No medals for Lamont in the ERM race

In My View

Gerard Lyons

THE Olympics brought some temporary relief from yet more depressing economic news and rekindled a memory of the 1979 General Election.

A Conservative Party political broadcast showed British runners leading an international field. But our runners then started to slow, as their coaches placed weights, marked with the words 'taxes' and 'unions', around their necks. Under this extra burden, the British athletes were soon overtaken by foreign competitors. The crowd called for a change of management: out went the old coaches, in came the new team. Very effective. The runners were the economy, the old coaches Labour and the new management, the Conservatives. In no time, off went the weights and the British runners were back in the lead.

Can you imagine a remake of this broadcast now? The location, which I think was West London stadium, would have to be the same, for despite the construction boom of the late Eighties, little money found its way into socially useful projects such as public housing or sports stadia.

In the 1980s, the British runners would have led the rest of the world. The crowd remains happy — at least those that backed the winner — and the management is unchanged. But if this were to be a true approximation of the economy, there would have to be a drugs test and the British runners would fail it! We would have to show our runners were ahead of the field merely because they had an advantage which had not really made them better, nor was it going to do them any good. It was an illusion, just like the economy's performance — the only way it kept ahead was because of the artificial boost from too much debt.

Take the stimulus away and the new broadcast would show the British runners well behind international competition and almost lapped. The disappointing message is that once we get back to basics, Britain is way behind the rest — and at a time when the competition is slowing down. At the very least, this situation demands a change in tactics.

Prudent economic policy should aim to avoid bouts of excessive inflation or periods of prolonged recession. The fact that Britain has suffered from both in a relatively short space of time suggests policy is badly flawed.

During the late 1980s, one could argue with justification that policy was short-sighted; little attention was paid to the supply-side and to longer-term prospects. Debt abounded and asset price inflation followed.

Today, the converse is true; the Government has a clear long-term anti-inflation policy. But the pursuit of zero inflation over all other objectives is neither the correct policy for the UK's present plight, nor a wise policy for future prosperity.

The Government has failed to identify that the problem is too much debt. The fortunate are able to boost savings and repay debts, but with real interest rates so high, more people and companies are struggling to contain their debts. The casualties will be high and will include many entrepreneurs. Even those with the ability to spend, lack the confidence to do so.

Just as forecasting models underestimated the extent of financial deregulation and its impact in boosting activity, they are now underestimating the impact of the debt overhang in prolonging the recession.

But it is not just a debt problem. The Government is ignoring the current account deficit, which could hit £12 billion this year. In a recession, we can see the trade deficit for what it really is: testimony to a lack of investment in Britain's manufacturing base. Thus we suffer from a high rate of import penetration.

When demand recovers, imports and the trade deficit will surge. Either interest rates will have to rise to protect sterling, or policy will need to be tightened to curb domestic demand and limit import growth. Either way, the trade deficit will remain a constraint on the economy.

Current policy is wholly inappropriate. The only way to solve the debt burden is to cut interest rates aggressively and, ideally, to below the rate of inflation. Unfortunately, policy errors limit the downside for UK rates: sterling entered the European exchange rate mechanism at the wrong time and at the wrong rate. This error was compounded by the EC's decision not to allow a Deutschmark revaluation in the wake of unification and, as a result, the Bundesbank had to raise interest rates, thus limiting the scope for a fall in UK rates. If interest rates fell, sterling could ease to a more sustainable level against the Deutschmark and dollar.

Since this is ruled out by the ERM, the second-best solution would be to offset the tightness of monetary policy by relaxing fiscal policy. However, the signs are not good, with the Government overzealous in its controls on public spending this autumn. Furthermore, the arbitrary constraints placed on fiscal policy by the Maastricht convergence criteria will limit the scope for a much-needed fiscal boost.

Short of leaving the ERM, there is no obvious way out of the present plight: policy will prevent a self-sustained recovery in domestic demand, while export growth will be constrained by the weakness of growth overseas.

There may be some near-term relief for the Chancellor if the French vote 'yes' in their Maastricht referendum and the Bundesbank decides not to raise interest rates again. Both are possible. Norman Lamont could then address the Conservative Party Conference with the markets talking about UK interest rates falling, albeit only by a minimal amount. But even if Lamont survives the present crisis, it is difficult to see him turning the economy round.

The trade-off for his policy is too high. It points to below-trend growth, low output and high and rising unemployment for some time. Expect unemployment to reach 3.4 million by the end of next year. The Government may think it can tolerate this, but I am not convinced.

Understandably, inflation will remain low. But the skill is not getting inflation down at the expense of growth, but keeping it down when demand is recovering. One of the biggest ironies is that the absence of a manufacturing base could prevent the Prime Minister from achieving his non-inflationary goal. To achieve zero inflation, prices need to fall in the manufacturing sector in order to offset stubbornly-high service sector inflation. This does not seem possible. If the Government was serious about reducing inflation, it should be boosting the productive potential of the economy. Yet we are in for a period of further corporate retrenchment, with investment suffering.

If we are to build a successful economy, the UK needs to invest more in its manufacturing base, boosting its size and its quality, ensuring that it can satisfy domestic demand and boost export growth. Although the Government is still committed to creating the right environment in which investment can occur, this is a long way off and will require a more active Government role.

There is a danger the success Britain has achieved in attracting inward investment by Japanese firms may be regarded as a substitute for the fundamental shifts required in the economy. But if we are to rely on inward investment, the Government needs to improve the education, skills and quality of the UK workforce so Britain can continue to attract such investment.

The Prime Minister's desire that sterling should replace the Deutschmark as the ERM's strongest currency surely reflects a misunderstanding: the strength of the German economy led to the Deutschmark becoming Europe's strongest currency — not the other way round. In the UK, something will have to give: either the Government's exchange rate commitment or the economy. At present it is the economy, but a sterling crisis may not be far away.

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William Keegan is on holiday.