Politically correct yes, economically no, Mr Brown

Dennis Healey could lay claim to being the first modern monetarist Chancellor following his introduction of money-supply targeting in 1976. The centre-piece of monetarism was to control the money supply to reduce inflation. Healey was only a half-hearted disciple, as was seen by the policy of his successor, Geoffrey Howe, who replaced him in May 1979.

Since then money policy has gone through many turns, but initially the Conservatives followed an international monetarist model, which in layman's terms meant a strong pound to squeeze inflation. The surge in the oil price ensured a large appreciation, given the pound's role as a petrocurrency.

All of which brings us to today. There are two similarities with the late Seventies and early Eighties. First, just as the Conservatives did untold damage to British industry in the early Eighties with too strong a pound, should they lose the election then one of their parting gifts to Labour will be an overvalued currency. Second, Gordon Brown gives every indication of wanting to be viewed more as a monetarist than the Keynesian Chancellor many in his party are hoping for.

Even though the pound fell sharply last week, as market expectations of an immediate rate hike receded, it still remains firm. Last week's speech by governor Eddie George shows the Bank of England wants rates to rise. It is not clear whether Kenneth Clarke will heed this advice, in which case the next rate hike may have to wait until after the general election. Thus sterling may not suffer before the election.

If the election is in May then by the time of the subsequent monthly monetary meeting the Bank of England is likely to believe a rate hike is long overdue. If Labour wins, Gordon Brown is likely to heed their advice and tighten. Not only could he blame the increase on the Conservatives but it would enhance his reputation with the financial markets as a Chancellor who intends to be tough.

This was also the message that came out of Gordon Brown's speech last Monday on Labour's responsible attitude to fiscal policy. Politically the speech was a success as it committed Labour to no income tax increases. Although many in the City treated his comments with scepticism it is difficult to imagine a more market-friendly speech.

Yet from an economic perspective a word of caution is needed. In the run-up to a general election political considerations will dominate over economics. Some would argue that this is already happening in monetary policy. But Labour's commitment to tough constraints on policy could become a straight-jacket. Policy flexibility is important, particularly if the economy slows or overheats.

A very useful lesson of what can happen when politics overrides economics is seen in the approach on the Continent to European Monetary Union (EMU). It is often said that the political enthusiasm in favour of a single European currency should not be underestimated. It is equally important for politicians not to underestimate the economic fundamentals in EMU's way. If politicians press ahead with a single currency despite the economic fundamentals, something has to give. This is already evident on the Continent, where the rush for EMU has resulted in weak growth, low output and high and rising unemployment.

It is clear that Gordon Brown will take no prisoners as he aims to establish his credibility with the financial markets. Just as he is likely to support a tighter monetary policy and greater autonomy for the Bank of England, his speech focused on how Labour will control the purse strings by endorsing the Government's spending plans and sticking to existing tough expenditure controls for the next two years.

By the time two years is up Brown clearly hopes to have rebalanced public spending, finding room within the overall total to boost the areas Labour thinks important, such as health, education and employment. This may prove harder than it seems, although the utilities tax will help. Even the Conservatives have found it difficult to keep public expenditure down and they have boosted spending significantly on health and education. If more is to be channelled into these areas this may require additional revenue.

Although Labour is committed to no increase in income taxes this need not prevent them raising other revenue. The last time income taxes rose was in 1977. Even though income taxes have fallen since then the tax take is broadly unchanged, as other taxes have risen. Labour can continue this recent Conservative tradition, by phasing out existing tax breaks.

The question is whether Brown's tough talk is more symbolic than real. The financial markets fear that Labour will manoeuvre itself into a corner where a reversal in policy direction is necessary. Indeed that is possible, but it will not happen immediately. Just as the Labour party is wooing the floating voter ahead of the election, afterwards they aim to please the financial markets and reduce long-term interest rates by being tough. Then, at a later stage, they may hope to realise the wishes of their traditional voters. But even as they wait, expectations should be held in check.

One sentence of Brown's speech stood out, "There is no long-run trade off between growth and inflation". This rekindled memories of Prime Minister Callaghan's conference speech in 1976 when he said governments cannot spend their way out of recessions. Callaghan's repudiation of Keynesianism will clearly live on in a future Labour government.

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ECONOMICS WEEK

Gordon Brown has left himself little room for manoeuvre in his attempt to be tough, says **Gerard Lyons**