



# HOUSE OF LORDS

Revised transcript of evidence taken before  
**The Select Committee on Economic Affairs**

Inquiry on

## **ECONOMIC OUTLOOK**

*Evidence Session No. 1 Heard in Public. Questions 1-32*

**TUESDAY 30 NOVEMBER 2010**

**3.35 pm**

Witnesses: The Rt Hon George Osborne MP, Mr Dave Ramsden and Mr James Richardson

Members present

Lord MacGregor of Pulham Market (Chairman)  
Lord Best  
Lord Forsyth of Drumlean  
Lord Hollick  
Baroness Kingsmill  
Lord Lawson of Blaby  
Lord Shipley  
Lord Smith of Clifton  
Lord Tugendhat

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**Examination of Witnesses**

*Witnesses:* **The Rt Hon George Osborne MP**, [Chancellor of the Exchequer], **Mr Dave Ramsden**, [Managing Director, Macroeconomic and Fiscal Policy], and **Mr James Richardson**, [Director, Public Spending, HM Treasury].

**Q1 The Chairman:** Good afternoon, Chancellor. Can I thank you very much indeed for coming? We realise that you have a pretty rigorous and vigorous life generally, but in the last few days exceptionally so, so we are very grateful to you for honouring your commitment to be with us today.

I have just a couple of preliminary remarks. Copies of Members' entries are available in the Register of Interests. We're not going through them today. This is being televised, so we would be grateful if everyone would speak up so that it is clear what they are saying. Chancellor, would you like to make an opening statement?

**Mr Osborne:** No. Thank you for inviting me to the Committee. I'm very happy to take your questions. Shall I just introduce my two colleagues from the Treasury? Mr James Richardson is the Director of Public Spending and Mr Dave Ramsden is the Chief Economic Adviser.

**Q2 The Chairman:** We're very grateful to them, too, for coming. Let me kick off by asking you how confident you are that you have done enough to meet the target of eliminating the structural deficit by 2014-15? If more consolidation or other steps are needed, would they be more likely to focus on tax rises or spending cuts?

**Mr Osborne:** Well, I'm pretty confident that we have done enough to fulfil the fiscal mandate, and indeed to fulfil it a year earlier, as your question alludes to. That's not just my judgment, of course; that's also the judgment of the Office for Budget Responsibility, which we've established and whose first autumn statement was produced yesterday. Their task is to assess whether we have a better than 50% chance of hitting the mandate and that is their judgment. I think, actually, they've put a 70% figure on it. So, yes, I am confident of meeting it. We've got quite a lot of room there and I think that's sensible, given the current economic environment.

**Q3 Baroness Kingsmill:** I wonder if I might ask for a little clarification from you on the relationship between growth forecasts and deficit reduction. If it's lower than forecast, do you plan to delay spending cuts? Or if it's higher than forecast, are they going to be less necessary? And could you just tell me a little bit about the employment implications of those? I appreciate that forecasting is a very uncertain science.

**Mr Osborne:** Yes, forecasting, of course, is uncertain. What we've tried to do, if I can first say this, is recognise that in a way that, frankly, previous Chancellors didn't. So, first of all, I've established an independent body to make the economic and fiscal forecasts. Second, they are making a central forecast, rather than, as the Chancellor previously did, building in caution into the forecasts without much explanation of what that caution was. And third, asking the Office for Budget Responsibility to present its different forecasts as fan charts to reflect the various risks around the central forecast. It has done all that.

It has also, and this was its own independent decision, in yesterday's document looked at two alternative scenarios, which it says aren't its central forecast but scenarios that have been put to it by various people out there. One is a scenario where the economy does not rebalance as it expects in its central forecast: in other words, there is not the increase in exports and investment that certainly I hope to see and which it is forecasting.

And the second scenario, which is relevant to your question, is the scenario where there is weaker demand. Under both those scenarios, alternative scenarios to the central scenario it presents, we also achieve the fiscal mandate. My judgment—and obviously you're entitled to disagree with it—was that one of the greatest challenges we faced as a new Government in May was to establish fiscal credibility. I think events elsewhere in Europe even today reflect the necessity of establishing fiscal credibility when you have the largest budget deficit in the European Union. So it's reassuring to know that, not only under their central forecast but under the two alternative scenarios they examined, we hit the fiscal mandate, and that's obviously an essential plank of stability for our economy at the moment.

**Q4 Lord Lawson of Blaby:** I will pass over your disparaging reference to previous Chancellors. There are two questions I would like to put to you. One is your definition of the fiscal mandate. I am slightly concerned that you seem to refer to it—and I think you referred to it in the statement you made which I listened to from the Peers' Gallery yesterday—as the current structural deficit. Is it not the case that what matters is the overall structural deficit, not the current structural deficit? In the private sector, the difference between capital and current makes sense because capital expenditure earns a return that services the debt interest. In the public sector, a great deal of defence spending, for example, is capital—weaponry and so on—but it still has to be financed; that's a serious part of the deficit. It certainly doesn't finance itself, however important it may be. Therefore, is it not

the case that it's the structural deficit overall that should be the fiscal mandate, not the current structural deficit, which is a completely artificial separation and creation?

The other question I'd like to put to you, if I may, is that there is always attrition in public spending cuts. In my experience, we were pretty determined in 1979 and the early 1980s, but in fact we didn't get everything we wanted and you're not going to get everything you want. There are rumours—they may not be true—that, for example, the cap on housing benefit is going to be postponed a little bit, so it's not going to come when you want it. And there's going to be attrition for all sorts of reasons, partly for political reasons, and partly for the technical reasons and the time lags that are inherent in all this process. If you find that your plans are slipping, therefore, will you just accept it, take it on the chin, or will you in fact introduce further measures to make sure that you do fulfil the fiscal mandate as properly defined?

**Mr Osborne:** Let me take both issues in turn, Lord Lawson. I'm not sure if we're breaking any convention, but you and I have talked about one issue on a number of occasions privately. I think there is quite a lot of merit in what you say about the rather artificial divide that sometimes Governments have to get into in trying to determine the difference between current and capital spending. However, I also think there is equal merit in the now quite long-established acceptance by many people across the political spectrum that there are certain long-term capital investments that Governments make that are inter-generational and for which it's perfectly reasonable to borrow because of the long-term benefit they bring, not just to the current generation but to future generations.

I completely accept, as I said to start with, that there is a debate to be had about where you draw the line.

My judgment on coming into office in May, given the external situation I found, was that this was not a moment to rewrite and redraw the accounting rules for current and capital

spending and give rise to any suggestion that I was somehow fiddling the definitions, because I'm not sure I'd accept your premise that we will just get rid of all distinction between current and capital spending. But I didn't think it was the right moment to get into a perfectly valid debate about exactly where you draw the line between current spending and capital spending. Maybe that is something that we will be able to return to at some future point, but it's not currently on the agenda.

I wanted to preserve the ability of the Government to borrow for long-term economic investment. I did skew the capital settlement I produced in October towards fairly well established long-term economic investments like transport spending, road schemes and the like. I think most people would accept that that is the correct definition of capital spending, and there's an intergenerational element to that.

I also, in setting the fiscal mandate, wanted to allow the automatic stabilisers to operate. This is not directly relevant to your question, but if I may I will bring this point in. Sometimes it's presented that what we are seeking to do is balance the books in one year or overnight and so on. This is a four-year plan. There is a distinction between current and capital spending, and it's also cyclically adjusted, so we allow the automatic stabilisers to operate. I just wanted to put that on the record.

The second question you raised is obviously a very good one, and here I do defer to your long-standing experience that things happen in politics, but I would say that we have a prevailing wind in a number of respects. First of all, I think we did establish before the election—both the Conservative Party and the Liberal Democrats who now form part of the coalition—that it was going to be necessary to cut public spending. So I think we have an advantage, which quite a lot of other European Governments don't have, in that we won an election on the back of an argument that we needed to cut public spending. And to be fair to

my coalition partners, they made a similar argument in the run-up to the election. I think that has been helpful.

I think it has also been helpful that we've been able to do this in a very collegiate way. I consulted a number of people, such as you and others who had been in the Treasury and been at the heart of government in recent decades, about how to reinvent a collective process for coming to spending decisions in government. The system I found in May this year was one where these decisions were made unilaterally by the Prime Minister and the Chancellor and then spending departments would receive a letter saying, "This is your settlement". This had been the practice for more than a decade. I reinvented—with the Prime Minister, of course, and my colleagues in the Liberal Democrat Party—a Cabinet committee procedure, the so-called Star Chamber.

We also invented—because obviously this was not a situation that previous Governments had faced for a very long time—a quadrilateral committee involving the Deputy Prime Minister; the Chief Secretary, who is of course a Liberal Democrat Member of Parliament; me and the Prime Minister. So there was a collective buy-in across government for the spending decisions in the spending review. That, too, I think, helps when faced with the kind of attrition that Lord Lawson describes.

Third, where we have made adjustments—Lord Lawson mentions the housing benefits, and the timing of the housing benefit changes—first, when it comes to that decision, what we have done is brought forward the point at which we apply some of the housing benefit policies to the flow of claimants on to housing benefit, and delayed the point where the housing benefit changes applied to the stock of housing benefit claimants by a matter of months. The effect is fiscally neutral, so I was happy for the DWP to proceed on the basis that it was fiscally neutral and therefore really an administrative judgment for the DWP—the Department for Work and Pensions.

The final point I'd make is that, I think, broadly speaking—and, again, this is something where we are quite fortunate in this country—I think public opinion is broadly on the side of the argument that we need to reduce spending. We've got a large deficit and we've got to do something about it. So, while I'm sure there will be arguments, as there always are in politics, about specific measures, the overall argument is whether we, as a country with one of the highest budget deficits in the world, need to do something about it. Actually, at least two political parties that believe that is necessary, but there is also a broad swathe of British public opinion that believes that is necessary.

**Q5 Lord Hollick:** Chancellor, I wonder whether we can come to one particular problem that I think is impeding growth at the moment—the lack of supply of bank credit, which is particularly harming the position of SMEs, which are very important to our growth, our future and job creation. What can you do in addition to exhortation?

Would you also like to comment on the likely impact of Basel III on the supply of credit? Indeed, perhaps you could share with us whether the Treasury has factored in the impact of Basel III on GDP growth.

**Mr Osborne:** That's a very important question from Lord Hollick. This is something that is absolutely right at the top of my watch list: the credit conditions in the economy. I think it's fair to say that there's a debate raging between the banks and business organisations, and indeed between businesses themselves, about whether there is a supply or a demand issue here.

We have sought to apply a number of interventions: extension of guarantees, which we did through the EFG scheme in the budget; second, increasing various government-sponsored venture capital funds, which we've also announced; third, encouraging the banks to create their own 3i-style fund. So there are a number of those sorts of interventions. Of course,

they are not by any means a comprehensive solution to the problem, and you are quite right to draw attention to the international regulatory environment under which banks are operating. And, of course, banks are under enormous pressure from regulators, markets and indeed internal pressure to de-leverage and de-lever and make sure that no one questions their safety.

So, the international community, of which of course we are part, and the Basel and G20 negotiations have sought to come to what I think is a good compromise, which is, “Let’s agree the standards”—this is what happened at the G20 in Korea—“Let’s agree the new capital and liquidity requirements”. The capital requirements are considerably higher than they were, but let’s have a long implementation period until we get there, and the banks have until 2018 to do it.

It was a deliberate judgment that you don’t want to act in a pro-cyclical way; that would not necessarily be the most sensible thing to do at the moment. But you also want to remove the future regulatory uncertainty that was hanging over the banks about the future of international regulation. There are still some issues to be resolved, for example around systemic and important financial institutions, and the Financial Stability Board is doing its work on that. I think we have come to a good place where we’ve resolved much of the uncertainty about future regulation, but we’ve given a long lead-in time so we’re not bringing in those requirements in a way that, as I say, would be pro-cyclical and counter to our broader economic interests.

I think that gets the balance right, but when it comes to other measures we might take domestically to encourage lending, particularly to the small and medium-sized business sector, there’s very much still work that we are continuing on. We’ve had a consultation paper on this. The consultation recently ended and we published our response to some of

the representations that were made, but I expect to have more to say on this in the coming months.

**The Chairman:** We'll come back to the other bank issues later.

**Q6 Lord Forsyth of Drumlean:** Chancellor, I think it's universally acknowledged that the reductions in the rate of growth of public expenditure and the cuts in welfare benefits will have a differential impact on the regions and countries that make up the United Kingdom. As it's St Andrew's Day, perhaps I could mention Scotland, where more than half the population are either directly or indirectly dependent on public expenditure. I wonder if you could talk about how it's proposed to see growth in private sector jobs and other measures that might compensate for the effects of this. And perhaps you could explain why today the Government is introducing a Bill to allow for a higher rate of income tax and a higher rate of stamp duty in Scotland, which presumably compounds the difficulties that have been created.

**Mr Osborne:** Let me come on to the second part of your question, Lord Forsyth, and let me first of all deal with the first part. I think it's a false assumption to assume that there is simply a north-south issue here. For example, per head of population the part of the country that consumes most when it comes to health and education services is actually London. There is quite a lot of regional disparity in the use of different parts of the public sector and there are certainly concentrations of public sector employment, but these may be in particular towns or particular parts of cities rather than in whole regions. I say this as a Member of Parliament myself from the north-west of England. We are very alert to potential regional disparities in the impact of the spending review, but of course we have tried to design it in a way that doesn't have that regional impact. We've also created a Regional Growth Fund as a pot of financing that can address potential regional disparities, if they emerge, and invest in schemes that will enhance economic growth.

It's not as if I inherited, as Chancellor, a perfectly balanced economic model. There was a geographical imbalance in the economy. For every 10 jobs created over the last decade in the private sector in the south of England, only one was created in the Midlands and the north of England. This is the challenge that we'd be facing, regardless of the current economic circumstances.

We have, as I say, established a Regional Growth Fund to address disparities as they emerge. I've introduced something which I don't think anyone has tried before, which is a national insurance cut for employers employing new people in regions outside the south-east and east of England. So there is a regionally based, job-stimulating tax cut that we've introduced. We were careful that the capital projects, which I referred to earlier, were properly dispersed across the country; for example, we gave the go ahead to important schemes like the Mersey Gateway. We are going ahead with the construction of a high-speed rail link up the spine of England, which I believe will change the economic geography of this country.

**Q7 Lord Forsyth of Drumlean:** But, Chancellor, in Scotland you're introducing legislation that will allow for income tax and stamp duty to be increased.

**Mr Osborne:** I was coming on to Scotland and the Calman proposals. First of all, because we didn't touch the Barnett arrangements and because we, relatively speaking, protected health and schools spending, which are the two largest drivers of the Barnett formula, actually that worked to Scotland's benefit in the settlement.

Now, when it comes to the Calman proposals, frankly I just think there is a disagreement between you and me about the merits of these. I happen to believe that, having established a Scottish Parliament by referendum of the Scottish people, it is sensible to give that Parliament greater fiscal responsibility and greater power to vary tax rates. That includes

income tax, stamp duty and the like, so we've chosen particular tax instruments that they will be able to use. We've also given them some borrowing powers as well.

I think that is perfectly sensible now that we've had more than a decade of devolution. Those arrangements have been established and entrenched, and it is, to use the phrase, the settled will of the Scottish people that devolution should remain.

**Q8 Lord Forsyth of Drumlean:** Sorry to interrupt you. Just on a point of fact, the Scottish Parliament had a power to raise the tartan tax that the Executive, which is controlled by the SNP, gave up this month. We now have a Conservative Government reintroducing that power in the form of legislation, the effect of which will be to have higher taxes in Scotland at a time when public expenditure is being reduced. Will that not have an impact on employment?

**Mr Osborne:** First of all, it's not a Conservative Government, it's a coalition Government. Second, the Calman proposals were the result of a joint agreement between the Labour Party, the Liberal Democrat party and the Conservative Party, three unionist parties working in Scotland to come up with unionist proposals to improve the devolution arrangements and make the Scottish Parliament more responsible for the taxes that it had to raise for the expenditure that it was committing to.

I personally, as an absolutely committed unionist, believe that is a sensible thing to do. I completely respect the fact that you have long disagreed with this policy, but it is a policy that was agreed, rather uniquely in our political system, by the Labour Party, the Liberal Democrats and the Conservative Party. So we managed to get cross-party agreement on it. The Scotland Bill will now implement that, and I believe it will make the devolution arrangements work better in Scotland.

Of course, you assume, Lord Forsyth, that it will lead to an increase in taxation, but that is not, frankly, my decision or your decision or this Parliament's decision. It will be a decision for the Scottish Parliament as elected by the Scottish people. There is a decent transition time, partly to get the administrative arrangements working correctly, but partly so that the Scottish people and Scottish political system can adjust to these new arrangements.

**Q9 Lord Forsyth of Drumlean:** Just one final very quick point, Chairman. Given that you say you are doing this in order to implement Calman, Calman recommended moving to a system of funding, based not on Parliament but on a needs-based arrangement from a Select Committee of this House, on which three members of this committee—Lord Lawson, Lord Smith and me—served. Why didn't you take the opportunity of this Bill to have fair funding throughout the United Kingdom by moving away from Barnett and introducing a needs-based system of funding so that the effect which you described of the Scottish Parliament being able to raise its own resources on a fair baseline basis would have been achieved?

**Mr Osborne:** I would say, first of all, that we are a coalition Government and the commitment to the Barnett formula was part of the arrangements for forming that Government. But second, there was a very good practical reason, which meant that I personally of course supported the commitment we gave, which partly relates to what Lord Lawson was saying, which is that if you're having to undergo a difficult fiscal consolidation, if you're having to carry the public with you on this and trying to explain to people that this is a reasonable thing to do because of the economic situation the country finds itself in and the very high deficit that we've inherited, and if you want to show that, to use the phrase that I've been using, we're all in this together, I didn't think it was the right moment to start upturning the arrangements that have been in place for many decades under Governments in

which you served, as well as Labour Ministers served, that allocated spending between Scotland, Wales, Northern Ireland and England.

Of course, although the question is seen, when you're sitting in Edinburgh, from a very Scottish-centric point of view, and a very English-centric point of view for English people sitting in London, in Cardiff there are strongly held views about the Barnett formula as well, and there has been work done by Professor Holtham on that. There are also strongly held views in Northern Ireland. So, given what I've got on my plate at the moment with this fiscal consolidation, to choose this moment to say, "I'm tearing up the arrangements that have been in place since the mid-1970s for allocating funding between the different nations of the United Kingdom", I'm not sure would have been politically the most sensible thing to do, quite frankly.

**Lord Forsyth of Drumlean:** Four members of this committee were in favour of changing the Barnett formula, because I gave evidence to that same Committee precisely along those lines.

**Mr Osborne:** I can't help reflecting that, while that might be your current view, some of you were the Chancellor of the Exchequer or the Chief Secretary at the time and decided for perfectly good reasons at the time, I expect, to stick with those arrangements. I've got my own political challenges and I didn't think it was the right moment.

**Lord Lawson of Blaby:** Like you, we had other things to do.

**The Chairman:** Likewise, and I won't go into the different views that were expressed at that time either on the subject. We must move on quickly, but two more questions on the regional impact.

**Q10 Lord Shipley:** Chancellor, I wanted to move us a little south of the border. I was tempted to raise the Barnett formula, but I think we've probably covered that, for the

moment anyway. I just wanted to draw your attention to something that was published yesterday in the north east by Durham University and One North East on rebalancing the north-east economy called *Mind the Gap*. I appreciate you may not have read that, but along with the south-west, the north-east has an economic model. Basically, it's run through the impact of the emergency budget and the comprehensive spending review and it has concluded that the job loss in the region over the four-year term of the CSR will be around 49,000, so just under 50,000 jobs, of which 20,000 will be in the private sector.

It basically says that there is a skills mismatch between those who lose their jobs in the public sector to take up jobs in the private sector, but it also says that the potential for growth in growth areas, particularly around manufacturing, renewable energy and so on, but also in export-led growth, will not make up the deficit of the near-50,000 job loss.

I hope you read that report. HM Treasury advice as part of the CSR consultation or advice to Whitehall departments was, and I quote, "To limit as far as possible the impact of reduction to spending on the most vulnerable in society and on those regions heavily dependent on the public sector". My question is: do you think the cuts are too fast and too deep in these areas, given that we're cutting the deficit twice as fast as the United States?

**Mr Osborne:** A couple of points there. First, we're very happy and would welcome the chance to read the report that you referred to. Second, I would point out that this is the judgment of the independent Office for Budget Responsibility. This is not the Chancellor of the Exchequer's personal economic judgment, nor even the judgment of my colleagues at the Treasury, but the judgment of Mr Robert Chote, Mr Steve Nickell and Mr Graham Parker. Mr Nickell is one of our foremost labour market economists, and I don't think anyone would question Mr Robert Chote's independence. They have come to the judgment that the effect of the spending of the fiscal consolidation, when allied with their other economic judgments, leads them to conclude that there will be a net creation of 1.1 million jobs in this

country over this Parliament, and that because in the spending review we took the decision to put a greater emphasis on welfare reform and reducing welfare bills than many had assumed earlier in the year, we were able to reduce the impact on the public sector headcount from what was previously forecast by the OBR. Those are the independent judgments.

I recognise, of course, that we've got to be careful of the regional impact. That is why there is the Regional Growth Fund. That is why there is a special tax break for companies in the north-east and other parts of the country and for new companies that are created that employ new people. Of course, I'd be very happy at any point to discuss this with Members of Parliament from the region or whatever, but surely there is a big challenge for us all, whether we represent the north-west, the north-east or anywhere else outside the south-east of this country: how we create a more balanced model of economic growth. Over the last 10 years, I think it is fair to say that we needed greater private sector involvement outside the south-east of England, and we are doing a number of things: reducing the corporation tax rate; encouraging multinational companies to locate in the UK; taxing profits off the back of patents at a lower rate to encourage some of the R&D work and innovation which I've seen for myself in the north-east. We're doing these things to stimulate all parts of the United Kingdom, including the north-east, and I think we should be optimistic about the future of the north-east and other parts of the country.

**The Chairman:** We have a lot to cover so we must move on fairly quickly, but there is one last question on this issue.

**Q11 Lord Tugendhat:** First of all, I have just a very brief observation on the Scottish issue. I spent eight years, as you know, as a European Commissioner. I saw a lot of the European Parliament, and I formed the view that if you give a body the ability to spend

money and you don't give it the responsibility for raising money you have an absolute recipe for irresponsibility, and there is a great deal to be said for matching those two functions.

But my question is about an expenditure programme. The biggest, of course, is the NHS. I declare an interest. I'm involved in the NHS through my chairmanship of Imperial College Healthcare. As you know, the bulk of the money is spent by the primary care trusts. I was therefore interested to read in Saturday's *FT* that Sir David Nicholson, the director-general of the NHS, has declared that the primary care trusts are in meltdown and that, despite that fact, he is going to impose Stalinist controls on their finances: an interesting combination. I wondered, in the light of Sir David's comments, how confident you are that the NHS is in fact going to be able to live within the ring-fence that you have set up.

**Mr Osborne:** The first thing I'd say is that the health settlement was generous relative to many other departments, but is still a tough settlement for the NHS, and in order to live within that settlement it has to undertake what I believe is necessary reform. One of the tragedies of the last decade is that productivity in the NHS fell year on year on year. A huge amount of extra money was committed to our National Health Service, but unfortunately outcomes did not match inputs. If more money without reform was a recipe for little improvement, less money without reform would be a recipe for poorer services, and I don't want to see that happening.

So I think you have to undertake reform and you have to undertake an effort to improve productivity in the NHS. That is what the health reforms that the Health Secretary has set out are intended to achieve. Some elements are drawn from health reforms attempted by the previous Labour Government in the middle part of this decade, so it's not completely reinventing the wheel. They have drawn some elements from health reforms attempted by previous Governments. They involve choice and contestability. They include trying to get a diversity of provision, and—this refers very directly to the point you raised, Lord

Tugendhat—they involved putting the GPs in the driving seat as commissioners in the health service, because commissioning has always been one of the weaker features of the National Health Service. Now, GPs, in concert with their patients, are making choices.

As with any reform, you've got to manage the transition from the system we've got today to the system that we will have in a couple of years' time when these GP-led consortia replace the primary care trusts, but I've got every confidence that David Nicholson, Andrew Lansley and others have a good plan. We regularly, as a Cabinet, review it and we are satisfied that it is a good plan to manage the transition. Of course, subject to the will of Parliament, we think the health reforms will lead to an improvement in productivity, and that is a good thing per se, but it's an especially good thing when, although the health service is getting real increases, it's not getting quite the scale of the increases that it was getting a few years ago.

**Q12 Lord Best:** Chancellor, the Bank of England has an inflation target of 2%, although there's a margin either side of 1%, but for most of this year inflation has been running at over 3%. How do you view this apparent failure? Do you think the Bank should be doing more about it and/or do you think its remit should now be changed?

**Mr Osborne:** I don't think the remit should be changed. I think the system we've got at the moment where the Chancellor sets the inflation target—I didn't change the inflation target on taking office—and the independent MPC seeks to hit the target using the instruments it has available is a good one and has worked well for this country. I think the Bank of England is held in high regard on that, so it's a good thing for us all. I wouldn't propose to change the remit.

In preparation for appearing before you today, I read the transcript of Mervyn King's appearance before you. I think he dealt convincingly with this question of the current rate of inflation and, I think, correctly identified some of the factors that have gone into this rate:

the VAT rise at the beginning of this year undertaken by the previous Government, the fall in the exchange rate and so on. I think the skill of the MPC is its ability to see through some of these factors. I am certainly, speaking as Chancellor, satisfied that they are able to do that, and that has been reflected in the exchange of letters that I have had with the Governor.

**Q13 Lord Hollick:** Chancellor, do you feel that we now need a credit policy, and if so would it be the responsibility of the Bank of England, conducted by the Central Bank or by the Treasury? If it were the latter, would that compromise the independence of the Bank of England?

**Mr Osborne:** I think one of the big policy challenges, not just for the British states but for other countries, in the next few years is going to be to develop these macroprudential tools. Everyone has talked about these macroprudential tools, but I've not yet seen a completely comprehensive list of what these tools are supposed to be. That is not really surprising; this has developed as a response to what has happened in the last couple of years where the classic western, certainly UK-US, view—that you allow asset bubbles to develop and there is not a lot you can do about them and then you mop up afterwards—turned out to have rather catastrophic consequences. There is a good debate now about developing macroprudential tools to try and deflate asset bubbles in a smoother, gentler way in the future. We have set in place changes to the regulatory structure, which explicitly sets up a body—the Financial Policy Committee of the Bank of England, which will set up on an interim basis before it gets statutory authority—in the first instance to develop the tools, and in the second instance to apply the tools. As I think Mervyn King himself has said, they will look at whether we can use capital buffers and whether there are domestic capital requirements that sit on top of international capital requirements. There are loan-to-value ratios in different parts of the credit market and different credit markets. I do not want to prejudge

that discussion. We are in the process of putting the Financial Policy Committee together, and it will be up and running pretty shortly. Its first task—I think the Governor said this when he appeared before you earlier this month—will be to develop those tools, which may or may not involve credit policy. Its second task will be to apply those tools.

**Q14 Lord Lawson of Blaby:** Since you mentioned the Governor's appearance before us quite recently, one of the things he said in this area, if I may quote it back to you, although you will well recall it, is: "One of the most astonishing facts in the build-up to the crisis was in the five years leading up to the crisis in 2007 two-thirds of the total credit extended by our banking sector was not to households, not to companies, not to the real economy at all, but to the other parts of the financial sector. Therefore I think the conclusion is that, at the very minimum, you need some other policy instrument to prevent that rate of expansion of balance sheets". I think that among the other policies— because there is no silver bullet, clearly, for dealing with this problem—the structural problem has to be addressed. One of the things that he favours—this is connected; it is a separate issue but it is certainly connected with the "too big to fail" problem—is that part of the remedy, which as you know I have argued for some time, is a structural separation between commercial banking and investment banking. I know it is more complicated than that but we don't have to go into that now. There should be a separation.

May I ask you two questions? One is: are you sympathetic to this? Would you favour it? Secondly, would you be concerned that if we were to go this way in this country, however desirable I believe it to be—you may believe it too—there might be a problem if other major financial centres did not go the same way? Or do you take the view of the Governor of the Bank of England that in fact if we were to go that way it would so strengthen confidence in the City of London and the United Kingdom financial sector so that in fact it

would be beneficial to us even if other countries, other financial centres, didn't go the same way? So, two questions, and I would be grateful for your answers.

**Mr Osborne:** First of all, of course, Lord Lawson, you're completely correct about the build-up of debt—household, banking and government debt—in the economy. Indeed, on the very first page of the Budget—I wanted to put it absolutely front and centre—I chose to put a graph that illustrated the challenge that the economy faces. In your exchanges with the Governor, I think he drew your attention to the size of the bank assets as a share of UK GDP and how high they got to: 548% compared to 90% in the USA. I think he said that the US could afford to have the occasional banking crash but it is a bit more painful for countries like the UK.

**Lord Lawson of Blaby:** We're five times as large in relation to GDP, right.

**Mr Osborne:** Exactly. We are putting in place arrangements that will enable macroprudential judgments to be made. That is what I was just talking about with Lord Hollick. You raised another question, which is: are there structural changes to the banking industry or to individual banks that should be undertaken to further protect the taxpayer? I will be frank. I find that one of the most difficult issues facing policy-makers today, and one of the things I find most interesting about this issue, is that people from very different places on the political spectrum have very different views that don't always accord with where you might think they would come from.

Coming into office in May, I found myself in a position where clearly the Governor of the Bank has a view, although I think he was careful when appearing before you, and indeed in general, not to be prescriptive about how he would address the questions he raises, but obviously he raises the questions in a particular way. The Governor of the Bank has a view, the regulators have a view, my predecessor had a view. Members of the Cabinet have different views, which are well known because they've previously expressed them before

coming into office. People such as you, Lord Lawson, who, without being too sycophantic, I have a great deal of time and respect for, write quite trenchantly about this. All sorts of different views are established on this and it doesn't fit into any of the classic debates in politics where you can put someone on an ideological spectrum and see where they are coming from.

So, I thought the best approach to try to resolve this issue was, in the first instance, to establish an independent commission to look at this, under the chairmanship of John Vickers, who I think is extremely capable and qualified to address this and is seen as impartial on the issue. In other words, in a debate where most people are *parti pris*, he does not come at it *parti pris*. He is an independent-minded, highly capable individual, and I have constructed around him a commission that properly reflects some of the different experiences that people bring to bear on this; there are some people with retail experience of banking, an exceptionally able investment banker sits on the commission, and someone who has a proper regard for the consumer interest.

I have tried to establish a broadly based commission to look at this issue, and I think we have succeeded in achieving to date—there is more to come—that people accept that it is a proper commission, that it is not *parti pris*, that it's properly examining the issues, and indeed is engaging the public in it as well. It is going around the country and holding public meetings and the like. It will come up with a report next year. Of course, it will then be a decision for the Government and for Parliament if we want to accept the recommendations of that report and if any legislative changes flow from that. At the moment I think it is sensible for me to not prejudge the report and not to express an opinion about what I think needs to happen because, having established the commission, I do actually now want to listen to what it has to say.

**Q15 Lord Lawson of Blaby:** May I press you a little bit further? Without being unduly sycophantic, I think it was an excellent idea to set up the commission, and I think that John Vickers was a very good choice as chairman of it. However, I would like, if I may, to disentangle two aspects of it. I don't know what the remit of the committee is, but I'd like you, if you would, Chancellor, to draw the veil aside a little bit and indicate which of the two you think is the bigger issue. The first issue is that, if all the major financial centres agreed to this, would you favour it? The second question is: although it might be a good idea if all the major financial centres agreed to it, would it be a problem if we did it on our own? These are two separate dimensions of the issue.

**Mr Osborne:** This is Lord Lawson, a former financial journalist, rather than Lord Lawson, the former Chancellor, trying to tempt me down a route which I don't think it would be sensible for me to go down.

**Lord Lawson of Blaby:** It's Lord Lawson, a Member of the House of Lords Economic Affairs Committee.

**Mr Osborne:** Of course, the judgment we all have to come to, in both Houses of Parliament, is a very difficult judgment. I said at the very beginning of this response that this was one of the most challenging issues about the proper balance between having a creative, innovative, dynamic financial services industry in this country that is able to compete around the world, for London and other financial centres like Edinburgh, for example, to be a centre of global finance, while at the same time properly protecting the British taxpayer from the potential consequences of being a home to that industry. And that is a very difficult balance to get right. That is one of the reasons why I have chosen one of the brightest people in the country, John Vickers, to go and look at the problem. As he has already made clear publicly, he is absolutely weighing into consideration precisely the issues that you raise in your question about international competitiveness, about what is right to do unilaterally, what is

right to do internationally. But, as I say, I will not be tempted by your question as a Member of the House of Lords, and a member of this committee, into answering it.

**Q16 Lord Lawson of Blaby:** May I just ask one further quick supplementary to this? I absolutely agree with what is implicit in what you are saying: that in financial services this country is world-class. There may be some other sectors in which we are world-class, but not all that many in which we are really world-class, frankly. This is a sector where we are world-class and therefore you don't want to lose that advantage. I have sometimes been concerned, but I'm glad to hear what you say today, that you talk about rebalancing the economy and therefore some people think this means diminishing the importance of the financial services industry, whereas in fact it is an area where we are world-class and it is a growth sector globally, and the only people who would cheer if we were to reduce the importance of our financial services would be our competitors.

But if, therefore, you want us to remain world-class and want investment banking to be creative, might there not be a choice at the end of the day between a separation that would allow you to regulate the investment banking sector rather less heavily, and a lack of separation—the existing system—which would force more intrusive regulation on the whole banking sector and therefore harm the creativity of the investment banking sector?

**Mr Osborne:** This is an argument that you have put well in a number of articles that I've read and it is one of the things that I'm sure John Vickers is looking at.

When I say rebalancing the economy, what I mean is, first of all, some rebalancing from public to private. At the moment almost half our national income is consumed by the state; second, some from domestic consumption to exports; and, third, I want the UK to be a home of global financial services, in all its shapes and forms. I think the Governor and members of this committee made a very good point that it is not just investment banking;

there is insurance, legal services and accountancy, which is something we might come on to. We want London to be the home for all of that. Hopefully we have a lot of things to recommend ourselves as a place to go: a stable political system; the rule of law; a good time zone; a very open economy; a good infrastructure going in to support, in an ongoing way, places like the City of London with, for example, the commitment to Crossrail; and a place where I hope people feel at home to come and do financial services.

But they have to be properly regulated. I am changing the system of regulation to make sure that happens. They have to pay their fair share of taxes. I have introduced a permanent bank levy which other countries have now followed. I'm requiring banks to sign up to a proper code of practice on taxation. When I came to office, only four banks out of the top 15 had signed up to a code of practice that the previous Government had trumpeted. I can tell you that today 15 of the top 15 banks have signed up to that code of practice, and we've made an announcement about that today. So, I think that it is perfectly reasonable to expect those financial services companies to make their fair contribution, and I think that if you get the balance right Britain can be a welcoming home to financial services.

Of course, the main question that you are asking, Lord Lawson, is a very difficult one: are there structural changes you should make to British banking, or indeed to British banks, unilaterally? Even if they're not agreed, if they're not implemented elsewhere, it's still necessary to protect the British taxpayer. What is the impact of that on the competitiveness of the City of London? Indeed, what would happen to those British banks and what would they choose to do? These are all proper questions, given the job I have for the independent banking commission, which will report to me and to my colleague Vince Cable. We will examine the recommendations, respond, and, depending on what the banking question says, either come to this House or not.

**Q17 Lord Forsyth of Drumlean:** Just slightly changing the subject, but also on the issue of banks, am I wrong to worry that we might face another liquidity crisis, given the huge sums in loans that are going to have to be refinanced in the short term? And do you have some contingency plans in place to deal with that should it arise?

**Mr Osborne:** We, of course, with the Bank of England and the FSA, constantly keep an eye on the liquidity of the banking system, and I meet regularly with the Governor of the Bank and the chairman and chief executive of the FSA to assess the situation in a routine way. It is not especially liquid at the moment. This is something I have been doing since I became the Chancellor. Actually, the funding position of the UK banks has improved in recent months. The month that I became the Chancellor, in May this year, was a very tough month; if you remember, it coincided with the concerns about Greece. Things have greatly improved for all the UK banks since May.

**Lord Forsyth of Drumlean:** I am thinking more of the loans that are going to have to be refinanced. One reads of figures of £350 billion and more, and one wonders where that money is going to come from, unless there is some kind of—

**Mr Osborne:** As I say, at the moment the UK banks are not having a problem financing themselves, and that is a good thing but it's something we constantly keep an eye on. When it comes to broader credit conditions in the economy and the ability of companies and the like to refinance themselves, I think it is fair to say that, for larger companies, the problems they experienced a year or two ago have largely dissipated. There remains a big challenge with small and medium-sized companies, which is the issue that, as I said to Lord Hollick, is very much at the top of my list of things that I am monitoring.

**Q18 Lord Shipley:** Chairman, if you want to move on to audit. I think we have covered quite a number of issues around macroprudential supervision. I was tempted to ask the

Chancellor whether he had a personal view about regulated supervision, and I understand that other people will have comments to make in due course. Do you have a personal view about the balance between regulation and supervision, Chancellor?

**Mr Osborne:** My view is that the most important element is judgment. This is a point that Mervyn King made to this committee, but it's certainly a point I very much agree with him on and have thought for a number of years, which is that it's very important for a regulator to be able to distinguish between meeting all the particular rules that are set out by Parliament and in regulatory codes, and stepping back and exercising some judgment, asking the question of Fred Goodwin, "Yes, you might have complied with everything, but is it really sensible to pay this price for ABN Amro in the autumn of 2007?". Sadly, that question, as far as I can tell, was not asked. No one exercised that judgment.

One of the reasons why I am handing prudential regulation to the Bank of England—not a decision that everyone has supported; my political opponents in the House of Commons oppose it—is because I think the central bank has more of a culture of exercising that kind of judgment than perhaps other regulators do. Once you've taken the view that the Bank of England, or the central bank, should be exercising macroprudential tools and should have a judgment on prudential regulations, it flows from that that you need to give them the microprudential responsibility so that they know what is going on in different firms.

Of course, there are going to be, as there are today, important rules and regulations that financial services companies need to comply with, particularly on the consumer side and the point of sale side. The big prudential judgments are the things that are difficult to set down on a piece of paper, and you need in the end a group of people who feel they have the power, the authority and the judgment to be able to challenge the chief executives of some very large and powerful institutions. That for me, in a way, was one of the driving thoughts

behind the changes that we have proposed to Parliament to the system of regulation in this country.

**The Chairman:** Chancellor you referred earlier to the fact that we had a session recently with the Governor. We have also been doing an inquiry—we are in the middle of it—into auditing, in particular the position of the Big Four in relation to competition and choice. In a session with them last week we also had a number of questions on the auditing of the banks in the last few years. I'm going to ask Lord Smith to ask you a particular question on that.

**Q19 Lord Smith of Clifton:** Sticking with the issue of judgment, Chancellor, it seems that in the run-up to the financial crisis, the auditors of the banks signed off on banks as going concerns, even though many collapsed soon afterwards. Do you have any views as to whether this was an unwarranted failure of audit, and, if so, what might be done to address the problem?

**Mr Osborne:** Unfortunately, I'm not going to say a huge amount now, because your inquiry is ongoing. There is also a European Commission Green Paper on this issue. I think it's an excellent area for investigation, but I would rather wait for the outcome of your report and the European Commission report.

**Q20 Lord Smith of Clifton:** Might I ask a supplementary to that? Do you think, Chancellor, that there should be a mandatory obligation to exchange relevant information both ways between auditors and regulators of banks in order to improve the future quality of both audit and regulation?

**Mr Osborne:** I certainly think that when you're looking at the future of bank regulation, you need to make sure that shareholders and others get correct financial information about

banks. Whether or not the audit function has failed shareholders, I think, is properly a matter for future investigation, and I don't want to prejudge that now.

**The Chairman:** I think banking supervision is implicit in that question, and we are also looking into that at the moment.

**Q21 Lord Lawson of Blaby:** As you know, I was very concerned about the inadequacy of prudential supervision of the banking system when I was Chancellor. For that very reason I created the 1987 Banking Act, which greatly strengthened bank supervision in this country. It may not have been adequate but the 1987 Banking Act certainly was a great improvement on the successor system which your predecessor but one set up.

Incidentally on the micro-macro thing, I think it's important, if I may say so—and I ask you whether you agree—that while there is a distinction, it is not a totally clear distinction, between the two, in the sense that if your microsupervision is really up to the task, the scale of the macro problem will not be as great as it would otherwise be. There is a strong interaction there.

One of the things that the 1987 Banking Act did was to insist—and it is something I attach great importance to—that there should be a legally protected dialogue, a private dialogue, between the auditors of the banks and the supervisory authority, and that worked quite well. When we asked the accountancy firms, in the hearing to which the Chairman alluded a moment ago, they said this disappeared because it was not passed over to the FSA when the responsibility for supervision was transferred to the FSA.

Can you tell me whether it is really the case that this duty of dialogue, which was enjoined by statute, between the auditors and the supervisors completely disappeared as a result of the transfer of the responsibility of bank supervision from the Bank of England to the FSA? Is

it your intention that, now it's going to be transferred back to the Bank of England, that that duty should be reinstated?

**Mr Osborne:** First of all, I was not in this job when the tripartite arrangements were put in place, so I will have to look—I do not recollect is the short answer—as to whether the duty entirely disappeared. Obviously, it disappeared in a substantial way; whether it entirely disappeared or not, perhaps I could write to the Committee about that. Certainly, I think it is something we very much need to look at in terms of the future reforms. I will have a discussion with the Bank of England about that as well and perhaps get back to you.

**Q22 Lord Forsyth of Drumlean:** Just before we leave the question of the audit, very quickly, Chancellor, it might be worth looking at the evidence that was given. One of the firms of accountants appeared to say to us that it signed off the accounts because it knew the Government was going to bail out the banks concerned and also appeared to say to us that it felt that it had to sign off the accounts after a dialogue with the Government because it would have been very awkward, which is rather awkward from the point of view of the shareholders who looked at these accounts as audited accounts and took a view. I do think there's an issue here that does need to be looked at very carefully.

**Mr Osborne:** I completely agree with that, and of course one of the things that I think everyone is agreed on is that we have to somehow make sure that shareholders have more information and feel more empowered to exercise their role as owners of these banks. There is a lot of focus on the role of the Government and the regulator, and there is an awful lot of focus on the role of the people who work in the banks, but there hasn't really been a huge focus on the people who own the banks. There are of course many small shareholders in our banks. If they don't get proper information about what these large

institutions are up to, they will find it more difficult to exercise the right that they have as a part-owner of the bank.

**The Chairman:** On the point that Lord Forsyth has just raised, we have asked the witnesses from the Big Four to send us a separate note, because we were very unhappy about some of the answers we were getting. They were unclear, so we are having a separate note sent to us. We may well follow this issue up further, and we'll certainly make sure that you see that.

**Mr Osborne:** Is it a joint note, or is that going to confirm the suspicion that they act in unison?

**The Chairman:** I think we had better wait and see what it says. We now move on to a separate subject.

**Q23 Baroness Kingsmill:** The big elephant in the room is, of course, European bailouts. I'm wondering what your view is of the consequences for the UK of these bailouts, and for Ireland in particular, as it is the most current. Where do you see the consequences for us, despite the fact that we are not in the eurozone? How does it roll forward for us?

**Mr Osborne:** Obviously an unstable eurozone is not a good thing for the UK. I think you have to separate, in the political debate in this Parliament, the issue of whether it was right for Britain to join the euro from the question of what you do now with instability in the eurozone.

**Baroness Kingsmill:** Yes, I don't think we need to open that whole debate.

**Mr Osborne:** Now, because a significant amount of UK exports go to the eurozone, and because of the interconnectedness of our economies, particularly with Ireland but also with other eurozone members, it is absolutely in our interest to try to achieve stability in the eurozone. There should be absolutely no Schadenfreude about what is happening to some

other European countries—and, of course, we have a responsibility to be part of the international decision-making that helps to try to bring about some stability. We are members of the IMF, of course; we are also members of the G7, which is an important voice in all this; as well as members of ECOFIN. In all those councils, we have urged: first of all, coherent, collective international action; second, that, where appropriate, countries with high budget deficits in the eurozone set out credible plans to deal with them; and, third, that where international support is required, it correctly identifies the problem.

When it came to Ireland, I had a judgment, which was whether we should make a bilateral contribution to the international effort to support the Irish economy, because obviously we're not part of the eurozone, so we weren't going to be part of the eurozone facility contribution. I took the judgment that it was right for the UK to be part of that action, and we have offered a bilateral loan of around £3.25 billion. I think that making that contribution enabled us to be part of the group that is working on that problem and to help set the conditions of the international package. It enabled us specifically to say, "Look, we've really got to address the banking problem in Ireland. If we're going to offer this support, it has got to be conditional on sorting out the banking problem". The Irish Government, of course, were very willing to hear that and are engaging with it. But you're right to say that the situation is concerning, and we are of course part of the group of countries that are constantly assessing what can be done.

**Q24 Baroness Kingsmill:** I wanted to take it in a broader sense. In a sense we've had Greece and Ireland, and the vultures are circling around Portugal. The threat to the euro is significant, one would have thought, if it goes as far as Spain. How do you feel about that? Where do you stand? How do you feel about this threat to the euro, and where does it impact on us and our economy and the strength of the pound?

**Mr Osborne:** It impacts on us because instability in Europe is not a good thing for the UK. It may interfere with what we're seeking to do in increasing exports, and it might damage investor confidence, and we want to make sure that doesn't happen. There is no evidence of it affecting the UK at the moment, which is a good thing. I, of course, talking my own book, nevertheless think that because of the actions we took since May, we have managed to take the UK out of the firing line despite having the largest budget deficit in Europe. And that is reflected in the gilt yields and the spreads over bonds and so on, which show a pretty remarkable divergence for the UK from the pattern we were on before May and the pattern we're now on after, where we're seen as a safe place. So it does have an impact on stability in the euro, even if we have managed to take ourselves out of the firing line.

What I think is required and what was decided at the meeting on Sunday, which I went to, of ECOFIN and the eurozone, plus the UK—I had not expected when I became the first Conservative Chancellor for 13 years that I would also be the first Chancellor Exchequer invited to a eurozone meeting; nevertheless, such events are the kind that Lord Lawson was talking about—is that European Governments with high budget deficits set out credible plans that reassure markets that they can get on top of those deficits. This is not an impossible thing to do. I would argue that the UK has shown that this is possible: that you can earn credibility and you can bring your yields down. I think at the same time we have to put in place credible international support packages for countries that seek assistance, like Ireland. I think a combination of those two things—countries that seek help get credible international support packages and countries with high budget deficits set up credible plans that people believe in to deal with those deficits—would help deal with the instability in the eurozone.

**Q25 Baroness Kingsmill:** So, could you anticipate giving similar support to Portugal as, for example, you have given to Ireland?

**Mr Osborne:** The Portuguese Government has not sought assistance, and I think—

**Baroness Kingsmill:** Well, I'm speaking—

**Mr Osborne:** I know, but I think one of the challenges we have at the moment is that everyone is guessing who might be seeking assistance. Of course, some people are paid very large sums of money, not too far away from here, to guess who might seek assistance, but I don't think the Chancellor of the Exchequer should engage in speculation about that.

**Baroness Kingsmill:** Well, let's not talk about Portugal. Could you anticipate giving another country similar sort of support?

**Mr Osborne:** The UK is part of the IMF. We're a shareholder in the IMF, so any IMF assistance would involve us as a shareholder. Although there is in theory and in practice a contingent liability, it would be quite unlikely that it would be called upon, to put it mildly. We are also part of the European financial stability mechanism, which was created in May. It was created in the few days between the general election and the creation of the coalition Government. I made it clear at the time that I didn't think the UK should sign up to that, but my predecessor signed up to that and we are now in the EFSM. It operates on qualified majority voting. I have secured in a verbal commitment which we now need to make sure is delivered in practice that that mechanism will disappear when the new permanent eurozone bailout mechanism is put in place from 2013, and we won't be part of that permanent mechanism.

When it comes to bilateral loans, what I said to the House of Commons is that there are very specific reasons why we are offering support to Ireland: because of the interconnectedness of our two economies; because we export more to Ireland than we do to Brazil, Russia, India and China; because we share a land border; because the Irish banks are deeply involved not just in Northern Ireland but in the UK, and union banks are involved in southern Ireland. There are many interconnections. There are, as I say, very special

reasons why we're offering that bilateral loan, and those very special reasons, almost by definition, don't necessarily apply to other places.

**Q26 Lord Tugendhat:** As I'm sure you would agree, Chancellor, each of the countries that has got into trouble—Ireland, Greece and others that may need assistance—have different problems that require different solutions. I'm sure the logic of your case of Ireland is impeccable, but the common feature throughout this crisis since it began with Greece has been the extraordinarily inept way in which the European countries and the European institutions have handled this crisis. When one compares the way in which crises in Argentina, Mexico and other places in which the United States has taken the lead have been handled with the way in which in these instances the authorities—Governments—are constantly running behind events and constantly running behind markets, there is a really big problem of crisis management. Could you give us a view as to how that might be improved? Do you think it could be possible to transfer some of the more major responsibility for this from the European institutions to the IMF, which of course includes the same countries but is an institution that has a good deal more experience of handling this sort of thing? And can you say anything about the management of the crises, whichever country it is that is at the centre of the storm?

**Mr Osborne:** I would make this observation. First of all—this is looking backwards and in no way relates to current events—it's not as if all IMF interventions have worked, so I am not sure the IMF itself has a perfect record of dealing with problems.

Second, of course, the classic IMF solution is to bail out and let the currency devalue 30% or 40%, which is what happened in a lot of South American countries that you referred to. Unfortunately this is a bit more challenging in the sense that these countries can't devalue because they're all in the same currency union. So it is, in that sense, a new challenge, and

while of course we've had crises in countries with currencies where they're pegged, I can't immediately think of a crisis in a country that was part of a currency union that was easy to resolve. So, I make that broader observation.

Given those challenges, to be fair to European institutions, they have adapted and, in the case of Greece, were able to create the eurozone facility on that crucial weekend in May. Here, on Ireland, we moved relatively quickly in the space of a couple of weeks to put together a pretty comprehensive, very large, IMF-led package and to get some good conditionality around it of the kind I was just talking about.

There is, of course, a debate about the future of managing these sorts of problems in a single currency area, and obviously the people principally engaged in this are the members of the eurozone themselves. On Sunday, in a meeting at which I was not present, they put together a statement about the permanent bailout mechanism, so they are precisely wrestling with the question you raised, Lord Tugendhat, which is: can we improve the eurozone arrangements? They put out a statement about the permanent arrangements they wanted to put in place, but of course one of the challenges at the moment has been trying to get the markets to distinguish between permanent arrangements and the current situation. That has not proved as simple as some had hoped. I think more clarity about that distinction and about the permanent mechanism from the UK's point of view. Although we're not involved in it, clarity, as it exists, would absolutely help. The individuals involved, whom I have seen a lot of in the last few weeks—they have been working long hours—are bright and determined people who are trying to resolve these problems. They have been doing it hand in hand with the IMF and its managing director, Dominique Strauss-Kahn, who I also think has played a very strong role in recent events.

**Q27 Lord Hollick:** Chancellor, a common ingredient of IMF rescue packages is the restructuring of debt. In the case of Ireland, we haven't seen any restructuring of senior bank debt. That obviously imposes a considerable cost on the country, which makes it more difficult to achieve the greater targets that are essential to make the whole plan work. Chancellor Merkel has made her views clear on this, as, I believe, has the IMF. What are your views? And on the bilateral loan that you've made, have you made any conditionality around no restructuring of senior debt: no haircuts on senior debt?

**Mr Osborne:** The question of the contribution from the debt holders, subordinate and senior, for the Irish banks has obviously been—as is pretty well documented in the newspapers—something that has been widely discussed. But a decision was reached that the senior debt holders should not be asked to make a contribution, and the reason that was explicitly given by the Irish Government was that they didn't want to set off a contagion effect. That is what the IMF has agreed to and what the other European Union member states have agreed to. So that is now the agreed position: that there will be no senior debt write-down for Irish bank debt, or indeed sovereign debt. However, subordinate debt holders in the Irish banks will take a haircut, and I think that is appropriate.

**Q28 Lord Hollick:** And have you made any conditionality around the loan?

**Mr Osborne:** First of all, I didn't want to set unique conditions on the UK bilateral loan. The Irish Government didn't want to be dealing with a huge number of different components. Talking about the broad conditionality, I think it is perfectly reasonable, if we're making a bilateral contribution and are going to set the interest rate, to set the maturity of the loan and so on. I have not set out the details to Parliament precisely because I said I wanted them to be in line with the IMF and eurozone conditionality, and the IMF and the eurozone have not agreed their conditionality yet.

But in terms of the broader conditionality, I have not set explicit policy requirements that the UK is demanding. Instead I took the approach that by offering a bilateral loan I was able therefore to be in the room and help determine the broader conditionality of the whole package and make very clear our views on what was required in the Irish banking system in terms of its restructuring, and I'm satisfied that Britain's voice was heard in those discussions. Given the interconnectedness of the two economies, I think it was sensible, therefore, to make the offer of a bilateral loan in order to be part of those discussions.

**Q29 Lord Lawson of Blaby:** I agree with Lord Hollick, incidentally, that sooner or later the restructuring of debts—which is the polite word for partial and organised default—is going to have to come, as it did with the Latin American problem in the mid-1980s, 25 years ago, which I remember very well. But I also agree that it is a question of timing and it doesn't need to be pushed now. It wouldn't be a sensible idea to push it now, but it will come. It will have to come.

May I come back to the European dimension specifically? You said that an unstable eurozone was not in our interests, but of course an unstable world is not in our interests. We live in a globalised economy and therefore we have an interest in the stability of the world economy as a whole. Okay, a large proportion of our present exports are to Europe, but the growth in exports is going to have to come almost certainly largely from the newly industrialising big countries like China, exports to China, exports to India and other newly industrialising countries. So we have an interest in the whole world economy; there is nothing special about Europe.

You mentioned the four dimensions to the Irish bailout, the IMF, the EFSM, the eurozone facility and our own bilateral facility.

I have no quarrel at all with our bilateral facility. I think, if I may say so, that you were absolutely right to do this. We have a special economic and political relationship with Ireland, which made that very sensible indeed. That may well not occur in other cases, in my judgment, but you may wish to comment on that.

It is sensible that the IMF should be the key body in all of this: as it was, incidentally, when the Wilson Labour Government had to go cap in hand to the IMF because of the problems in 1976. We were members of the European Union but we couldn't appeal to the European Union. They wouldn't have had any time for us at all anyway; we had to go to the IMF. So the IMF should be the key player. Then you have these two European dimensions: the EFSM and the eurozone. The eurozone I can understand because, although the eurozone is in itself clearly a mistake, it is not responsible for the problems that these countries got into, but it greatly exacerbated the problems, no doubt about that, and that is for the eurozone members to sort out: and we are not a eurozone member, fortunately.

But the EFSM is an anomaly. Why should we be part of that? I was very glad to hear you say a moment ago that you have the agreement of your colleagues that we should extricate ourselves from that. I hope very much, and I hope you can confirm, that you are absolutely determined that that will be the case.

**Mr Osborne:** Well, I'm absolutely determined that that will be the case. The EFSM was created in the weekend before the British general election and the creation of the new British Government—a unique period of British history where there was a gap between the election results and the creation of the new Government. I made it clear to my predecessor, Alistair Darling—who, to be fair, kept us out of the eurozone facility, which was also being created at the time—that I did not think the UK should be part of the EU27 mechanism. This is a mechanism that operates off the EU's resources, but there is a contingent UK liability if, for whatever reason, the country involved defaulted on its payments to the EU.

However, it exists; I've had to deal with the world as I found it, two days later. It operates by QMV and so, frankly, I faced a choice over the past few weeks whether to exercise my vote against—bear in mind, we're dealing with a delicate situation with a very close economic and political neighbour—and almost certainly lose the vote since no one else was going to vote against its use, or accept the situation I had inherited but then try to change for the future. I chose to try to do that.

The eurozone put out a statement about the permanent bailout mechanism on Sunday. I've made it very clear that I don't want the UK to be part of that. Of course, the Germans believe it requires treaty change and therefore our consent to that treaty change, so we have quite a lot of leverage in making sure that the UK is absolutely not part of that. But I have also wanted to make clear that this permanent bailout mechanism didn't just replace the eurozone facility; it also replaced the European financial stability mechanism.

**Q30 Lord Lawson of Blaby:** Has that been agreed?

**Mr Osborne:** The situation is—I don't mind telling the Committee this—that on Sunday the eurozone had their meeting without me being present. They came forward with this statement. It is entirely appropriate for the eurozone to be able to put out a statement if they want to, but an ECOFIN meeting followed immediately on it. I made it clear at the ECOFIN Council meeting that the UK would not accept the continuation of the mechanism beyond 2013, and at the meeting Jean-Claude Juncker, the chair of the eurozone, made it clear that he agreed with that. He accepted that the EFSM would not continue beyond 2013; he said that to me in the council. I tried to arrange for a journalist to ask him that question at the press conference, which he said he would answer in a satisfactory way. Unfortunately, there were very many journalists there and no one asked him the right question.

**Lord Lawson of Blaby:** Well, you have answered it now.

**The Chairman:** And I think you made that position fairly clear in the other place yesterday, too. Chancellor, we hope we can go on just a little longer. We have detained you for a long time.

**Q31 Lord Tugendhat:** This, I think, is a final question, and I will keep it brief. Do you have plans to limit bank bonus payments at this time of austerity in this country? Whether or not you do, to what extent do you think that it is reasonable and practical to have full disclosure of how the bonuses are calculated and the terms under which they are paid?

**Mr Osborne:** First of all, I think the banks should exercise a huge amount of restraint at this time. I think they should be cognisant of the fact—not just in this country but I'm particularly concerned about this country—that these are not the easiest of economic times, even with the more encouraging economic news from the OBR yesterday, and that a lot of people are having to accept some difficult decisions from the Government in order to reduce the deficit. I think the banks would do well, for all sorts of reasons, to acknowledge that and reflect that in their bonus payments.

Second, I have introduced a permanent bank levy. I think that it is reasonable to ask the banks to make a permanent contribution. Indeed, my predecessor, Alistair Darling, acknowledged that the bank bonus tax as he constructed it would not work on a permanent basis because people would very quickly find very simple ways to avoid it. It only worked because it came in for one year very rapidly and people didn't have an opportunity to find ways around it.

Third, I've asked the banks to sign up to this code of practice. As I say, today I can announce that 15 of the 15 top banks have signed up to it; only four had signed up to it when I came to office.

Finally, on the question of disclosure, Sir David Walker did a report for the previous Government about disclosure. I think disclosure and transparency are good things, but David Walker himself has said that it would be a mistake to introduce his report unilaterally. He wrote an article in the *FT* saying this. I think it would be slightly odd to ask someone to provide you with that advice and not at least listen and consider that advice. He has provided that advice. He had hoped, when he first did his report, that there would be more progress at a European international level than there has been.

What I have done this week is write to my colleagues in the other European Union member states, saying, "Will you look at Walker's proposals? And let's see if we can agree these at a European level", which would help to deal with the regulatory arbitrage issues and competitiveness issues that Lord Lawson was referring to earlier. So I've written to my EU27 colleagues. There is an appropriate directive into which this could be fitted, and I would very much like to see progress on this at a European level.

So, I'm in favour of disclosure; I'm in favour of the approach that David Walker sets out. I think this is best achieved multilaterally rather than unilaterally, and I am now engaged in the process of trying to achieve that.

**Q32 The Chairman:** Chancellor, can I exercise the chairman's prerogative and ask you one last question? The chairman of the equivalent committee to this in your House, the Treasury Select Committee, drew attention yesterday to the fact that the Red Book forecasted that the savings ratios would remain broadly steady at about 6% for the next five years, but the latest forecast assumes a fall in the savings ratio to just over 3% for the remainder of the years. To those of us who have been very disturbed by the level of the savings ratio for some considerable time, this is clearly something that I would hope would be a priority, and I note that you said yesterday that you are looking to find ways of

encouraging savings more effectively than was the case in the past. You have already produced some consultative documents about tax changes. What priority do you give to improving the savings ratio?

**Mr Osborne:** I want a higher level of savings than we saw over the previous decade. I think the savings ratio was too low over the last decade. It did, obviously, rise to around 6% in the way that one might expect, given the economic circumstances. I have, like you, noted that the OBR has now forecast that it will fall back a bit to 3%. To what extent that is driven by the low interest rate environment and the impact that has on savers remains to be seen. I think there are policy measures we can take over the coming period to try to encourage savings. The whole area of savings and pensions is notoriously complex and quite often policy interventions have not worked, but it is an area of policy that, as I said to the chairman of the Treasury Select Committee in the Commons, we want to do much more on, and I hope to be able to bring forward those proposals in due course.

**The Chairman:** Thank you very much. Chancellor, you have been very generous with your time. You have had a gruelling recent few weeks, so we are very grateful to you for appearing in front of us.

**Mr Osborne:** It's better than opposition.

**The Chairman:** Some of us at least here would echo that. You have been very open, vigorous, very thorough and, if I may say so, commanding in your appearance before us. Thank you very much indeed, and we hope that we will see you again before too long. Thank you.

**Mr Osborne:** Thank you.