A year's hard Labour, a year's hard Gordon

Labour looks as though it could break a long-standing tradition by managing to get itself re-elected, says Gerard Lyons. This is a feat they couldn't have pulled off if they had won in 1992.

One down, how many more to go? It is one year since Labour was elected to power. Almost immediately after winning the general election last May there was a feeling that Labour would remain in power for some time. This is still the consensus, although I think it is far too early to jump to any conclusions.

How should we judge Labour's first year in charge? Radical and cautious are two words that can be most identified with Labour's handling of the economy in the first year. Although these are two words that are not always used together, in Labour's case they are justified.

Many of the institutional changes that have been introduced have been radical. In particular, the decision to give independence to the Bank of England within days of election victory. Meanwhile, macroeconomic policy has been cautious, particularly towards government spending.

This is a break with Labour's past and, in this respect, the government will view its first year as a success. Prior to the general election, Labour was nervous, concerned that the problems that denied them victory in 1992 would strike again.

The biggest hurdle Labour had to overcome was to be viewed as trustworthy enough to run the economy. Fortunately for Labour, the electorate had not forgiven the Conservatives for the pound's devaluation on Black Wednesday. This made Labour's task slightly easier last year but, in order to avoid any nasty surprises, they tried to minimise differences between themselves and the Tories over the running the economy.

This was most dramatic in the area of fiscal policy. Financial markets feared a spending binge, while many of Labour's natural supporters wanted higher public spending in a host of areas. To ease the worries of the markets and to alleviate fears that income taxes would rise, Labour promised not to raise taxes and also committed itself to the Conservatives' tight public spending plans for the first two years of government.

Since winning power, Labour has stuck to these plans, although this is partly because they inherited an economy in good shape. If Labour had won the 1992 general election it might have proved disastrous for them, as they would have been unable to prevent Black Wednesday. By contrast, Labour inherited a healthy economy at the 1997 election.

Previous economic recoveries have either run into an inflation or trade problem or both. Not this time. Growth has been balanced and steady.

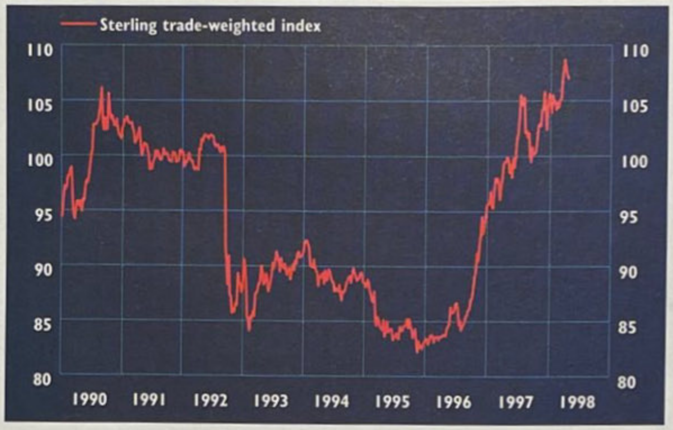
The combination of a buoyant economy boosting tax receipts and a tight control on government spending has brought the budget deficit down sharply. The public sector borrowing requirement for fiscal year 1997-98 was only £0.9bn, compared with £22.7bn in fiscal 1996-97.

Chancellor Brown's two Budgets have been part of this tough strategy, particularly his first Budget last July when tax increases were concentrated on pension funds and utilities. And a new code for fiscal stability has been introduced. This keeps the UK on course for Emu membership and also highlights the current plan not to use fiscal policy for demand management. This new approach to has left the job of fine-tuning the economy to the independent Bank of England.

One way of interpreting Labour's economic approach is the grandly named 'Political theory of the business cycle'. In order to gain the credibility of the floating voter, a political party should announce cautious policies geared towards the political centre which will woo over the floaters. Then, once elected, the government should keep policy tight, as there is nothing to be gained politically from being generous just after an election, and this will leave them able to build up a war chest and relax policy in the run-up to the next election.

However, there is one downside to this. What happens if the economy slows? Latest economic indicators are mixed, but there is enough reason to be cautious. Economic policy is very tight, and could slow the economy sharply over the next year. Government spending is under tight control and since being made independent the Bank of England has raised interest rates in five quarter point moves, to 7.25%. As a result the pound has strengthened.

STERLING FLIES AGAIN



Like fiscal policy, the performance of the pound has also been a big break with tradition. The economy is now suffering from a sterling crisis, but not of the traditional type associated with a Labour government. Instead of falling sharply the pound has risen too far.

So far, the government has had a hands-off approach to the pound, claiming there is little they can do. It is remarkable that a government that wants to tie the rate of the pound for all time in Emu should show little interest in the damage the pound's current strength is causing the country's exporters.

Although the euro is set to start next January, with possibly 11 members, the government is adopting a wait-and-see strategy. I don't think the euro is a good idea for the UK, but the British policy is understandable. In the unlikely event of the euro proving a success, the UK can still enter.

While the government has adopted conservative macroeconomic policies, big changes are planned in the area of microeconomic policy.

Here the government is planning to interfere in a number of areas – promoting a welfare to work policy to help the young unemployed and soon announcing a minimum wage. It is clearly too early to judge the impact of these government policies. Reducing unemployment and tackling poverty are essential requirements for any government, but is not clear that this will be best achieved by current plans.

The prime minister keeps reminding his Party that no Labour government has been re-elected. Given Labour's majority, a pre-condition for success next time around is to avoid a major economic downturn. So far, so good but difficult times are not far away. ●

Dr Gerard Lyons is chief economist of DKB International.