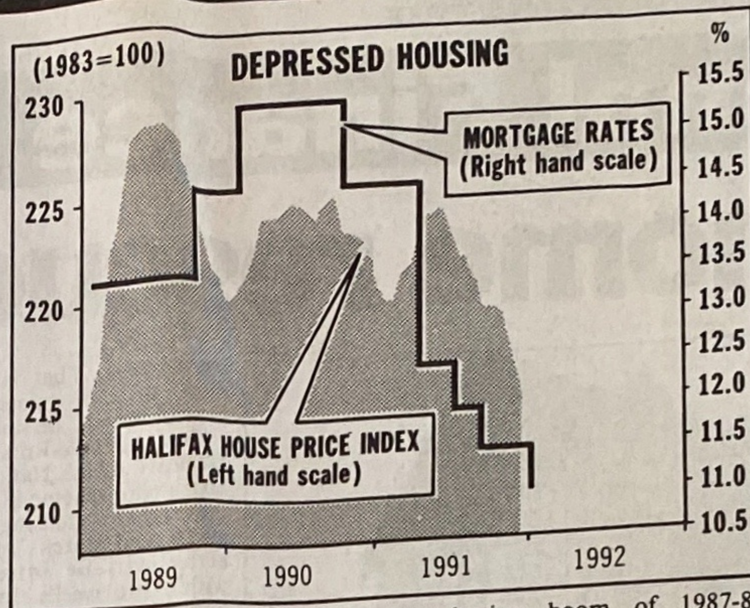
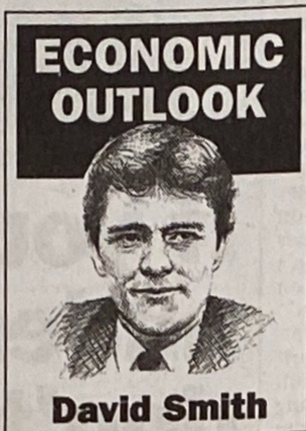
Election blocks the recovery





David Smith

THE ECONOMY, it is now admitted in Downing Street and the Treasury, is not recovering and will probably not do so before the election. Indeed, the election itself, by adding to the mood of uncertainty, is an additional factor preventing recovery.

For individuals, the case for delaying big spending decisions is undeniable. People on above-average incomes, and thinking about either trading up in the housing market or making a large consumer purchase, will be deterred by the possibility of a post-election increase in taxation.

And the more that ministers play up the tax dangers of a Labour government, the more they will scare people off spending ahead of the election. Labour said last week that the increase in National Insurance contributions for those above the present £20,280 ceiling might be phased. In practice, consumers are rational enough to regard firmly pledged tax increases as more or less the same as actual increases.

For companies, similar uncertainties apply. Negotiations over a link-up between American Telephone & Telegraph (AT&T) and Cable & Wireless seem to have been put on ice until after the election. Throughout industry, with the notable exception of Nissan in Tyne & Wear, investment decisions are being postponed until the political situation is clarified.

There is no doubt that election uncertainty is complicating the economy's emergence from recession. Indeed, I described this last June as the Tories' catch-22 – their need for a pre-election recovery is compromised by the electorate's natural tendency to retreat further into its shell until the dust has settled.

The Tories now believe that recovery is not an essential ingredient for election victory, so long as people can be made to believe that the future is brighter than the past. They may be right.

The interesting question is, by what route will the recovery arrive and how long it will take?

For some time, my view has been that the debt burden left from the overblown 1980s, coupled with the desire of companies and individuals to nurse painfully burnt fingers, would mean that recovery, when it comes, will be muted. This is now the majority view.

The symptoms of this are not hard to find. The Abbey National led top building societies into a round of mortgage-rate cuts last week not out of altruism, but because of the depressed state of the housing market – which Norman Lamont's temporary suspension of stamp duty has failed to lift.

Perversely, the mortgage lenders appear to be contributing to the weakness of the market by adopting a highly cautious approach to property valuations. People applying for an 80% mortgage on a property valued at £100,000 are likely to be told they can have their 80% mortgage, but that the building society thinks the house is worth only £90,000.

Roger Bootle of Greenwell-Montagu characterises the likely recovery as so weak "you may need a microscope to see it". Michael Saunders of Salomon Brothers says: "The monetary squeeze on the domestic economy is tighter than on any occasion since the 1920s. The pain felt by over-indebted borrowers, and the experience of falling house prices, is likely to create an aversion to debt that will restrain economic growth for several years."

I agree with all that. The idea of a type of biblical retribution – seven lean years to follow the seven fat years of consumer-led growth in the 1980s – has a lot to be said for it. And although there is some dispute about the role of real interest rates in stimulating demand (the official view is that nominal rates are far more important), nobody can deny that real rates are high. Even if the next move in Bundesbank rates is down, they are likely to remain so.

Add in the effect of the downturn in the world economy – delayed recovery in America, downturns in Japan and Germany – and the prospect is indeed bleak.

So why is there a little niggle at the back of my mind – a small doubt about whether things will turn out in quite this way? The answer is that the government, in its determination to get re-elected, is throwing quite a lot into the pot. Base rates fell from 14% last February to 10.5% in September and will drop further if the chancellor gets half a chance. The autumn statement featured substantial increases in public spending for 1992-3, with £11 billion added to programme spending and £5.6 billion to the planning total.

As for the budget, the prospect of a £20 billion public-sector borrowing requirement for 1992-3 has not dampened the government's enthusiasm for tax cuts. Indeed, the budget bidding starts at 1p off the basic rate of income tax, or its equivalent in higher allowances. A £3 billion tax-cutting package will not be a surprise.

It may be that all this, and more, can be absorbed without undue excitement by a flat, debt-laden economy. But the other possibility has to be allowed for – that the government is committing the classic error of postwar demand management – overstimulating an economy that is ready to recover of its own volition.

This is not, as I say, my main view. But imagine a situation in which the Tories are re-elected and the fear of higher taxation is removed. At the same time, the full impact of interest-rate cuts and tax cuts, as well as higher public spending, are kicking in. The possibility would be of a post-election consumer splurge, one that a re-elected Conservative government would not welcome.

Why not? The clear preference in Downing Street is for a steady but sustainable recovery, building up gently through the lifetime of the next parliament. A repeat of the Nigel Lawson problem, the post-election boom of 1987-8, would again put the economic cycle out of synch with the political cycle. It would be stamped on hard. Just a possibility, as I say, but one to think about.

Finally, there are one or two loose ends to clear up from my piece of three weeks ago, "Forecasters with egg on their faces".

Peter Warburton of Robert Fleming and Paul Turnbull of Smith New Court should have featured among the best for their predictions, in December 1990, that gross domestic product would decline by 1% last year. Turnbull also got close on inflation, unemployment and the balance of payments, and was spot-on with a prediction of 10.5% base rates for the end of 1991.

There are honourable mentions too for Gerard Lyons of DKB International and Neil MacKinnon of Yamaichi Securities, both of whom predicted a 1991 decline in gross domestic product. None of these four, incidentally, featured at the time in the Treasury's monthly compilation of independent forecasts.

The overall message, that the forecasters did badly last year, still stands. Of 32 forecasters sampled by Consensus Economics at the end of 1990, only eight predicted that GDP would fall during 1991.

Another point has been raised by readers, put up to it no doubt by economists. They ask: Did we, having been so free with our criticism, do any better? Modesty would normally forbid me to mention my record, but since I have been asked . . .

In September 1990 I predicted a decline in GDP in 1991, and said comparisons with 1980-81 were becoming increasingly appropriate, putting us firmly in the "deep recession" camp. On December 23, 1990, I wrote: "Many overborrowed sectors of the British economy resemble some Latin American debtor country, in which a long period of austerity is needed. The recession will not be short and shallow."

So far so good.