MAJOR'S RETREAT

John Major is forecasting solid recovery next spring after a short recession. Industrialists and City analysts fear he is too optimistic. Report by David Smith

JOHN MAJOR does not like the word "recession". Treasury officials, in drafting the autumn statement, were careful to use such euphemisms as "weak activity" and a "sharp" growth slowdown. The chancellor, understandably, wanted to avoid feeding the gloom.

But recession, by any definition, is what Britain is in. And November 8, 1990, was the day on which the Treasury, if not the chancellor, admitted it.

The British economy's dive in the second half of this year closely matches the beginnings of the last great recession, 10 years ago. Then, in the first half of 1980, the decline in gross domestic product was 1.4%. This time GDP is projected by the Treasury to suffer a second-half drop of 1.2%.

In 1980, the economy continued to slide and did not pull out until well into 1981. This time, the Treasury is banking on a short recession, and a solid recovery from the spring of next year. If it is wrong, it will be more than the Tory party's re-election chances that suffer.

AS THE Treasury put the finishing touches to the autumn statement last week, the storm clouds gathered. The Confederation of British Industry held its annual conference in Glasgow against the background of the biggest drop in business confidence for 10 years. After it, CBI leaders intensified their call for further base-rate cuts. Car and commercial vehicle sales slumped last month and third-quarter business failures, according to the accountant KPMG Peat Marwick McLintock, were 64% up on a year ago.

In industry, recession has been a reality for several months. One CBI delegate, Roland Long, said: "People are having their lives ruined as a result of economic mismanagement, of which they are the victims and not the perpetrators. It's happened before – for many of them it's the second time in 10 years."

John Banham, the CBI director-general, warned of the danger of "the human tragedy of a one million increase in unemployment and a collapse in investment."

For Major, the use of such language would be as indelicate as swearing in front of the vicar. He has developed his own style in delivering economic statements in the House of Commons. Gone is the flamboyance of his predecessor, Nigel Lawson. Instead, the approach is that of the cricket club chairman at an end-of-season dinner, running through the team's results. And, like any competent chairman, he knows his audience expects him to emphasise the good news.

Public spending, according to the chancellor on Thursday, is back in fashion. Gone are the days when Tory chancellors trumpeted the spending cuts and growled about the unavoidable increases in Whitehall budgets. Major announced a new planning total for 1991-2, negotiated by Norman Lamont, the chief secretary to the Treasury, of £200.3 billion, £7.9 billion above previous plans and nearly £20 billion above the current year's outturn.

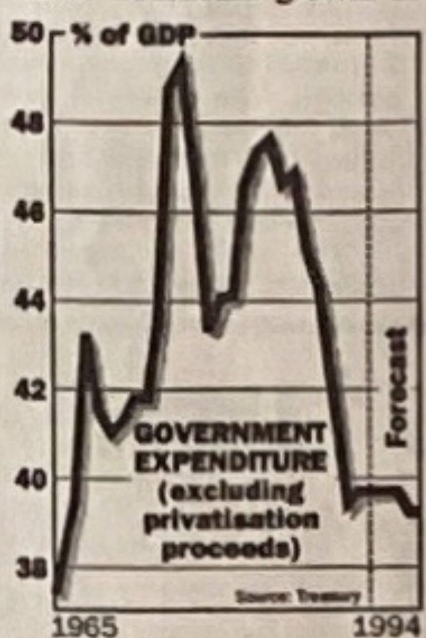
He announced extra money for local authorities to hold down next year's poll-tax increases. Nearly £3 billion each was added to the social-security and health budgets. And the railways, for so long the whipping boy of public spending battles, find themselves on the receiving end of the Treasury's largesse.

Some of these increases, of course, simply reflect higher-than-expected inflation. The government has not singled out social security as a priority area for higher spending, but the main benefits are linked to inflation. Similarly, in highlighting the extra money for local authorities because of the poll tax, Major was making a virtue out of necessity.

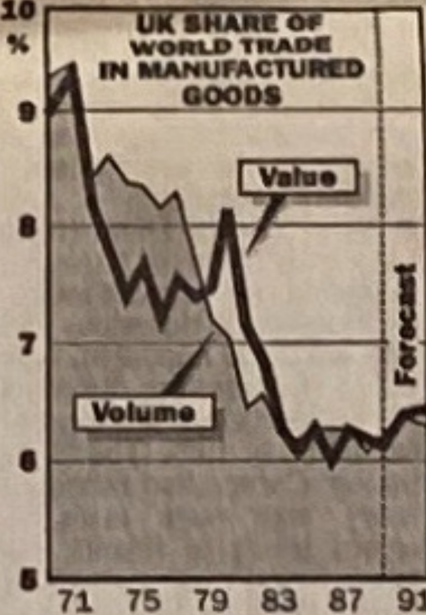
The grim part of the autumn statement, the forecast, was left until the end. Even then, the gloom was fairly well hidden. He said: "It is clear that growth has now slowed down sharply. GDP is forecast to grow by 1% this year. This figure is the same as the forecast I made at the time of the budget, but the path has been slightly different, and I expect output in the second half of the year to be down on the higher-than-expected level in the first half.

"This period of weak activity should last until early next year, after which I expect growth to resume. GDP is expected to grow by over 2% in the course of 1991, though year-on-year growth is forecast to be only 0.5%."

Described this way – a bit of additional growth in



Lamont: 'tight settlement'



the first half of this year, followed by a second-half downturn, to be followed by a recovery early next year – the economic outlook does not sound too bad. But it sits uneasily alongside the gloom emerging from industry.

According to Goldman Sachs: "There is now a chilling possibility that the economy could tumble into an even deeper recession. The October 1990 CBI survey is uncannily similar to that which was taken in January 1980, just as activity was falling off a cliff. If business confidence worsens further in the coming months, then company spending on investment, stocks and employment could drop sharply enough to produce a recession which rivals that of 1980 in severity."

Roger Bootle of Midland Montagu said: "The pain in the corporate sector is intense and firms are only now getting down seriously to the business of passing it on to others through cutbacks in investment, stocks and employment levels."

BRITAIN's recession took a long time to arrive. When Major took over as chancellor just before last year's autumn statement, he used the phrase: "If it isn't hurting, it isn't working." A year ago, the Treasury expected the economy to be flat in the first half of 1990, followed by a second-half recovery. He warned: "This does mean 1990 may not be an easy year."

But Major's first winter was one of declining confidence in the pound, and sterling's fall eased the impact of high interest rates on industry. The chancellor had rejected the option of raising base rates as soon as he took office. Politically, an increase in base rates above 15% was unacceptable. Until the prospect of the pound's entry into the European exchange rate mechanism helped restore international confidence in sterling last spring, he could only watch helplessly as his monetary policy stance was undermined.

The result was that the economy continued growing in a period when, in order to bring down inflation, it should have stopped. That delay is central to the current uncertainties in both the economic and the political outlook. One year on, the economy is in a downturn, and it is 1991 that will be a difficult year. But the pattern of his forecast is remarkably similar. The first half of next year will be flat, followed by a significant second-half recovery.

The omens are not good. The Gulf crisis will depress business and consumer confidence as long as it lasts. A war, and the probable rise in oil prices to $50 a barrel, would hit an already weak economy hard.

Even without an oil-price surge, many economists fear that the recession will persist through the whole of next year. Keith Skeoch, chief economist at James Capel, predicted a full year of falling output. He said: "The view that the slide in activity will come to an abrupt halt to be followed by a boom in the second half looks overly optimistic."

Skeoch's particular concern is the colossal company sector financial deficit, running at an annual rate of more than £30 billion. The Treasury expects companies to reduce this deficit by cutting stocks, together with a modest, 2.5% drop on business investment. He expects a bigger fall, of 5.5%, in investment, together with an even larger rundown in stocks.

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FOR THE YEAR ENDED 29 SEPTEMBER 1990

	1990 £m	1989 £m	Change
Sales	548.3	515.4	+6.4%
Pre tax profits	33.5	28.6	+17%
Earnings per ordinary share	20.36p	16.62p	+22.5%
Dividend per ordinary share	9.0p	8.5p	+5.9%

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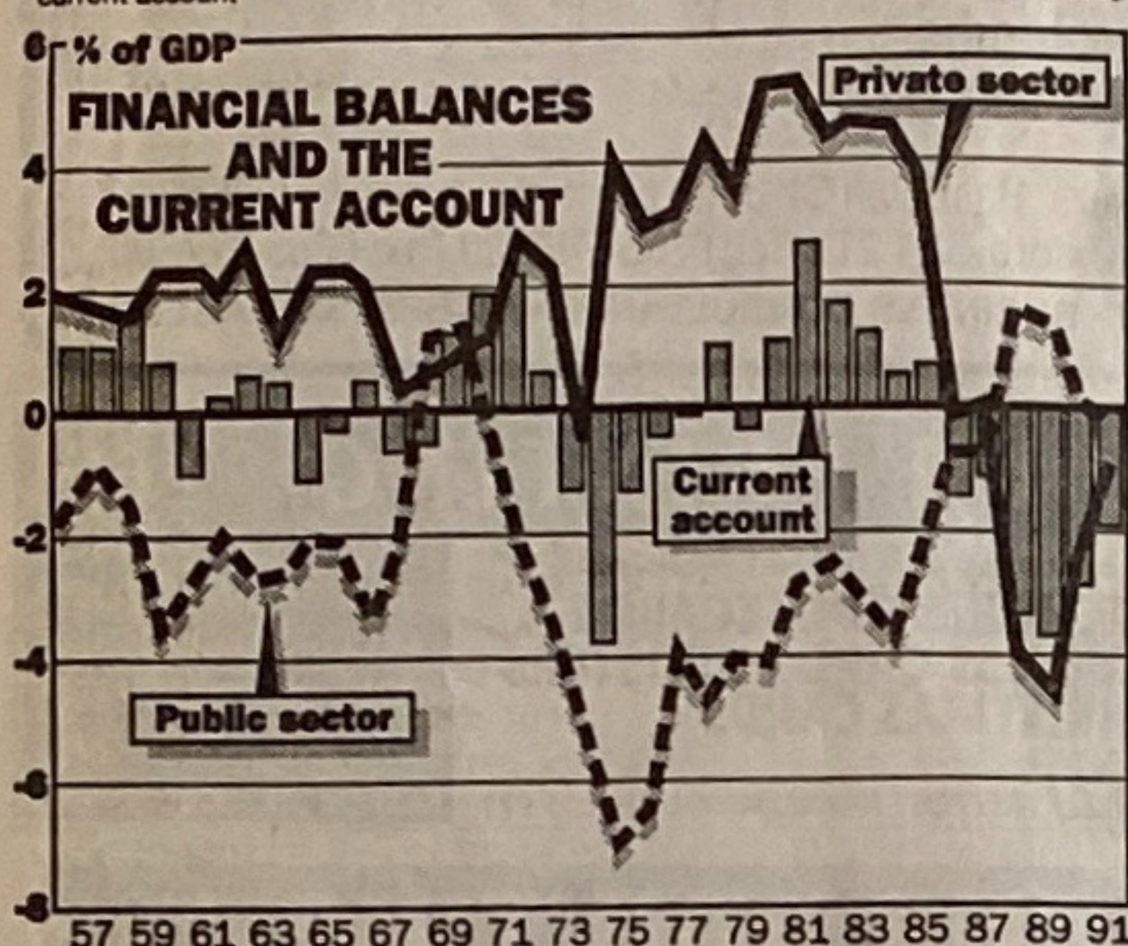
INTO RECESSION

Britain's economic prospects

Percentage change on previous year

	1989	1990	1991
Consumers' expenditure	3.75	2.5	1.75
Government consumption	0.75	1.5	0.75
Fixed investment	4.75	−1.5	−1.75
Exports	4.25	4.5	2.5
Imports	7.0	2.5	1.25
GDP	2.0	1.0	0.5
Manufacturing output	4.25	0.0	−0.5
Inflation	7.5	10.25	5.5
Balance of payments* (£bn)	−19.0	−15.5	−11.0

*current account Source: Treasury



Chancellor John Major may see inflation fall but fears of lengthy recession a growing

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The good news for Major is that, for the first time in three years, there is a general acceptance that inflation will fall sharply next year. There is little doubt too, that on the back of a weak domestic economy, imports will be subdued enough to produce the expected narrowing in the current-account deficit from £15.5 billion this year to £11 billion next. Worries over the current-account deficit in the long term will, however, remain.

On inflation, having got it badly wrong this year, with a fourth-quarter outturn nearly double the forecast of a year ago, the Treasury could not afford to do so again. Indeed, having used prospective inflation as the basis for sterling's entry into the ERM, Major had little option but to come up with *a forecast which supported* his decision.

According to Warburg Securities: "Inflation of 5.5% is quite feasible, given the number of one-off factors, which seem set to drop out of the index."

This week, the government is expected to report that inflation rose to 11% in October. But from then on it should be downhill all the way. Inflation is set to halve over 12 months, the steepest fall since the early 1980s. Interest rates, subject to the constraints of the ERM, could come down, although less rapidly. The timing of the Tories "golden scenario" may have slipped, but many of its ingredients remain in place.

The hope, and the big uncertainty, is on the response of wages to this inflation downturn. Even a big fall in inflation over the next 12 months would represent a tarnished achievement when set against a background of recession and sharply rising unemployment.

Major said: "Unemployment has been rising since the spring and may continue to rise in the months immediately ahead, but job prospects will improve with a resumption of growth, the more so if employers keep tight control of costs, including pay rises."

There has been little indication so far in the present pay round of negotiators responding either to the recession or the new disciplines of sterling's entry into the ERM. The Treasury is cautious about the speed with which such a response will come through. It expects 10% growth in average earnings in the current financial year, edging down to 8.5% in 1991-2.

THE autumn statement was the first important economic policy announcement since the pound's entry into the ERM last month. But sterling's membership of ERM may turn out to be a mixed blessing, if it means that base rates have to be kept high during a period when the economy is crying out for reductions.

The Treasury recognises this danger. But according to one insider: "As long as we do not cut rates until the markets believe that it is fully justified, there should be no problem."

The pound, however, has been trading in the lower half of its ERM range for most of the period since entry was announced on October 5, even with base rates at 14%.

Although part of its weakness reflects market expectations of further base-rate cuts, it has also been influenced by the government's political difficulties and worries about Britain's lack of competitiveness at its ERM central rate against the D-mark of DM2.95.

And the markets saw little in the autumn statement to reassure them on sterling. The Treasury expects unit labour costs in manufacturing to rise by between 6% and 7% next year, roughly three times the average of Britain's international competitors.

Gerard Lyons, economist at DKB International, said: "The statement provided little new support for sterling, which remains vulnerable. If sterling is not to fall to the bottom of its ERM band there may be little room for the chancellor to manoeuvre intest rates significantly low."

There is a wa)ut for the chancellor. Mablm Roberts of Phillip & Drew expects Major to shift sterling on to he narrow 2.25% bands (the ERM over the next 1 months, as Britain's inftion rate comes down. This could make it easierto cut base rates, by lniting the pound's movments even further and b underlining the governmat's commitment to the ERM parity.

It might wll be needed. The econom has slowed more sharpy than the Treasury expcted when it took the deasion to enter the ERM. If the policy dilemma btween ERM membership and lower interest rates imposes itself, Major will be severely restricted in his ability to turn the economy round in time even for a 1992 general election.

Talking the economy out of a downturn

JOHN MAJOR, in presenting the Treasury's new economic forecast last week, made sure that the health warning was printed clearly.

"The Gulf crisis and its effects on world oil markets make the future unusually difficult to predict," he said. In other words, blame Saddam Hussein if we get it wrong again.

But the forecast, like so many before it, presents a picture for the economy in which, however uncomfortable the position is now, it gets much better in a year's time. Inflation is slated to fall to 5.5% in the fourth quarter next year, from a predicted average of 10.25% for the current quarter. By November 1991, the economy will be recovering nicely, and the current-account deficit will be on its way to oblivion.

The Treasury forecast, as it happens, is not very different from the consensus among independent economists. And, as Brian Pearce of the ITEM Club discusses below, it does not appear to have required much bending of the Treasury model to produce.

The question we must ask is if we should ever believe the Treasury's economic projections, or at least the gloss chancellors put on them.

Suppose that, a year ago, Sir Terence Burns, the government's chief economic adviser, had presented the chancellor with a forecast showing that inflation would be in double figures in the second half of 1990. Would this figure have been published? I doubt it, and for two reasons.

The first is that the forecast is constrained by the need to present an idealised version of policy. An accurate forecast of this year's inflation path, for example, would have required the Treasury to admit in advance that local authorities were going to bust the government's guidelines for average poll-tax levels.

The second reason is that the inflation forecast has a key role in influencing expectations. It may be, as indicated in their response to sterling's entry into the European exchange rate mechanism (ERM) that union negotiators take little notice of Treasury predictions of sharp falls in inflation. They believe it when they see it.

But the forecast does play a part in the behaviour of companies, in the way they set prices and their willingness to resist pay claims. An employer is more likely to stand up against a double-figure claim if he believes inflation is likely to drop to 5.5%.

It also features importantly in financial market expectations, and this is particularly important within the ERM. Who would hold sterling, apart from the fact that its high-interest status would be guaranteed, if inflation was officially projected to stay around current levels for the indefinite future?

Major was as keen this time to influence fragile business expectations, in an economy now admitted in the official forecasts to be in recession.

Thus, the prospect of a significant recovery in output in the second half of next year was given great prominence, while observers could have been forgiven for missing the fact that, on the forecast, the economy will be in decline for the next six months. Whether the beacon of that second-half recovery will shine through the winter gloom remains to be seen. It will be no surprise to me if by the March budget the expected 0.5% growth in the economy next year has disappeared.

The political requirement to minimise the recession is a pressing one. In spite of all the government's rhetoric, Britain is not going to adjust to German-style anti-inflation discipline this side of a general election. Indeed, this is part of the Treasury forecast. This year and next, unit labour costs in British manufacturing are predicted to grow at between two and three times the international average. The Treasury expects consumer spending to remain perky (up 2.5% this year, 1.75% next), which does not suggest a savage squeeze on wages.

There is, therefore, a perceived need, and it was evident in Major's tone last week, to try to ensure that the recession is both shallow and short-lived. Even then, the forecast is for a small (0.5%) drop in manufacturing output next year, after zero growth this year, as well as a 2.5% fall in business investment.

In economic terms, there are advantages in getting the misery over with now, if it means we do not have to go through another difficult adjustment after the election.

In its recent bulletin, the Treasury was candid about recent forecasting errors. The failure to predict the size and consequences of the Lawson boom was explained by a series of factors, not least the effects of financial liberalisation. But the Treasury believes if boom conditions returned they would do a better job of forecasting it.

But the new game in town is forecasting the length and depth of the recession. Recession is a complex process. And the response to it by businesses and individuals unpredictable. I fear that the Treasury may be underestimating the extent of the downturn. The programme of gradual, half-point base-rate cuts in prospect for the coming months may be water off a sick duck's back.

It is understandable that Major and his Treasury forecasters do not want to paint a blacker picture than conditions justify. It is also no surprise (although it may not help bring down pay settlements) that in looking to the future, the chancellor stresses the recovery hill that lies beyond the valley. But we should not be surprised, equally, if the recession is worse than we have been led to believe.

A SIMPLE