Room for more optimism in growth forecasts

It is ironic that the Government will have to revise down its growth forecast at precisely the time the economy is picking up. In early July the Chancellor will unveil his summer economic projections. In the last budget Mr Clarke was excessively optimistic when he predicted 3% growth this year. Judging from the economy's performance to date a downward revision is inevitable - possibly to 2%. But as previous policy easing feeds through and prospects on the continent improve growth should now start to rise.

The economy has been growing at a sluggish pace for some time. Trend growth since the war has been 2.4%. Yet we have not even achieved this growth in any quarter since the last three months of 1994. In the first quarter of this year growth was a miserly 1.5% on an annualised basis. Such performance fully justifies recent interest rate cuts. It also suggests the economy has plenty of slack, allowing it to grow above trend for many years before inflation pressures appear.

Yet financial markets are concerned that inflation is around the corner and a replay of the Lawson boom is in sight. That is wrong. The economy still faces downside risks in the next three months, but thereafter it should grow at a steady pace, with low inflation. Next year, growth could even reach 3%, but inflation will remain within the Government's 2.5% target.

The economic picture remains mixed. The manufacturing sector is still weak, as Friday's survey from the Confederation of British Industry showed. Export orders slowed to their weakest level since February 1994 and despite some improvement in domestic conditions, there has been a fall in the number of manufacturing firms who expect output to rise in the next four months.

Manufacturing and service sector employment has fallen this year, following strong jobs growth in the last two years, pushimh the unemployment rate down to 7.7%. Despite this, there has been a lack of a 'feel-good' factor. Consumer spending has been sluggish. Retail sales fell 0.1% in May and rose by an annualised rate of only 2% in the last three months.

Yet financial markets remain concerned about credit conditions. So too does the Bank of England which last month warned lenders about cheap rates. The latest lending figures must have added to their concern.

There are two main components of personal borrowing: consumer credit and mortgage lending. The amount of consumer credit is, however, dwarfed by mortgage lending. After rising steadily in recent years consumer credit has been buoyant recently. Despite this, personal borrowing has remained subdued, as net mortgage lending has been weak. Now, with house prices rising, the negative equity effect will fall and more people may be willing to take advantage of cheap mortgages available.

This was evident in last week's data which showed mortgage lending by banks rose £696 million in May, well above the monthly average of £609 million in the previous six months. Mortgages by the building societies were £4.2 billion in May and in the first five months of this year are 14% higher than the same stage of last year.

The Chancellor needs to watch credit conditions which support stronger future growth but developments in manufacturing will continue to depress overall activity during the summer. With continued good inflation this should allow scope for a final 0.25% rate cut to 5.5% in the next few months.

Thereafter further rate cuts may not be necessary judging from the recent growth in credit and could be counter-productive, unnerving the financial markets, pushing long-term interest rates up.

Monetary policy should be set on current developments and immediate risks. Not always on expectations about what could happen in one to two year's time.

If interest rates need to rise in two year's time when the economy is stronger that is fine, but to not cut them now because of what some people fear about two year's time is wrong.

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The economy will grow steadily but won't boom, says **Gerard Lyons**

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