darling announced phenomenal cuts in public spending but in government... sorry, particularly investment Osborne didn't really do anything but, as Boris Johnson says, roads don't vote. Roads get cut. We actually cut the infrastructure always so I would reverse that and basically I would redress the balance in terms of the benefit system needs to be addressed and the health system.

So that's what I would do and I think these are some of the structure issues. But I do think there is a big issue. We do have lots of near term challenges. As I was saying when you look at the $58 trillion world economy $41 trillion of that is the West. The West has a deleveraging process. Big companies in the States and in the UK in good shape. Big banks in the US and the UK seem to be in good shape. It's the small medium sized companies who are starved of credit and you link back into the question from Professor Rollo maybe trying to get the lending to the small medium sized firms during the crisis. So we need to be aware there are still near term challenges. Therefore central banks in the West need not only keep rates low I think need to increase quantitative easing. But against those near term challenges we've got the longer term upbeat assessment and therefore try and encourage the likes of China and India and even Germany to spend more.

In terms of the couple of questions... unit labour costs etc. I think the relative position is very interesting. We have a shift in the balance of power but in the West the winners are the big companies, maybe Standard Chartered, HSBC, is banks in the UK well positioned in the emerging markets. Winners are those who are positioned in the future growth markets. Therefore companies in the States and in the UK that have the ability to invest unfortunately might not decide to invest at home. After the last US recession US firms came out with their balance sheets good shape. They didn't invest in Ohio or in mid America as they used to in the past. They invested in China and in Asia and that's the challenge. So what we have is relative change. The unskilled workers in the West are the ones who have been squeezed. So the gap between the rich and the poor... between corporate profits and wages is getting wider and that creates big challenges and therefore I think it's beholden upon any government to actually put context around this. I think a lot of people are bamboozled by everything. The fact that so few people in the UK judging from the Pew survey which...

Vanessa Rossi

The YouGov survey.

Gerard Lyons

The YouGov survey, sorry, seem to think India is important. It's staggering, the UK has fallen in importance in trade to India quite considerably. The confederation of Indian industry was over here two weeks ago, a big delegation. They come each year. They're desperate to boost trade ties. Thankfully the Prime Minister, the Chancellor and leading members of cabinet are going to India on the big delegation at the end of July. So we need to start changing perceptions and hopefully getting more people thinking globally and I would argue the financial sector has an important part to play in that as well, thanks.

Vanessa Rossi

Danny.

Danny Gabay

On the submarine question I wouldn't just single the Germans out. The Americans have been doing that in the Middle East for some time. You lend money, they buy your arms. You lend more money, they buy more arms. That's the nature of the industry but I don't think defence spending is a major issue and I don't think we'll be doing too much of it in the next decade or so.

In terms of the broader picture my... the question about infrastructure and government investment I would approach in a completely different way. It's not for the government to invest. There's been too much government spending, that's the problem. We need private sector investment. For all of that talk about the golden rule and Gordon Brown was going to improve the infrastructure 1.5% of GDP that's what government investment is worth. Last year business sector investment fell 23%. That's the problem. That's what needs to come back and that's profitability not the government. That's not to say that we don't need better infrastructure. We do but it's not necessarily the case that the government can provide it. They're not in that position.

What I would say is in terms of how to get growth back and how to make it work it's not just about how quickly you reduce the deficit it's how you do it. If you try to reduce the deficit by raising taxes you're chasing your own tail. It won't work. You'll do what Japan did in 97. You'll do what America did in 37. It has to be through lower spending. The government comes along and says we're in an awful mess you're going to have to pay for it. That doesn't make me want to go out and buy a new car. The government comes along and says we're in a mess, we're starting to address it I might start looking to a point where taxes might come down, my position might get better as a consumer. So I think the broad picture is this and my last sort of comment I thought I'd leave you with this thought. In 1945 the G7 had debt to GDP ratio of about 110%. From 1945 to 1975 it reduced it to about 30. From 1975 to 2010 it's been gradually climbing. It's now at 110%. We're exactly where we were without having fought a world war. That position is unsustainable. Thank you.

Vanessa Rossi

Yes, that's final. Any last burning entry here that I absolutely can't turn down? Just one more from the gentleman in the middle there and then we really have to go, sorry about this.

Bat-Erdene Chinuukhei

Hello, my name is Bat-Erdene Chinuukhei. I'm from the Embassy of Mongolia. My question is to Dr Lyons and you mentioned about four groups of global shifts in which there are four groups of winners. I guess Mongolia can be included in the group with natural sources, huge natural sources. Indeed Mongolia has quite huge natural sources and on the other hand its geographical location is quite significant lying between two giants; Russia and China. So you also mentioned that Britain can be... is also included in the group of creativity with countries of creativity. So my question is that how is Britain going to use these new economic opportunities?

Vanessa Rossi

Yes, one last point from Gerry I think about the issue of...

Gerard Lyons

I think you mentioned Mongolia actually will stand a chance. I'm particularly interested in Mongolia. Inner Mongolia, which is obviously part of China, is rich in rare earths which are essential to most things, even mobile phones etc. So, yes, Mongolia generally has a lot of potential, lots of opportunity but I think bringing it back to the context, I say the winners will be those with the cash, the commodities, the creativity but above all I think the UK needs to think globally. We have an important role with Europe. We have an important role with the States but I think we use those to the exclusion of other areas. We should be boosting our trade ties with China, India, economies in Asia but also across Africa we should recognise the phenomenal changes there. But also we should be arguing for level playing fields. Actually the policy tools and institutions in many of these countries held up far better during the crisis than we could have expected but I think there is a role that we can play but I think we need to focus very much on those markets in the East and the developing markets.

At the same time coming back to the points made look we've had a big shock. The problem is still working its way through the system. Europe, of all the regions, is probably the most impacted still. The net funding gap for European banks is huge. We haven't gone into the details of that. Our biggest market closest to home still has to probably go through the biggest economic shift yet. America is changing and it still is likely to underperform. So globally what we have is a sub trend recovery but at the same time don't forget what's happening on the ground. I could take you across markets and economies and cities across Asia and Africa and you would just be blown away.

Just go... if ever you go to China just spend a day in Chongqing. 32 million people, 16 million people in the urban centres and you go there one week after the next and this is real change. China is actually... Chongqing is 600 kilometres up from the three gorges dam. The water level reached its maximum a year ago. They had two mid size ocean tanker ports in Chongqing which is in Central China because they go from tankers there right out to the open sea. Wage levels there are actually lower than the wage levels on the coast. We have a phenomenal... it is an industrial revolution, I kid you not. India is opening up. You go to India, the rate of change. You sit here in the West you can be as pessimistic as hell. We have a big debt problem, the housing market we need to actually work through it but if you just sit here you will lose what's going on elsewhere.

Obviously we shouldn't underestimate the near term challenges but the longer term opportunities are just absolutely phenomenal. That's why when you look at opinion polls younger people in the UK are far more optimistic than older people. We always think older people, I wouldn't include myself as old thank you, but people older than those in this room always think we're in terminal decline but I don't think we are. There are lots... we need to play to our strengths. We mustn't kill the financial sector. We must recognise that BP is something we should be supporting not criticising and maybe our media also should learn that we shouldn't always be knocking ourselves but we do need to learn some fundamental lessons as well. That's my view.

Vanessa Rossi

Thank you Gerry. I think that wraps us up extremely well for lunch actually back into the world economy again, thank you.