Interest-rate expectations improve, despite Labour's lead

There have been two significant recent developments. First, the result of the Wirral South by-election means a Labour landslide is a serious possibility. Second, continued low inflation and a loss of economic momentum has triggered a fully justified improvement in interest rate expectations.

Whereas the 1992 election was the one to lose, 1997 is the one to win. In 1992 Labour not only had a tax policy which the voters disliked, but they were committed to sterling's ERM membership. If Labour had been in power for Black Wednesday it could have wounded them mortally.

Now, the economy is in relatively good shape. The performance of the supply side of the economy has improved, particularly the labour market. Inflation is set to stay low and the budget deficit may prove a pleasant surprise, as recovery boosts tax revenues. The disappointment is the lack of demand, partly due to tight policies, and the low level of investment.

A Conservative revival cannot be ruled out. People do change their mind during the election campaign and the Prime Minister has already proved he is an effective campaigner. But any revival may be too little, too late.

Despite economic recovery, the Government has not benefited from a feelgood factor, as the economy's performance is seen by many as disappointing. There are two possible reasons. First, despite falling unemployment, job insecurity and sluggish wage growth have been a feature of the recovery. Second, the economy's current performance contrasts with people's memory of the late Eighties, when house prices soared, wages rose and there was a general feelgood atmosphere.

What the Government has failed to explain is that this recovery is for keeps. Instead of the fool's-gold boom under Chancellor Lawson the economy is now enjoying a steady basis for sustainable non-inflationary growth.

Financial markets are assuming the electorate will act in an equilibrating way, swinging back to the Tories, but still giving Labour a healthy win. If not, and the opinion polls prove correct, there could be a landslide. There is a view that a landslide would encourage a Labour Government to be more expansionary and interventionist, as backbenchers and unions demand more spending.

This seems unlikely. A landslide would be seen as an endorsement of New Labour. Rather than risking an expansionist policy it is more likely to encourage Labour to be cautious. If Labour wins, then the bigger its majority the greater Tony Blair's hold on the party. He can plan for being in office for more than one term and the greater will be the scope to persist with tough policies in the early years, even if this risks a confrontation with the unions over public-sector pay.

Gordon Brown would try and fulfil his aim of tough control of public spending, attempting to dispel Labour's image as a tax-and-spend party, and gain credibility with the financial markets. Labour's hope is that by being tough in the first few years it can reap the benefits in the run-up to the following election, when it can relax policy.

It all sounds too good to be true. But one thing a Labour Government can ill afford is an economic slowdown. They need the 'growth dividend' to keep the budget deficit down. As a result, it makes little sense for Brown to want to tighten monetary policy.

Although interest-rate fears have eased in recent weeks the markets believe monetary policy will be tightened, whoever wins the election. This is not clear-cut. Under Labour the outlook for interest rates will depend on the state of the economy, Bank of England advice and the stance of fiscal policy.

If Labour unveils a tough fiscal policy within weeks of the election this should lessen the need for aggressive monetary tightening. Ideally, rates should be left unchanged. Their desirable policy could be a cautious fiscal stance alongside interest rates being low enough to allow the economy to reap the benefits of subdued inflation. Achieving low inflation is of little economic benefit if monetary policy is too tight. And sterling should be at a competitive level where industry does not suffer.

But Brown's position on rates will be heavily influenced by the Bank of England. During the last week the governor and deputy governor repeated calls for a quarter-point rate hike, even though the Bank of England expects the target of 2.5% for underlying inflation to be achieved this year.

If by the time of the first post-election monetary meeting the Bank is still arguing for a rate hike then Brown is likely to agree. He may even allow rates to rise from 6% to 6.5% but no more. It is difficult to see what could be gained from tightening monetary policy aggressively, particularly if the economy doesn't need it. By agreeing to Bank of England demands, Brown can blame any rate increase on the Tories and at the same time seek to establish his tough image with the financial markets. But it is better to be right than to be tough. Even if Labour wins, interest rates should peak at a lower level in this cycle than the financial markets expect.

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ECONOMICS WEEK

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