Ken Clarke faces trouble if economy goes 'boom'

Is Mr Clarke presiding over a boom? One might imagine that most Chancellors would like to have a boom named after them, but not in the UK. Boom often becomes associated with the word bust, as previous Chancellors Maudling, Barber and Lawson have found out.

The Conservatives have lost power twice since World War II, on both occasions following booms that got out of control. Four years ago it proved to be third time lucky for the Tories. Despite the Lawson Boom and Bust they were re-elected. Their best hope of winning the general election rests on generating another boom and a recovery in the feel-good factor. Opinion polls suggest the Budget failed to provide any help. Amazingly, people not only felt the Budget had bribed them but they also felt worse off as well!

The City fears the Chancellor is stoking up a pre-election boom. The cut in income tax at a time when spending is already rising did not help sentiment. And there is a general feeling that Clarke is dragging his heels on interest rates.

Yet interest-rate sentiment has improved during the last week, following testimony by the Bank of England governor Eddie George to the Parliamentary Treasury and Civil Service Committee. One could be forgiven for thinking one is at a race meeting when the Bank gives evidence to the Committee. There is so much reference to 'odds' and 'probabilities'. Talking in such terms highlights the problems UK policy makers face. Economic trends are never clear-cut and different probabilities have to be attached to possible outcomes.

The problem for policy makers is not so much which horse they should back as opposed to which one they currently hold the reins to. The City fears it is a horse racing out of control. One can understand such concerns given events in the late Eighties, but it feels to me more like a plodder finding a new lease of life and on a course that still has lots of hurdles.

Basically the markets think the economy is heading for a boom. I don't and judging from what Eddie George said, neither does he. But the risks cannot be ignored and, just to be on the safe side, the Bank still wants to raise rates. Yet he implied that an immediate hike was not needed and that rates need to rise to only 7%, which is far less than the City has feared. Thus there was a welcome fall in the pound.

The Governor is right when he says the economy is "On the verge of a domestically driven upswing", and not about to repeat a 1980s style boom. As George said, there are no close parallels between the Lawson Boom and now in terms of economic data but there is a conceptual parallel in that we are enjoying a domestically driven expansion.

This is a perennial problem for the British economy. Growth has all too often been skewed towards the consumer, with investment remaining sluggish. The UK needs a balanced economic recovery, with higher investment and exports supporting the rebound in consumer spending.

One of the big uncertainties is the impact of next year's building-society windfalls, which could total £20 billion. Such a large sum needs to be put in context. The one penny income tax cut in the Budget will cost the Treasury £1.3 billion in the first year, and £1.8 billion in a full year. If all of the windfall was spent it would have a dramatic impact. The Bank of England assumes the bulk will be saved, as people regard such windfalls as unexpected additions to their wealth. There will probably be a small net leakage into the economy, as some people spend their money, although the risk is that a greater proportion will be spent.

Analysing economic prospects one needs to distinguish between underlying structural changes and cyclical trends. A rebound in spending is long overdue. But this cycle has been very different, marked by sluggish wage growth and continued job insecurity. Some of the worries about jobs may be lifting, but the economy is still being affected by global disinflationary pressures, which will force companies to exercise tight control on all aspects of costs, including wages. Thus spending will rebound, but it is unlikely to boom as it did in the late Eighties.

There is a general assumption that there will be a healthy rise in investment next year. The trouble is that many of the same factors such as healthy balance sheets and profits that are in place to boost investment were also evident earlier this year and yet failed to produce any significant upturn. Overall, investment still remains weak, particularly in the manufacturing sector, where despite a recent recovery investment is still 14% below the level of a year ago. Perhaps the best hope for investment is the recovery in demand. This has triggered a rebound in output and an improvement in investment intentions. But the fear of higher interest rates and any renewed strength for the pound could always dent this optimism.

Where will these imbalances show up? The Bank fears higher inflation, but not just yet. Yet a deterioration in the trade balance may be a more likely response, as import penetration rises. That at least would be a familiar problem faced by most UK Chancellors.

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ECONOMICS WEEK

Financial markets continue to fear this is a Clarke boom that will soon turn to bust, says **Gerard Lyons**