Waiting for Labour to spell it all out

Do the financial markets expect Labour to win the next election? If so, are investors worried? The Labour Party has had a commanding opinion poll lead for such a long time that Mr Blair is clear favourite to be Prime Minister. However, it is by no means guaranteed. Economic recovery could boost the feel-good factor, while Labour could slip up as its economic policies are put in the spotlight.

Traditionally, financial markets penalise left of centre governments while giving right-wing administrations support. However, this old rule of thumb may be breaking down, partly because economic policies have converged. This is as true in the UK as it is in many other industrialised countries.

The Labour Party has effectively endorsed the Conservatives' anti-inflationary policy. This reflects a trend across Europe. Even at the last election, with Neil Kinnock as leader, Labour shared the Conservative government's enthusiasm for the deflationary mentality of the ERM. Of course, as was obvious at the time, devaluation was on the agenda whoever won the election.

Judging from last year's annual Mais lecture at the City University, delivered by Mr Blair, Labour will put an anti-inflationary policy above all other economic wishes. Alongside the Labour Party's apparent enthusiasm for a single currency, it is possible the financial markets may not fear a Labour government at all.

That may be premature. It is surprising how Labour has been able to side-step specific questions on their policies. Thus uncertainty remains and for this reason the markets have not fully taken on board a Labour victory.

International investors need to be clear of two key areas. First, fiscal policy. Second, Labour's policy towards Europe. Most domestic investors expect Labour to win but many of them do not expect the election to be held until next year. It is only in the immediate run-up to the election that investors may adopt defensive strategies, selling gilts, equities or sterling. Just look at how sterling fell at the start of the beef crisis, not just on concerns about the economic fall-out but because of the fear of an early election.

Fiscal policy is the biggest market uncertainty. Could a Labour government control public spending, particularly on priority areas such as education, health and housing? Gordon Brown's tough talking suggests they will, but if they do, it will disappoint many of their traditional supporters. One area of economics, called the political theory of the business cycle, may give some insight. This suggests Labour is appealing to the floating voter ahead of the election. As traditional Labour supporters will vote Labour, whatever its policies; victory depends on wooing the floating voter. And, in the process, Labour is hoping to win over the financial markets.

Furthermore, this theory suggests that once elected, the emphasis should be on winning re-election. To do that, tough policies should be adopted immediately and for the first two years or so, allowing scope for policy easing with rate cuts and higher spending in the approach to the following election. On this basis, Labour could adopt a tight policy once elected, particularly if taxes were raised, even if only by a small amount.

But Labour will need to spell out in more detail some of its key expenditure plans. Until then, investors will be wary. It is only once exact details are given that the markets can decide whether such policies are credible.

If Labour does not plan to raise taxes, then the only way it can boost public spending without the budget deficit rising is to achieve stronger economic growth. This is their aim but their caution suggests policies may need to be geared more directly to achieving stronger economic growth.

One reason to believe policy could be tight and anti-inflationary once Labour wins is its apparent enthusiasm towards Europe. The Maastricht Treaty points to a deflationary mentality, with little room for fiscal or monetary manoeuvre and constraints on the labour market through the Social Chapter.

There are many reasons why Labour could endorse Monetary Union. Politically, it could be seen as a way of bringing Britain to the centre of European decision-making, in the process making it more difficult for any future Conservative administration to leave a Monetary Union and repeal the Social Chapter. Economically, it would reflect Labour's misplaced fear that Britain would suffer outside a single currency.

Even though Monetary Union points to weak, below-trend growth and high unemployment, Labour's endorsement of it would lessen the risk of a premium attached to a Labour victory. Investors may believe there are binding fiscal and monetary constraints on policy. It would remove the possibility of a sterling crisis that has undermined previous Labour governments. Instead of a higher premium on UK government debt, gilt yields could converge towards those in Germany.

The trouble is that while such policies may lessen the financial markets' fears of a Labour government, the economic benefits will not be good. That could force Labour's traditional supporters to demand a more radical policy once elected. Thus any honeymoon period for a new Labour government may be short-lived.

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The Labour Party needs to spell out its key expenditure plans clearly before the markets can shake off their wariness, says **Gerard Lyons**

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