Master, Wardens, Your Excellencies, My Lords, Aldermen, Sheriff Ladies and Gentleman.

It's a privilege and great pleasure to have been invited to deliver the 26th Tacitus lecture in this wonderful Guildhall. And I'm fortunate, too, in another respect. That's because our hosts – the Worshipful Company of Traders – have a central part to play in my story tonight.

I'm going to argue that the United Kingdom is approaching a crossroads.

In one direction lie fractious politics, an inward facing economy, and a gradual loss of competiveness that threatens our national wellbeing over the long term.

In the other lies a very different vision. A country which is going through hard times, but which has a sense of purpose and a determination to make its way in the world.

Open to trade and investment, and the movement of ideas and people.

A sense of long term strategy, and a global leader in innovation. A willingness to take risks in order to open new markets and develop new products and services.

All this will absolutely be necessary to revitalise the economy, which is the subject of my lecture tonight.

All these qualities are within our reach.

And they are surely all part of the DNA of this Worshipful Company of World Traders.

We start off from a difficult place.

Five years into what is turning into the longest period of economic depression in the United Kingdom in modern times, there is a sense of weariness in the land.

The animal spirits of industry appear heavily sedated.

The failure of our economy to grow means that tax revenues are well below – and benefit payments well above – what the Chancellor had been anticipating.

So his fiscal consolidation programme is running behind schedule, and we face years more of belt tightening and austerity.

Productivity in our economy has collapsed. Our banking system, a critically important part of a healthy economy, remains under attack and reeling from the effects of what are often self inflicted wounds.

Trust in business has been damaged.

There are political divisions everywhere. About our role in Europe. About immigration. About whether and how to address the marked increase over the past 30 years in the degree of inequality in our society.

And all this at a time of enormous changes in the way the world works, on a scale that happens perhaps once in every two hundred years or more.

A massive shift of economic power to the east. Much more interconnectedness. Increasing pressure on resources and the environment.

I'm going to argue that to revitalise our economy in these extraordinary circumstances, we are going to need a new sense of direction.

Our current trajectory points to at least seven lost years, with output unlikely to get back to the level it reached at the start of 2008 until 2015.

It could take longer than that.

And it will leave scars.

On a generation of young people who have lost the habits of the workplace.

On the infrastructure of our economy, and on the pace of innovation.

We must be more ambitious than that.

And we can be, given strong leadership from government, industry and the City.

So my lecture tonight will come in three parts.

The first is gloomy. It's about why the current outlook for the UK economy looks bleak, and why we need a course correction.

In the second part, I'll try to explain why we should be very confident that positive change is indeed achievable.

And I'll wind up in the third section with some ideas about the way forward.

So let's get the gloomy bit over and done with.

The central problem is that the necessary rebalancing of our economy - away from debt-fuelled household consumption and government spending and towards exports and private investment - is not yet taking place.

This rebalancing lies at the heart of the government's economic strategy.

And so far, at least, it's not working.

That's why Moody's chopped our Triple A rating last week.

Let's start with the trade story.

Sterling has devalued by around a fifth since the summer of 2007, which should have been enough to give a marked boost to our export volumes.

But instead our performance on exports has been deeply disappointing. Over the past four years, they've been nudging ahead at less than half the rate achieved in the ten years prior to the crisis.

Politicians blame the crisis in the Euro zone for this slowdown, and of course the weakness in our major export markets are an important part of the story.

But there's more to it than that.

The big worry is that even allowing for the influence of poor demand from the Euro zone, UK exports have underperformed. Despite the devaluation, the UK has only managed to maintain its share of manufactured exports in the past few years. And it's lost market share in the volume of services exported.

That largely reflects weakness in the exports of financial services, which make up about a quarter of all our trade in this sector.

Demand from overseas markets has obviously taken a knock in the crisis. But it may also be that supply of UK financial services has fallen as financiers in the City – people in this room – have become more risk averse. Less willing to test the water in new markets.

An obvious challenge here for this Company of World Traders.

The position got worse in the second half of last year as sterling strengthened against the Euro and falling productivity pushed up unit labour costs in our industries.

So it's no surprise that sterling has come under pressure again since the turn of the year.

A necessary correction, perhaps.

But a sign of weakness, rather than of strength.

And these problems are part of a longer term concern about how Britain is going to make its way in the world.

Since the year 2000 and despite the benefits of an independent currency, the UK's share of world exports has fallen faster than that of any other country in the Group of 20, including France, Italy, and of course Germany.

That's not exactly a ringing endorsement of our national competitiveness.

So trade is not providing the growth momentum that we'd all been hoping for. In fact, it's been the main factor behind the poor performance of the UK economy over the past year.

Nor is business investment a much brighter story.

It fell steeply in the wake of the banking crash, and is still around an eighth down from its high point at the end of 2007. Spending on machinery and equipment was especially hard hit: down by around a quarter in year one of the recession, it has barely increased since then.

It's normal for investment to fall during downturns, as companies seek to conserve their cash and worry about the likely future levels of demand.

But business investment fell by a lot more in this recession than it had in past ones, and has remained flat for longer too. There's been a bit of a pick-up in the past few months, but that's mainly down to just a couple of sectors – quarrying and utilities. Growth elsewhere remains fairly muted.

As with the export story, this is part of a longer term pattern.

The latest OECD survey of the UK shows that just before the recession, investment in fixed and intangible assets in this country was running at just 15 per cent of gross domestic product.

In the US the figure was nearer 20 per cent, while in Sweden it was pushing 25 per cent.

UK investment was particularly weak in machinery and equipment, and in research and development.

If you take the really long term view and look at the percentage of national income invested in fixed capital between 1970 and 2008, you find that the UK comes bottom of the rich country league table.

Moreover, in the OECD's rather dispiriting words, innovation in this country "remains fairly low in an international context and relatively few firms seem to innovate."

Of course, we all know that patents are a very crude measure of innovative success. Still, it's not exactly cheering that none of the top 20 organisations holding patents to graphene – the wonder new material developed at Manchester University – is British.

I'll come later to why it might be that British businesses tend to invest less than others in long term assets like plant and equipment or research and development.

But the point to emphasise for the moment is that business investment is not for the time being providing the growth momentum that our economy so badly needs.

And along with trade, this investment has to be the main driver of the rebalancing story.

In the meantime, another important component of the economic engine is also spluttering.

Household consumption was always going to have a rough time after the credit bubble in the first half of the past decade. But things have turned out even tougher than you might have expected. Inflation has run well ahead of the target rate of 2 per cent since 2009, and way ahead, too, of the average increases in wages and earnings.

That's added up to the fiercest squeeze on living standards in 90 years, as evidenced in the growing number of blankly shuttered windows that are disfiguring so many of our high streets.

And again, things aren't going to get a whole lot easier any time soon. On the Bank of England's latest projections for inflation, living standards are unlikely to recover much in the next two or three years.

Although family debts are not as high as they were, they still represent a big worry for many people. The household debt to income ratio now stands at around 145 per cent, compared to less than 110 per cent through the 1990s.

No wonder the mood of many people is not exactly cheerful right now. Among other worries, they are heavily dependent on interest rates staying low.

For the reasons I've explained, the absence of growth has done serious damage to the hopes of getting our public finances back into reasonable shape in the lifetime of this parliament.

Indeed, on a like-for-like basis government borrowings in 2012-13 could actually turn out be higher than they were last year – although

the Chancellor will be doing everything he possibly can to avoid this embarrassment

Whatever the precise final number, the deficit for the year will be running above 7 per cent of GDP – which is well down from the truly scary figure of nearly 11 per cent in 2009, but still the highest in the European Union and not sustainable over any length of time.

So the Chancellor has no choice but to keep his foot on the brakes. The problem is that he has already done the relatively easy bits, and those parts of his programme that will be toughest to deliver are mostly yet to come.

Thus by the end of this financial year, around four-fifths of the planned tax increases and two-thirds of the planned cuts in capital investment will have been driven through.

But according to the Institute of Fiscal Studies, only around a third of the cuts planned in benefit spending and a fifth of the cuts in day-to-day spending on public services will have been implemented.

It's much harder to cut spending on welfare than it is on roads.

And with an election now looming not much more than two years away, this will be a real test of the coalition government's fortitude.

Of course there is one apparently good piece of news in the headlines which is the extraordinary rise in private sector employment, to the highest level since records began 40 years ago.

But I'm afraid this also comes into the gloomy section of my talk, because it too carries a decidedly worrying message about our future.

At one level, of course, it's great news that so many people are in employment rather than not, earning money, paying taxes, and – perhaps most important of all - keeping alive the habits of the work place.

But at another, a rise in employment at time when the economy is roughly 13 per cent smaller than it would have been if it had kept on its pre-crisis trend tells a terrible story about what's happening to productivity in our workplace.

According to figures from the Office for National Statistics just a couple of weeks ago, output per hour in 2011 – the latest date for which comparable figures are available – was running a full 16 percentage points below the average for the rest of the major industrialised economies, the widest productivity gap for 20 years.

And this matters.

In the words of the economists, "A country's ability to improve its standard of living over time depends almost entirely on its ability to raise output per worker."

Are we turning into a low wage/low productivity economy? That's exactly the opposite of where we need to be at a time when economic power is slipping away from the rich West to the emerging economies in the East and the South.

Economists have any number of explanations for what's going on, some more optimistic than others. I don't propose to run through them now, although we could discuss them later if you would like.

I'd like to take the relatively optimistic view.

Contrary to those who argue that the best way to get the economy moving is to slash employment rights and make it easier to hire and fire, these employment numbers in fact demonstrate that our labour market is already extremely efficient.

Employees are willing to trade wages for employment. And at a time of so much uncertainty, companies are preferring to take on more labour rather than make the long term commitments of investing in new services and equipment.

If that's correct, Britain's productivity weakness will turn out to be temporary. Employment will not grow much when the recovery eventually gets properly under way, and we'll see a gradual improvement in output per hour as today's employees take on more work.

Here's hoping, anyway.

But in the meantime, our economy is becoming less competitive and our wealth creating edge is being blunted.

I'll turn now to what you will be relieved to hear is the final part of my gloomy section one.

I promise that my story will be getting more cheerful soon.

But first I want to talk about the direction and priorities of the British business sector.

I've already mentioned its relatively low commitment to long term investment, to research and to innovation.

It's a striking fact that over a fifth of business R & D in this country is paid for by foreign owned companies. That's roughly five times the similar figure in Germany.

Over the past 30 years, British investors have become increasingly unwilling to invest in research and to support capital intensive industries that by their nature require long term finance.

Look, for example, at what's happened to our building materials industry, most of which has been acquired by companies from France, Switzerland, Mexico and elsewhere.

Or consider the structure of our power generating industry, which is going to need over £100 billion of new investment in the next decade. It's already clear that very little of this will be financed on the back of British balance sheets.

The arguments about the dangers of short termism in British business are very familiar, and again I don't intend to run through them tonight.

But I would like to repeat the point made by Dominic Barton, the Global Managing Director of McKinsey, in a speech a few months ago.

He argued that "business communities in developed economies such as the UK and the US have become too focussed on a narrow set of objectives and meeting short term performance expectations at the expense of long term value creation."

There is growing academic evidence to support this view.

One recent study, for example, finds that the market based governance systems of the UK create greater pressure towards cuts in research and development than in other European countries, where shareholdings are less widely dispersed and takeover pressures are lower.

Basing executive pay on the financial performance of the firm has "a particularly strong negative impact" on such investment, the study concluded.

The fashion for share buybacks has also too often been at the expense of innovation investment.

Barton argues that executives must understand that capitalism is not a zero sum game. They need to recognise that serving the interests of all major stakeholders – employees, suppliers, customers, creditors, communities and the environment – is essential to maximising corporate value.

There are real risks in the narrower approach, which focuses on the interests of shareholders above everything else.

To use the language of Professor Colin Mayer, of Oxford's Said Business School, in a new book:

"We have created a system of shareholder value driven companies whose detrimental effects regulation is supposed to – but fails to – correct, and in response we seek greater regulation as the only instrument that we believe can address the problem."

"We are therefore entering a cycle of the pursuit of ever-narrower shareholder interests moderated by steadily more intrusive but ineffective regulation."

That pattern surely lies behind the problems of the banking sector, which in pursuit of ever higher returns on shareholders' capital took ever larger risks until the system collapsed, and which now faces stifling regulation as a consequence.

It helps to explain current anxieties about the integrity of our food production chain, which inevitably also now faces more regulation.

I hesitate to suggest that this too will be a case of shutting the stable door after the horse has bolted.

And it also shows why public trust in business, which has to be the main engine of economic recovery, is as low as it is today.

If we are to unleash the power of market forces to drive our economy to a better place, which we must, then we are going to have to make changes here too.

We are going to have to think again about the real purpose of business.

And that's a job for people in this room much more than it is for government.

It's a challenge for investors, and for world traders.

Enough of the gloom.

The point I've been trying to make so far is that the current trajectory of our economy is bleak.

The best we appear to be able to hope for on the current track is a faltering economic recovery, and a long and painful period of rebuilding our public finances.

There's no great sense of national purpose. Of what we are trying to achieve beyond the necessary austerity.

Policymaking seems more tactical than strategic.

Business too often seems part of the problem, rather than the essential solution. Too preoccupied with their own interests and that of their shareholders, executives can't be trusted to do the right thing for their customers or for the community more broadly.

That's the popular perception, at any rate.

We have to be able to do better than all this.

And so on to section two, and the conviction that a course correction towards a better place is indeed possible.

The key to the long term success or failure of a nation, as many studies have shown, lies in the strength of its institutions.

Countries which have such strengths, where citizens feel that on the whole they will get a fair deal, can pull through troubled times and build a platform for future recovery.

Countries which don't, can't.

And although we British love to complain about how badly our country is run, in relative terms we are very strongly placed in this respect.

We have a head of state who is widely trusted and respected.

We have a parliamentary system which, for all its maddening idiosyncrasies, works better than most.

We have the rule of law, and contracts that can be counted on.

Despite what you read in the newspapers, most of us pay our taxes.

And we have a whole series of independent agencies to stop politicians from poking their noses where they don't belong.

The Bank of England. The Competition authorities. The regulators of privatised services. The National Institute for Health and Clinical Excellence. The Office for Budget Responsibility. The list goes on.

Our businesses constantly complain about regulation and red tape. Yet the recent OECD study shows that this country has the least restrictive product market regulation of any member state, and the overall level of administrative regulation is also well below average.

Barriers to foreign direct investment are low, and we get more than any other European country. The figure hit $77 billion in 2011, higher than for any developed nation apart from the United States.

Our science base is very strong, again second only to that of the United States in most areas. And we have an unfair share of the world's best universities.

It's true that our manufacturing sector has shrunk faster than those of other major economies in the past 15 years, and there are concerns about the strength of our supply chain.

But we still have important pockets of global excellence in areas like aerospace, defence and life sciences. British vehicle assembly plants are now among the most productive in the world.

The City of London is the world's greatest capital market and a source of real economic strength. It can and must withstand the present attacks, and play an even bigger role in a world where capital markets are going to be more – not less – important in financing economic development.

And of course we have strong competitive advantages in a host of other service sectors, from legal services through to movie animation.

For all these reasons and more, the UK has been moving up the league tables of global competitiveness.

On the latest reading from the World Economic Forum, it comes in at number 8 out of 144 countries, two places up on the year before and four places higher than in 2010-11.

Of course it's true that our public finances are in a bad shape, and outstanding government debt is reaching worrying high levels when expressed as a share of economic output.

But a point that is not emphasised enough is that this debt is brilliantly well financed.

Its average maturity is 14 years, which is twice as long as that for Austria, the nearest contender in Europe.

For this and many other reasons, it's absurd to suggest we are somehow in the same boat as those troubled countries in the Eurozone periphery, which are having to roll over their borrowings much more rapidly.

Our business sector has plenty of firepower, too. Small firms are still finding credit expensive and difficult to come by. But if you look at private non-financial corporations as a whole, you find they are holding no less than £672 billion on deposit or in currency, equivalent to more than two fifths of gross domestic product.

If they could only be persuaded to invest some of this cash mountain, the economy would soon be in a better place.

And here's my final reason for optimism.

In the course of my long working life, I have twice lived through periods when the long term outlook looked bleak, and Britain felt sick.

In the late 1970s, after the humiliation of being bailed out by the International Monetary Fund, when trade union oligopolies seemed to run the country, and British productivity lagged well behind its main rivals.

In the late 1980s, when inflation felt like a fact of life, and policy failures led to another humiliating crisis in 1992.

But today we don't worry any more about over mighty trade unions or rapidly accelerating inflation.

And in the years leading up to 2007, we did show we could outstrip other rich countries when it came to productivity growth – and not just thanks to the strength of our financial services.

Increases in product market competition, improvements in the levels of technology, openness to foreign business and talent – all this helped to drive up national prosperity over that decade.

My point is this.

We've done it before.

We can do it again.

And so on to my final section three, and what might be done now to put the economy on to a better trajectory.

As well as strong institutions, successful nations tend to have something else in common as well.

They have a sense of where they think their future wealth and jobs might come. Not an old fashioned national plan, full of unrealistic targets. But some kind of vision which brings government, the private sector and voters together with a shared sense of purpose.

I visited Korea a couple of months ago, and was struck by the way all kinds of different people there spoke about the way their hard work today would create opportunities for the future.

Countries like Singapore, Israel and Finland have similar attitudes.

Austerity is not enough.

Most people don't get out of bed in the morning to defend the country's Triple A credit rating.

Our coalition government talks a lot about growth, and has launched all sorts of initiatives with that in mind.

But it's hard to spot an overarching vision of the future, clear enough to make investment of time and money today seem exciting and worthwhile.

In the struggle to meet fiscal objectives for the short term, there is a risk that the longer term possibilities get pushed to one side.

NESTA, the National Endowment for Science, Technology and the Arts, makes a strong case that we should stop arguing about whether the Chancellor should go for Plan A or for Plan B.

Instead, we should focus on Plan I, which is the case for innovation-led growth.

Innovation drove nearly two thirds of the UK's productivity growth in the last decade.

Innovative firms create more jobs, build more wealth, and export more goods and services than the rest. In a globalising world,

innovation is the key to competitive advantage and rising standards of living.

And government has a central part to play.

It’s not enough just for it to create the right macro-economic framework and then get out of the way.

The US is a champion of free markets. Yet according to one analysis, 77 of the 88 most important innovations in a recent 35-year period were found to have been fully dependent on government support, especially – but not only – in the first phases.

The algorithm or “secret sauce” that made the Google search engine so successful was initially funded with federal money.

As well as funding, many of the basic elements of successful innovation systems are also shaped by governments, whether it’s the provision of education and skills, research capabilities, infrastructure or technological specialisation.

Innovative success is built around complex systems which somehow have to combine lively start-up cultures with state subsidy, entrepreneurial flair with disciplined implementation, speculation with hard graft.

And the state has a vital role to play in all this.

This is the vision that can take us through these hard times.

This is where our policies need to change.

Countries like Germany and Korea, many of which already invested more in research and innovation before the crisis, rapidly scaled up their investments in this area as part of their recovery plans.

The UK ring fenced its research budgets, but in contrast to other big economies, its overall spending on R&D was lower in 2010 than in

2005, and the other components of dynamic innovation have also been squeezed in the cuts.

The business sector has done the same, also from a comparatively low base. NESTA's analysis shows a 5 per cent fall in innovation investment from 2008 to 2009, and suggests that the fall has continued since then.

The UK financial system does not, for the most part, finance innovation in British businesses. And an analysis by the Department of Business shows that the credit crunch has tended to penalise the most innovative firms.

We need to reverse these trends.

Of course, public spending has to be constrained. But it must be done in an intelligent way. Just as it's wrong to saddle future generations with heavy burdens of government debt, so it's wrong to deprive them of economic opportunities by channelling government spending into current consumption as opposed to productive investment.

Increased current spending adds to the debt that has to be financed by future taxpayers.

Investing in an asset which will create an economic return greater than its cost create a public asset which will add to, rather than subtract from, the income of future generations.

It's surely time for the Treasury to differentiate between the two. We should be re-prioritising public spending, giving greater weight to investment in areas that will help to build our future wellbeing.

I'm absolutely not arguing for some great stimulus package which would send the bond market into a tizzy.

But a credible innovation policy will need to be backed up by resources.

We need a new business bank, larger than the one that is currently being discussed, to support innovative firms and bring greater competition to a retail banking sector which is more heavily concentrated among a handful of large institutions than in any other advanced economy.

We need to attract talented researchers and innovators from around the world, something which the current immigration policy is making especially difficult.

We need public investment in technology infrastructure, and support for early stage technology businesses.

We need to do more to support innovation in our small and medium sized enterprises, which in 2009 received by far the lowest level of support for R&D in the whole of the OECD. The current government has taken steps to put this right, and could do more.

But we won’t build a world class innovation system just through government intervention.

It’s going to take full hearted support from industry, from traders, and from the City more generally.

What’s it going to take to persuade industrialists and financiers to adopt the longer term view? To invest in products and services that might take more than a few years to payback?

Maybe the government could do more to encourage them.

I’d be interested to hear your views about skewing the corporate tax system, in order to make it much more attractive to invest after tax profits, rather than to retain them.

About changing the accounting rules, so that the real cost to continuing shareholders of expensive share buybacks was reflected in the accounts.

About rebalancing the structure of shareholder voting, so that those who had been around for years would have more say in the future of the business than those who only bought their shares a couple of days ago.

But in order to unleash the dynamic forces of the market economy, the real leadership will have to come from the city and from industry.

From the people in this room.

They – you – will need to work with government to develop a vision of an innovative future that the public will be ready to buy into. That consensus is necessary, because investing for the future requires making sacrifices today.

This in turn is going to call for a change in the mindset of our business leaders, and of those investors who have the ultimate power of hiring and firing them.

They need to rebuild public trust in business, and show by their actions that it lies at the heart of a healthy society, as opposed to being a rapacious outsider.

They need to stop their short term, quarter by quarter earnings focus. They have to recognise that successful business is about building long term value for customers and that profit is a means to an end – which is creating better products and services for customers. Profit is not an end in itself.

In other words, they must act more like owners, and less like temporary agents. They need to take a stewardship role, and think about ethics as well as about earnings.

People have been banging on about this kind of thing for years. Is there any reason to think that things might be about to change?

I'm hopeful, for five reasons.

First, if we've learnt anything at all in the past half dozen years it's surely been about the limits of markets. Businesses don't operate in a parallel universe where anything goes. They need to be part of the communities in which they operate.

Second, they have to recognise the public mood is changing. Five years ago, company boards were asking why the business didn't relocate to Dublin to reduce its tax liabilities.

Today they are more likely to be asking about the risks of dodgy tax arrangements that might get them up before a select committee in parliament.

Third, companies that took the longer view by and large came through the hard times better than those that didn't. Take those firms in the German mittelstand that have stuck to their knitting for years and have helped to turn their country into the most successful exporter in the world.

They think about shareholder value – but in terms of future generations, rather than of today.

A number of great companies in the UK are now deliberately moving in this same direction.

Fourth, it's become increasingly clear that the idea that businesses exist primarily to maximise shareholder value leads to a dead end. To go back to Professor Mayer's words, the pursuit of ever narrower shareholder interest leads inevitably to more intrusive and ultimately ineffective regulation, crushing the life out of entrepreneurial spirits.

And fifth, as global economic power shifts to East, it's obvious that the innovators will be the winners.

There is no more striking example of this than Apple, the most successful and the most innovative company in the world.

So I'm hopeful.

Nearly eight years ago now, Britain won the contest to stage the 2012 Olympic games.

Right up to the last moment, there were those who said we couldn't hack it.

But the nation had a vision of what could be achieved.

This big idea had cross party support, which survived unscathed through a change of government.

It attracted brilliant managers and creative minds.

It inspired a whole generation of British athletes to near-superhuman efforts.

It pulled in armies of cheerful volunteers, who in many ways were the most inspiring feature of the whole event.

And it turned out to be a triumph.

What we need now is a similar vision.

Of a country that can and will get through hard times, and deliver an innovative future that will raise living standards and create new opportunities.

It's up to our leaders in government, industry and the City to deliver.