

Presentation by Shona Dobbie

I've been asked to talk today about the new coalition government in the UK and what this might mean for the UK economy but I'm going to start with a quotation from Albert Sulzberger, he was a former publisher of the New York Times and he said, "every coalition has its problems, as every married man will tell you" and I'm sure all the married women in this room would also agree. And the reason I'm referring to marriage is that we've just seen a very interesting courtship between David Cameron, Nick Clegg and their respective parties.

First of all we had the initial bickering, I'm sure you all know that when David Cameron was asked his favourite joke, he innocently said "Nick Clegg" and then we had the initial period of attraction with the "I agree with Nick" phase which was so popular in the televised debates. Following the election, we had a period of intense wooing and then it looked like the relationship might be doomed because Nick Clegg flirted very briefly with Gordon Brown but that was seen to be a dangerous liaison and he soon rebounded back to form a coalition with David Cameron.

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The question is: is this a marriage of love or is this a short term marriage of convenience and I think we have to wait to see the answer to that but if every coalition has its problems then this one is certainly facing them from the very first day.

This chart looks at public sector net borrowing and debt. If you look at the orange line you can see that net borrowing has increased dramatically over the last few years, in fact it's quadrupled to a level of £150 billion and that's equivalent to £6,000 for every single household. If net borrowing increases it adds to net debt and you can see from the grey line which is measured on the right hand side that net debt has been increasing steadily and currently stands at around £900 billion. Even using the forecasts of the previous labour government, which were fairly optimistic, net debt is expected to increase to £1,400 billion by 2014 and that would be equivalent to £55,000 for every single household.

Now, given all the headlines that we've seen in the last few weeks, you might be tempted to think that Europe is in a much worse position than us but this chart shows that actually the UK's fiscal position is worse than the eurozone as a whole. We were performing better up until 2003, but after that point the European policy makers did make a real concerted effort to try and bring budget balances back under control but there was almost no improvement in the UK. Even in the peak years of the boom, when we were getting lots of tax revenue from the financial sector and real estate, public sector spending was still high and there was almost no change in the deficit and so we went into this downturn with a fairly weak fiscal position.

By 2009 the deficit in Europe had increased to almost 6%. The deficit in the UK was standing at closer to 12%, so our fiscal situation is twice as bad as the situation across Europe as a whole. But of course Europe's made up of

many countries and this chart looks at the European Commission's own forecasts for budget deficits in 2011 and you can see the comparison is not favourable to the UK. We're expected to have the second worst performance, second only to Ireland, and even worse than Greece. This is because Greece has already started to implement some of the necessary fiscal moves whereas we in the UK haven't really started yet and we're clearly up there among the problem countries with Spain, Greece, Ireland and Portugal. Unless there is a significant change in policy on a per capita basis in 2011 our budget deficit stands to be 25% to 30% higher than in Greece or Spain and more than two times as high as the per capita deficit in Portugal.

If we look at debt the situation isn't quite so bad, but the numbers are still quite poor. UK's debt as a percentage of GDP is expected to reach 87% in 2011. The previous golden rule which was introduced by Gordon Brown, when he was Chancellor, said that debt shouldn't rise above 40% of GDP but if you look at us on a comparison with our European peers we don't look so bad. In fact you could say we're one of the best of a bad bunch and we might be tempted to take some consolation from that but this of course isn't the peak of the problem. Debt in the UK is expected to keep on rising as long as we're running deficits and by 2014 debt could be as high as 100% of today's level of GDP.

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So clearly the new government has to do something about this. This chart shows that the reason for the deterioration in our finances is really that

expenditure continued to rise even while, with a financial crisis and the global recession, tax revenues were falling away and in order to close that gap you have two choices. You either cut public spending or you increase taxation. In the conservative manifesto it appears that the conservatives are keen to have an 80/20 split between spending cuts and tax rises. Now we have a coalition government that ratio might be lower, but it does seem that the weight is going to be given towards the spending cuts and spending cuts do tend to be more successful in reducing a deficit. If you rely on tax policy you run the risk that will people will change their behaviour and their spending patterns and you won't get back the amount of revenue that you were expecting. But spending cuts also have a bigger impact on GDP and so we need to expect that growth in the UK, at least in the short term, is likely to be lower because of this and that might mean that monetary policy is left looser for longer.

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Even if you've decided that you're going to make the moves in terms of cutting public spending then the question is where. This pie chart looks at the expenditure expected in this fiscal year, a total of £704 billion which is equivalent to more than £27,000 per household. Health, education and policing together account for more than a third of this and these have all been ring-fenced at least to some extent which means that the bulk of the cuts are going to have to come in the other categories. Now we're not likely to get much clarity on this ahead of the public spending review in the autumn but we do need to consider that it might mean some fairly serious cuts in some of

these categories, such as defence and possibly regions and that could be bad news for Scotland.

Here in Scotland, public spending per head is currently running at 21% higher than per head in England and we also have a much higher share of public sector workers. The general rule of thumb is that public sector workers account for almost 20% of the total work force in the UK, 25% in Scotland and in Dundee it's considerably higher, in fact it's closer to 35% .

Now, although we're seeing countries across Europe introduce much tougher fiscal policy, there is a lot of concern as to whether this is going to be successful and I think this is where the UK does have some advantages. First of all, we have an independent central bank which can gear monetary policy to the state of the UK economy and not to some broader region as is the case in Europe. You can see that the Bank of England has already cut interest rates right down to a record low and they've introduced quantitative easing to the tune of £200 billion and although they recently paused in the programme of quantitative easing they do stand ready to increase this again should it be required for the stability of the economy.

A second advantage that we have is a very flexible exchange rate. For a lot of the countries in Europe, which are facing difficulties even though the euro has fallen, they do face the problem that it's still probably too high for them to generate the high rate of growth which they require at this time and that doesn't need to be the case in the UK.

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You can see on this chart that sterling has already fallen against the US Dollar and the Yen and it's held pretty steady against the already weakening Euro. Now this should help our exporters to gain some competitiveness and this might help to generate some economic growth.

Another advantage that we have is that we have been here before. In most of the twentieth century, in fact in more than half of the years of the twentieth century, we did live with a debt level which was higher than we're facing today and we do have experience in cutting a fairly high fiscal deficit. A good example of this was in the 1970's, even though it was a very painful process and even though it involved the IMF, we did bring down a fairly high budget deficit and it's that experience and track record which might prove significant when we're trying to maintain credibility in the eyes of international investors.

So as Nick Clegg and David Cameron celebrate their union and enter number 10 it's clear that the challenges facing them are huge. With a commitment to try and reduce the budget deficit by half over the course of this Parliament, that means finding almost £80 billion either through cuts in public spending or by increasing taxation. The conservative manifesto gave us details of about 20% of this, the other 80% we still have to find out about and trying to get these policies through Parliament is going to require a very strong and stable government so we do have to hope that this is in fact a marriage made in heaven but I think we can possibly take some comfort from the words of Vince

Cable, the new Business Secretary who has been at pains to remind us recently that sometimes an arranged marriage does work out better than a marriage borne out of love.