ECONOMIC INTELLIGENCE

EI/42 June 1994

CENTRE FOR INCENTIVE TAXATION

THE FUTURE BEYOND OUR KEN

CHANCELLOR of the Exchequer Kenneth Clarke's anxiety about inflation, and his emphasis on monetary policy as his key tool, confirms that the government has no strategy for positive growth in Britain's manufacturing sector.

Britain is not a good "buy" for investors who are adopting a medium-term strategy for their investment portfolios (some of the best bets are in debt-laden developing countries: see page 2). For investors who want to retain an interest in the UK - or employees trying to fathom whether they are still likely to be made redundant - the problem is to decide whether Britain will continue to be its worst enemy. The answer is not an optimistic one.

Whether Premier John Major is now sacked or not by the Tories after the hammering they have been taking in elections is irrelevant to economic strategy, because a consensus exists between the Treasury and the Bank of England. Unfortunately, the thrust of conventional economic wisdom is entirely misguided, a fact that emerged during Mr Clarke's speech to industrialists on May 17. He said: "Too many people still hanker after the go-go growth of living standards they enjoyed in the years of boom. Well, this Chancellor does not want a boom because boom gets followed by bust."

In fact, there could not be a boom of the kind the Chancellor fears, even if he pulled out all the stops for it. Why? Because wage levels are low and unemployment high; and investment will remain painfully low for several years as the country wallows at the bottom of the OECD's league table of savers (due mainly to government dissaving). On the other hand, there *will* be a bust, at a time that can be predicted; and it *will* be caused by conditions that the Chancellor's monetary policy cannot neutralise.

The flaw in public policy can be identified as the failure to employ a theory of the business cycle that works. The theory that correctly predicted the Crash of '92 has been exhaustively documented in EI since 1988. One of the crucial relationships is illustrated in the graph.* This indicates how the cost of land applied increasing pressure on people's living standards, with predictable consequences for industrial output and, eventually, the whole economy.

The theory identifies the land market as the mechanism that cyclically drives the economy over the precipice. What does it tell us about the next few years? Be your own analyst and put the EI theory to the test.

* The Chancellor fears a "go-go" boom. But with the underlying rate of inflation at a 20-year low, the slight rise in wage settlements in the last three months presents no risk of "overheating" from the demand side of the economy. On the supply-side, the price of borrowing money in the capital markets is low enough to encourage entrepreneurs. No problems so far! What of the third factor of production - land? There has been some recent alarm at the sudden rise in the price of residential land in the south-east (see EI/41). What does this mean "on the ground"?

Take the prospects for Higgs & Hill, the construction group that is asking shareholders for £22.2m to buy land on 13 sites. The average cost of a plot: £24,000. The average sales value per house: £82,000. This yields a land/house price ratio within the limits of profitability, for the company, and affordability, for the consumer. And the psychology of speculation among home-owners, which is a crucial element of unsustainable booms, does not exist.

* For the next few years there can be no housing-led activity of the kind that drove the fake boom of the late '80s. Yet the Chancellor is haunted by the legacy of the Lawson years: he is tilting at windmills. The result is twofold. First, misinformed policy is protracting the recession: it is not laying the foundations for the tougher competition in world markets that is in prospect when the rival economies finally lift themselves out of the trough. Second, the government is not preparing to prevent the boom/bust that will one day take us back to '92. But by then, our Ken will not be around to pick up the pieces.

* *Urban Land Markets: Policies for the 1990s*, Paris: OECD, 1992, p.53, based on data from Ronald Banks (editor), *Costing the Earth*, London: Shepheard-Walwyn, 1989.