

The Cutlers' Feast, May, 2010.

Speech by the Principal Guest, Gavyn Davies

Master Cutler, Lord Lieutenant, High Sheriff, Lord Mayor, My Lords, Ladies and Gentlemen

What a week it has been in British politics. In the past seven days, the betting markets have confidently expected, in quick succession, a majority Conservative government, a minority Conservative government, a Lib-Lab coalition and finally the Lib-Con coalition which actually transpired. Professor Stephen Hawking said recently that aliens inhabit parts of the universe, and at times in the past week I thought they may have landed at Westminster.

In the end, though, the British constitution, a marvel of flexible human engineering, has once again triumphed, and I am sure that we will all want to welcome the new government, wish it good fortune, and express the hope that it will enjoy every success.

Tonight, I want to comment on the political and economic situation which the new government now faces. In the past 36 years, I have worked for several governments which have faced severe economic threats comparable to this one. In fact, prior to this week, I used to be able to claim that I had had the privilege of working on economic policy for all six of the Prime Ministers who had been in office since Mr Heath – though in one case, Mrs Thatcher, I only survived for a couple of days. Mr Cameron has now come along with the sole intention of spoiling my personal statistics.

Nevertheless, here goes.

Britain now has a coalition government which commands 363 seats in the Commons, and a comfortable majority of 77. But we also have a hung Parliament in terms of underlying party affiliations. And a respected commentator said yesterday that the Conservative and Liberal Democrat parties only have one thing in common – mutual loathing. Should we be worried about the durability of this arrangement?

I remember extremely clearly the last time we had a hung Parliament, since I was a young economic adviser in 10 Downing Street throughout its duration. In fact, I first went to work in Downing Street on March 5th 1974, one day after Edward Heath resigned the Premiership, following a weekend in which he had tried to conclude a coalition deal with the Liberals. The similarities with Gordon Brown's actions last weekend were uncanny. Mr Heath said privately at the time that he had to try to stitch together a deal with the Liberals, because otherwise Labour would enter Downing Street by the back door, and stay there until 1980. How right he proved to be.

That precedent was clearly what was worrying both David Cameron and Gordon Brown last weekend. Incumbency is a major factor in politics, and Mr Cameron's success in wooing the Liberal Democrats could well keep him in office for a long while.

When Harold Wilson's minority Labour government took office in 1974, there was universal scepticism about whether he could survive for more than a few weeks. These were febrile times, and there was even some loose talk about a coup being mounted against the Wilson government. Even when Harold Wilson won an overall majority of just 3 in the second General Election of 1974, most analysts said that the government could not last. But I remember Mr Wilson telling his advisers very clearly that the government would survive a full term and, with the ultimate help of a formal agreement with the Liberals, he was right.

I suppose the political lesson that I have drawn from these experiences is that the government which has emerged from the 2010 hung Parliament is quite likely to survive for the full term that it now promises. And political stability is much needed, because the experience of 1974 warns that the consequences of an unstable minority government for economic policy can be very bad indeed.

The minority Labour government in 1974 inherited a rising inflation rate. Its response at the time was to deny that this was happening, to restate the figures based on dubious arithmetic, and to set budgetary policy so that it encouraged inflation to rise, rather than fall. By the time inflation peaked in 1975, it had reached the remarkable rate of 27%. I have little doubt that the government's precarious Parliamentary position contributed to that outcome, though there were many other causes as well. So, whatever your political viewpoint, it is a very good thing that the stark lessons from 1974 have been heeded, and that a relatively stable administration seems to have emerged from the horse trading of the past few days.

What economic dangers does the incoming government face this time? It does not face an inflationary threat like we did in 1974. Quite the reverse : the collapse of the global financial system during the credit crunch has such severe consequences for the global economy that deflation – falling prices – seems to be a greater threat than inflation, at least in the next couple of years.

Nor are we facing an imminent threat of a double dip recession. In fact, the UK economy is recovering much more rapidly than most people have realised. It is true that our official GDP statistics do not substantiate this, showing an annual growth rate running at only about 1%, which is not enough to stop unemployment rising. But fortunately our official GDP statistics are barely worth the paper they are printed upon. Business survey data, which tend to be considerably more accurate, suggest that the economy is now growing at the much healthier rate of some 3-4% per annum. To some extent, this is being driven by an automatic bounce-back from the depths of recession, with postponed expenditure on items like cars and computers now being undertaken, but there are also signs of a more durable recovery in exports, consumer spending and capital investment.

So if inflation is low and the economy is recovering, what is the problem? As the Master Cutler has already observed, the problem is that the recovery from recession has been built, to a worryingly large extent, on the stimulus from the budget deficit under Labour, and the direct increase in the money supply undertaken by the Bank of England. Essentially, the private sector balance sheet – banks, households and companies – ran into severe trouble during the credit crunch, so private spending was slashed dramatically. Rightly or wrongly, the public sector filled this gap with a huge expansion in its own balance sheet, or to put it more plainly the public sector increased its indebtedness in order to cushion the effects of the cutback in private spending. We do not yet know whether the government and the Bank of England will be able to repair their financial positions without pushing the economy back into recession.

The coalition agreement published yesterday says that the new government will move more rapidly than Labour had planned to reduce the size of the budget deficit, with most of the additional measures of fiscal tightening coming from public spending cuts, rather than an even higher burden of taxation. This means that the key strategic decision in the lifetime of this government has already been made. What is this likely to mean? In the last Labour Budget, the Treasury said that the budget deficit would fall from 11% of GDP in the last fiscal year to 4% of GDP in 2014, meaning that the budget deficit will improve by 7% of GDP during the new Parliament. Of this 7%, the Labour government planned that around 2 percentage points would come automatically from the improvement in the economy, and that 5 percentage points would come from discretionary measures to tighten fiscal policy.

The new government is now saying that this 5 percentage point tightening needs to be considerably larger, with most of the adjustment coming from public spending cuts. For this statement to be meaningful, it must imply that the coalition is planning to tighten discretionary fiscal policy by around 6-8 percentage points of GDP in the coming Parliament.

This is absolutely massive. If implemented, it would be considerably larger than the budget action taken by Mrs Thatcher in the early 1980s, and by John Major in the mid 1990s, both of which tightened fiscal policy by around 4 % of GDP over several years. The measures to achieve this tightening were not spelled out by any of the parties in the election campaign, but George Osborne will have to do exactly that in his emergency budget in 50 days time.

He does not have an enviable task. He will probably have to do more on the tax front than Labour had planned, and he may well need to turn to an increase in VAT to accomplish this. Furthermore, to achieve credibility, he will need to spell out in much greater detail where the public expenditure cuts will come from. It seems to me doubtful whether he can achieve the massive cuts required – amounting to about 5% of GDP, or 10% off spending plans, without cutting deep into frontline services, but we shall see.

No British government has made cuts of this size, so it is not clear whether the economy can continue to grow as this happens. On the bright side, many economists wrongly

warned ahead of the Thatcher and Major cuts that they would cause the economy to fall back into recession. I remember refusing to sign the famous letter from 364 economists arguing exactly that in 1981. These economists were proven too pessimistic because confidence was restored, and the private sector grew rapidly enough to offset the withdrawal of public sector support. The scale is different this time, but we must all hope that the same forces will once again win the day.

I want to end with a few comments about manufacturing industry, which I know is close to the heart of many people in this room. In the past 15 years, it was fashionable for economists to argue that there was nothing special about manufacturing, and that it would be fine if banking and other financial services continued to expand at the expense of a shrinking manufacturing sector. The Monetary Policy Committee at the Bank of England routinely argued that they had no responsibility for the health of any particular sector of the economy, and nor did they have the weapons to address these issues, even if they want to. And the Treasury seemed to welcome the strengthening in sterling which caused such severe problems for manufacturing a decade ago.

The good news for The Company of Cutlers in Hallamshire is that all of this has now changed. Manufacturing may only contribute 18% to UK GDP, but it contributes 62% to our exports. With the banking sector contracting, public spending being sharply cut, and tax rises hitting consumers, Britain will have no choice but to export its way out of trouble. It cannot do this without the success, profitability and expansion of the industries represented in this room. If the new government does not already know this, then it will very soon find out.

It is therefore, more than ever before, my privilege to conclude with a toast:

To the Manufacturing Industries of Hallamshire