Interest-rate fears fade as growth slows

Market fears about inflation are overdone. There is no justification for further rises in base rates, argues Gerard Lyons

INTEREST RATES are not far from their peak. In my view base rates do not need to rise but the government's rigid inflation target could yet trigger the Bank of England to tighten policy. Whatever they decide, the authorities should be patient as domestic and international trends suggest growth is already slowing.

Developments in Britain have to be put in an international context. A recovery in world growth, led by America, has given a big boost to the British economy in recent years, ensuring government policy was successful. Higher taxes capped domestic demand and allowed government borrowing to fall, while improved world growth allowed exporters to benefit from sterling's collapse after its exit from the ERM.

International events still have a key influence on British prospects. Disinflationary pressures point to steady world growth, subdued inflation and low interest rates. It is hard to imagine Britain bucking this global trend and experiencing the rapid growth or high inflation that is leading to demands for ever higher base rates.

Intense global competition is keeping inflation down. British companies are not immune to global trends and need to cut costs to compete with low-cost and increasingly high-quality exports from southeast Asia.

Consumer behaviour the world over has changed. After the excesses of the late 1980s, people now expect value for money. Job insecurity and sluggish wage growth have reinforced this, so producers and retailers have to keep prices down to maintain market share. Recovery on the Continent has been weak this year because of a sharp fall in business and consumer confidence. It is not just Britain that is suffering from a lack of feel-good factor.

We are far from the lax policy and buoyant credit conditions of the late 1980s. Thus talk of high inflation and rising interest rates is unjustified. At best the world economy will experience steady growth, at worst recession. In either case inflation will be low.

Financial markets have begun to realise this. Last year three key fears overhung markets: higher inflation, rising official interest rates and high budget deficits. This year inflation and interest-rate worries have eased, driving markets higher. However, worries about budget deficits should persist for some time, particularly if world growth disappoints.

The trigger for an easing in global inflation fears was a change in American fortunes. Mexico's financial crisis and slower growth in the United States prompted a dramatic shift in expectations for interest rates. The top graph shows where the market expected American rates to be by June. Last October and November, pessimism about inflation prevailed. Sentiment changed early in December and fears of higher American interest rates have since evaporated. Now American rates look set to fall before the end of the year. The market was also wrong about Germany and Japan, where rates have fallen this year.

Is Britain about to buck this international trend? I think not. The speed with which inflation and interest-rate fears have eased overseas suggests the chancellor should treat market fears of higher British inflation with a pinch of salt. Previous interest-rate hikes and tax increases are still feeding through, but are already slowing the economy, with retail sales, mortgage lending and industrial production all slowing.

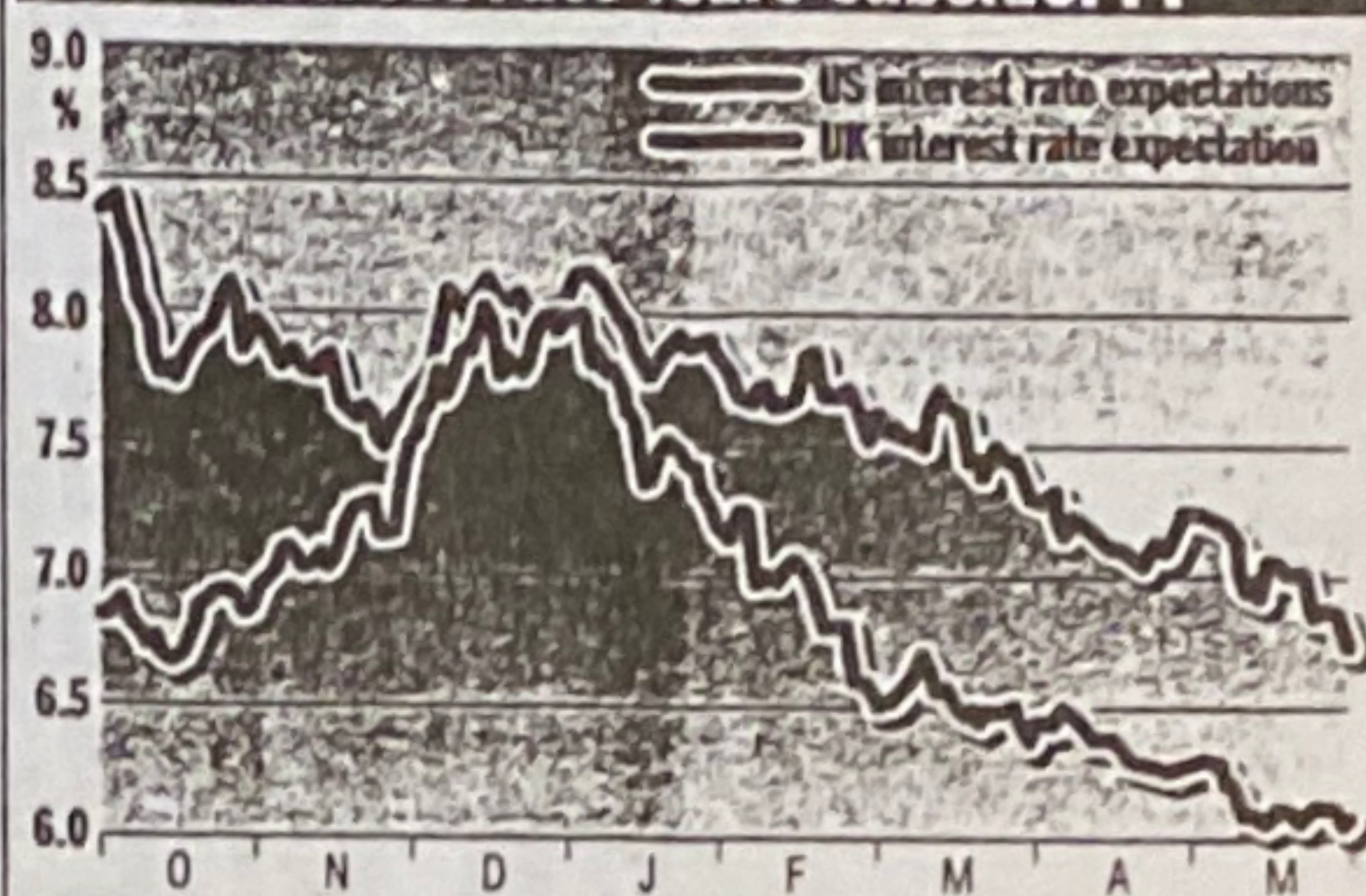
‘Previous interest-rate hikes and tax increases are still feeding through but are already slowing the economy’

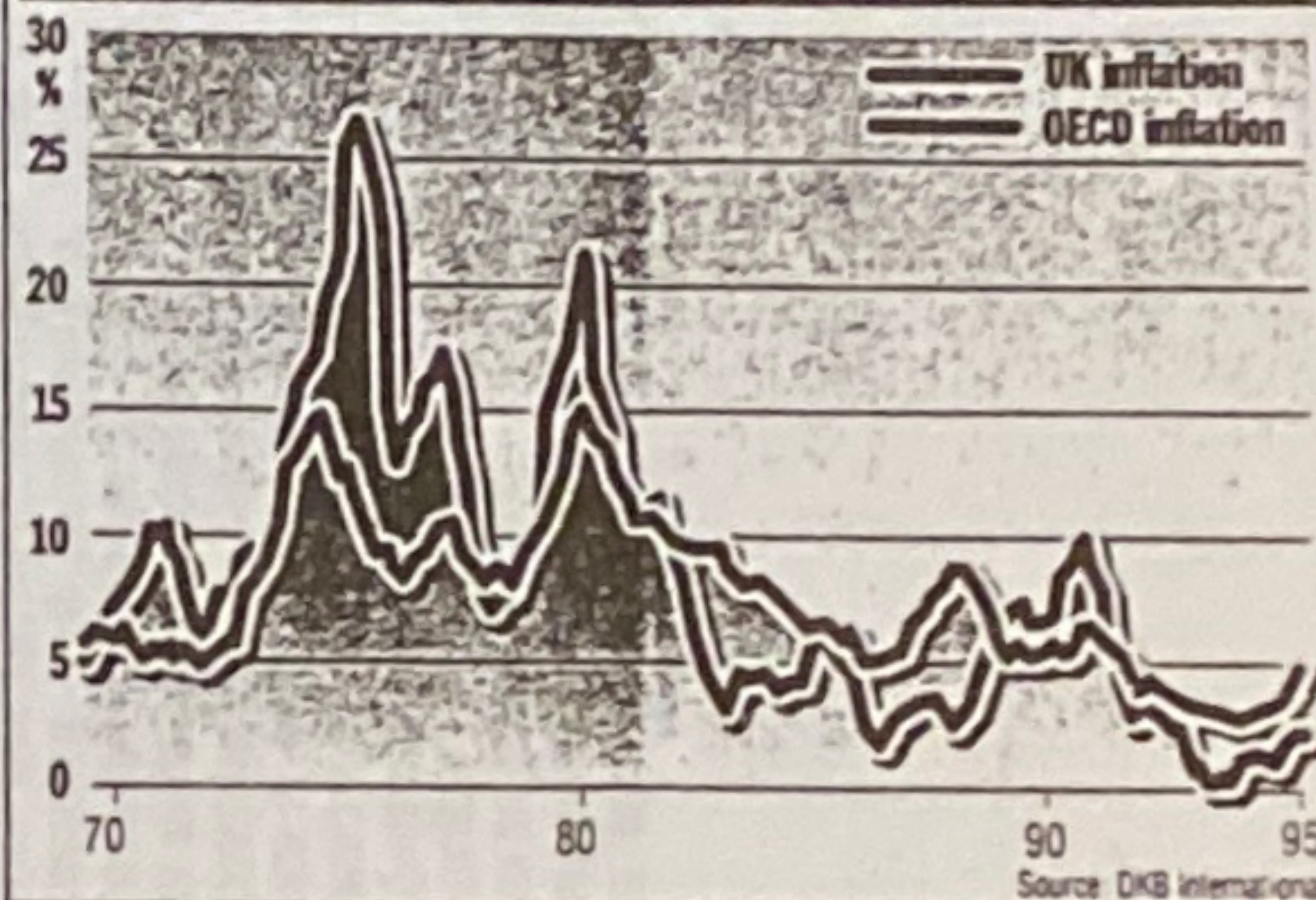
However, I can understand the Bank of England's caution. Britain has a poor track record on inflation. We also seem to like inflation. Witness the way people crave higher house prices. This needs to change.

The Lawson boom shows that a dash for growth now would create nothing more than a fool's gold recovery. What is needed is a balanced recovery where investment is boosted. The areas of the British economy that do well are those that invest. And the success of inward investment, attracted by our flexible labour market, shows that British productivity can be as good as elsewhere.

Despite the fact that the corporate sector has repaid debt and now has a healthy cash pile, investment has been poor. Many factors explain this but interest-rate uncertainty is not helping. Higher rates hit investment in two ways: preventing a recovery in domestic demand, thus reducing the need for firms to invest, and raising the cost of capital. Since interest rates doubled from 7.5% to 15% under Nigel Lawson, is it any wonder firms do not want to gear up for higher investment? Companies want to see a period of stable interest rates, allowing demand to recover.

The pound's fall does not point to the need for higher rates. British policymakers have often been obsessed with a strong pound. Harold Wilson's attempt to avoid devaluation and sterling's ERM days are two examples. Sterling is just another price. It should be allowed to move freely and correct economic imbalances. When policymakers manipulate sterling it triggers problems elsewhere in the economy.





After sterling's ERM exit the market wrongly expected devaluation to trigger inflation. Worries over the pound's recent fall are also overdone. When the pound left the ERM the economy was weak, with spare capacity. Now the economy is stronger and has less capacity. But strong competitive pressures have prevented higher commodity prices feeding through fully into higher factory gate or retail prices.

The inflation impact from sterling's fall has been absorbed in the supply process, hence current inflation remains low.

The biggest risk to UK inflation is a rapid rebound in growth hitting supply bottlenecks and forcing firms to raise prices. This explains the Bank of England's concern and why it is following an intermediate growth target. The Bank doesn't want to take any risks. Just in case higher growth triggers inflation, it believes rates should rise, even if current inflation is low. The trouble with this is that the cost is borne by the real economy, as was the case in the ERM, with output being hit.

Two lessons emerge from the present policy debate. First, there is a strong case for resisting the bandwagon towards an independent Bank of England. If left to itself, the Bank will always opt for pushing rates higher. Independence means monetary overkill, with interest rates rising too far. Also it does not guarantee consistency between monetary and fiscal policy. Nor is it democratic.

It would be wrong to put all the blame on the Bank of England. It is trying to prove its credibility by achieving the government's inflation target, which is to have underlying inflation between 1%-2.5% by the end of this parliament.

The second lesson is that this target is inappropriate. The target is very low and the time over which it is to be achieved takes no account of the economic environment. It is set in terms of an arbitrary link to the end of this parliament. Perhaps we should shift to a "medium term" target like the Bundesbank, thus allowing greater flexibility in response to economic conditions.

Base rates are 6.75% and should stay there. Even if rates rise, they will go no higher than 7.5%. This may be too optimistic for the market pessimists but let inflation be the judge and jury of that.

● *Dr Gerard Lyons is chief economist of DKB International, the London subsidiary of Japan's Dai-Ichi Kangyo Bank*