Clarke has no reason to raise rates or to cut taxes

The Chancellor's Budget options are limited because of high borrowing and strong growth, writes **Gerard Lyons**

On 26 November Kenneth Clarke, the Chancellor of the Exchequer, will present his fourth budget and the last before the General Election. Conservatives hope it will be a good one, boosting their electoral chances. But if the last two budgets are anything to go by, they shouldn't get their hopes too high. In the past Clarke has failed to be swayed by external pressure and has heeded the advice of his Treasury advisers, delivering cautious Budgets.

This weekend the Chancellor has taken his advisers to Dorneywood, his country house. Were it not for the forthcoming election they could relax, as the economy is doing extremely well, helped by previous policy easing, particularly interest rate cuts.

The improving economy suggests little need for a fiscal boost. Even though the stronger economy should help the Tories, the approaching election means the Chancellor is under pressure to do something special.

Clarke has already received much advice. Various budget submissions suggest he is being urged to keep policy tight. The Bank of England does not want tax cuts, just a lower budget deficit. But his Cabinet colleagues, who are clearly aware of the constraints Clarke is under, are trying to steer him in the direction of tough spending cuts and tax reductions.

Before finalising his strategy the Chancellor needs to be clear about the state of the economy.

Last year he lowered his official growth forecast within weeks of the budget and revised it down further in the summer. He needs to assess not just the outlook, but where the risks lie.

The Chancellor should not be fooled into expecting a healthy global economy. European growth will be weak and the US economy is slowing to a steadier pace of growth. Alongside sterling's strength, export growth may decelerate slightly. External inflation pressures should be low, as sterling's strength minimises the risk from higher oil prices and other commodity prices remain subdued.

It is at home where the risks lie. Growth is gathering momentum, likely to rise from 2.3% this year to 3.5% next. The financial markets are worried that stronger growth means higher inflation. It doesn't, as has been seen in the US. Of course stronger growth means there are potential inflation risks and these need to be closely monitored. But such fears must be kept in context. This is no Lawson Boom, despite the rise in house prices from depressed levels, and even allowing for the boost to consumption from next year's building-society handouts.

In recent years competitive pressure and price resistance from consumers have squeezed retailers' margins, keeping inflation down. With consumer spending recovering a key question is whether this will continue?

September's inflation data was disappointing, as retailers boosted margins. Such price rises have not stuck in recent years, having to be subsequently reversed. Even the British Retail Consortium, who have been upbeat about consumption, admitted last week that there is still strong consumer price resistance. If this continues, it will cap inflation.

The key is wages. In the late 1980s people didn't mind paying higher prices because their wages and house prices were rising. Higher wages now would not only push unit labour costs up but could also trigger a change in sentiment, allowing people to tolerate price rises in the shops.

In view of this, last Wednesday's news of a rise in underlying earnings triggered alarm bells. Earnings have risen from 3.25% last December to 4% in July. Whilst some skill shortages may demand higher wages, overall competitive pressures are set to persist, keeping wages down. Surely it is a sign of low inflation when the markets are worried about earnings at 4%. In the last cycle earnings hovered between 9%-10%. Falling unemployment overstates the strength of the labour market. So a wage-price explosion is unlikely.

Even if the Chancellor felt the need to give the economy another helping hand his fiscal position doesn't really allow him many options. In the first half of the fiscal year the Public Sector Borrowing Requirement is at its lowest for five years, but it is still a high £16.1 billion. Although stronger growth will help the deficit fall quicker, a table in last year's Budget Red Book suggested that the impact is not huge. 0.5% faster growth each year reduces the PSBR by another 0.5% of gross domestic product, around £3 billion, after two years.

In such an environment the Chancellor needs a cautious budget. There is no need for tax cuts.

The best strategy is to continue with a cautious fiscal stance offset by an accommodating monetary policy.

Even so, he will probably cut a net £3 billion, paid for by small spending cutbacks and savings to spending plans from low inflation. Such a budget will not only dampen fears of a rate hike but if it occurs alongside continued sterling strength and good inflation news he could even squeeze a final 0.25% rate cut.

The biggest risk in the UK, and a big difference with the US, has been the lack of investment in this cycle. This does not point to an immediate problem as there is still ample spare capacity in the economy. But it could trigger future bottlenecks if something is not done. I still favour tax incentives for investment but these will not happen. Instead the Chancellor has to boost confidence. The Chancellor needs to convince industry and the electorate that the economy will remain healthy and that inflation and interest rates will not rise.

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