Clarke needn't worry about inflation

Chancellor Kenneth Clarke's role as a cheer leader for the economy was put to full use last Tuesday. Delivering the Government's summer economic forecast he gave an upbeat assessment of prospects over the next year. It seems too good to be true: strong growth, low inflation, no current account problem and a steady fall in public borrowing.

There was even more. The Chancellor criticised the Bank of England's inflation forecasts for being too pessimistic. While Clarke was correct, it is amazing he said this in public. It can hardly help Bank of England and Treasury relations at a time when financial markets are worried that further rate cuts will be politically motivated. From now on rate cuts will be more credible with Bank of England support.

The Chancellor's criticism is remarkable when one considers how poor the Treasury's forecasts have consistently been. While the Bank of England continues to see an inflation bogeyman that fails to manifest itself, the Treasury always expects a rosy economic scenario that never materialises. They have misread the current expansion and in previous recoveries they failed to predict the inflation surge or current-account crisis that was to follow past consumer booms.

The question is whether they are about to break with tradition as expansion gathers pace without any associated problems? Perhaps they are. There is a first time for everything.

The economy is in a very competitive position. The decision of the Korean conglomerate Lucky Goldstar to invest in Wales is another sign of that. The Chancellor's growth forecasts are optimistic but they are fully justified, as the benefits of previous policy-easing feeds through. He expects the economy to gather momentum in the second half of this year, allowing 1996 growth to reach 2.5%. Next year he predicts an above trend growth of 3.25%.

This expansion will not be balanced. It will led by the consumer. The Chancellor hopes investment and exports will support the rise in consumption, but the investment picture has been disappointing. At the same time he predicts a rise in fixed investment next year, Clarke has had to cut his investment forecast for this year.

Financial markets are worried that buoyant consumption will trigger inflation and trade problems. I do not think it will. The Chancellor expects inflation of 2.5% at the end of this year and 2.25% at the end of next. Global disinflationary pressures will force companies to keep costs down and encourage consumers to resist price rises.

Rather than worry about problems that may not materialise the summer forecast contains a big current problem – the budget deficit. Compared with last November's budget forecast, the Government expects to borrow £4.5 billion more this fiscal year and £7.8 billion more next. Weaker growth than the Government expected and a fall in the tax take as people and firms side-step taxes explain this.

Despite this overshoot, the Chancellor confidently expects borrowing to fall sharply in the future. It could, but don't bank on it. During the last decade the average forecasting error on the Treasury's PSBR forecast is 0.75% of GDP, which is plus or minus £5.5 billion in today's money. Experience suggests the Treasury's forecast will not be proved correct.

The best way to bring borrowing down is strong growth. In the next few years the economy may grow above its trend rate of 2% but such strong growth may not be sustained. For borrowing to fall, spending needs to be brought under control. The latest summer forecasts show this has clearly not happened, even though total spending is expected to fall by 0.5% this fiscal year.

The Government has been tight on spending recently, but it has been government investment that has been cut.

That is the wrong area to attack, particularly as the Private Finance Initiative has not taken up the slack. Yet it is no more than one should expect. A recent OECD study showed that in ten of 15 countries who tried to reduce borrowing the emphasis was on cutting spending, with government investment the first area to suffer. Politicians don't like cutting spending on sensitive areas and they don't want to raise taxes.

Britain's level of debt is a worry and it reflects the inability of the Government to reduce the social-security budget.

Tax cuts this November may be politically necessary but are not economically justified. Either the economy is growing strongly as the Chancellor expects, in which case taxes don't need to fall. Or the economy is weak and borrowing high in which case taxes can't be afforded.

If the Government wants tax cuts, it will have to slash public spending. That should mean tough choices ahead of an election. More likely the Chancellor will cut next year's planning total to create enough room for a tax cut.

If they win the next election, Labour will have to raise taxes to boost spending. It will be difficult for the party to keep both the financial markets and their voters happy. There will be upward pressure on public spending and it will be hard to keep the public-sector pay bill down. Whether we are in EMU or not, the Maastricht convergence criteria of a 3% budget deficit is becoming accepted as a benchmark for government finances. This reinforces the need for a continuation of a tight fiscal and loose money mix, with no scope for tax cuts and interest rates remaining low for some time. Further base rate cuts are how the Chancellor will cheer up his back benchers.

Dr Gerard Lyons is Chief Economist of Dai-Ichi Kangyo Bank (DKB) International

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The Chancellor's summer economic forecasts show there is no case for tax cuts, says **Gerard Lyons**

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