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Major facing tough Budget balancing act

Despite signs that monetary policy is succeeding in reducing domestic demand pressures, underlying problems on the current account and inflation are set to persist.

Against the background of sluggish domestic demand, the supply-side of the economy is suffering. Output and productivity growth are falling while corporate profits are being squeezed. This environment is reducing investment intentions and will result in labour shedding.

Accumulating evidence of a slowdown in the economy will emerge this quarter. While this may point to scope for an easier policy stance, the economy will not be able to tolerate this without higher inflation.

The key to the movement of domestic inflation will be the movement of pay and earnings. Signs on this front have not been encouraging. Furthermore, historical analysis of pay settlements in the 1980s implies that average settlements are unlikely to decline by more than 1.5 percentage points over the course of any one pay round.

Thus, even on a fairly optimistic outlook, settlements would only fall to 8 per cent by mid-year. In view of this, only a large decline in wage drift (overtime and bonus payments) would prevent earnings growth rising to 10 per cent by the summer.

This is unlikely, as estimates of wage drift produced from the CBI's manufacturing pay data bank suggest the contribution of wage drift to earnings growth is unlikely to fall below 1-1.5 percentage points. At its lowest over the 1980s, wage drift still added 1.4 per cent to growth in average earnings. Clearly average earnings have further room to advance.

The Chancellor's commitment to reducing inflation points to interest rates remaining high for some time. Furthermore, a tight fiscal policy in the Budget is required to help reduce domestic economic pressures. But, just as importantly, the Budget needs to address underlying economic imbalances.

Only if fiscal policy is successful in encouraging a rise in savings while giving incentives to industry to boost investment, can interest rates be cut. Even then it is likely that without some controls over bank lending, lower interest rates, with a deregulated financial environment, will allow consumer borrowing and credit growth to rise. In fact, any attempt to boost the economy over the next year and before an election could mean a greater inflation and current account problem.

The current account deficit remains an important long-term problem for the economy. The Government's surplus minus the private sector's deficit is identically equivalent to the deficit on the current account.

For the current account deficit to remain unchanged the private sector's deficit must be cut by an amount equal to any fall in the Budget surplus. More importantly, the current account deficit must be reduced to prevent a run on sterling.

This implies that the Government would have to announce a very tight fiscal policy, aimed at boosting the Budget surplus. Or the private sector would have to reduce its deficit sharply, entailing a cut in investment and stocks. Either way a recession would be likely.

Given this, it is clear the Chancellor has a difficult balancing act to perform. On the one hand, Mr Major will need to keep interest rates high and fiscal policy tight to counter rising inflationary pressures and a further deterioration in the current account deficit.

On the other hand, he will be keen to avoid a recession, which would seriously hit investment intentions and prevent a longer-term improvement in productivity and the current account.

Also, a recession would seriously undermine the Government's popularity. Ironically, if interest rates do not fall sharply before the next election, a political risk factor is set to re-emerge as a negative influence on sterling and gilts.

Against this background, cash remains the most attractive option. There will be little scope for short yields to fall.

Furthermore, yields at the long end are not yet high enough to take into consideration the risk factors involved. With real yields on long gilts standing at only 3.5 per cent, longer-term investors should be increasingly attracted to those available on harder currency European bond markets.

Real yields in Germany are 5.1 per cent, in France 6 per cent and in the Netherlands 7.3 per cent. Thus the short-term strength of sterling makes a switch into harder currency bond markets advantageous.

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