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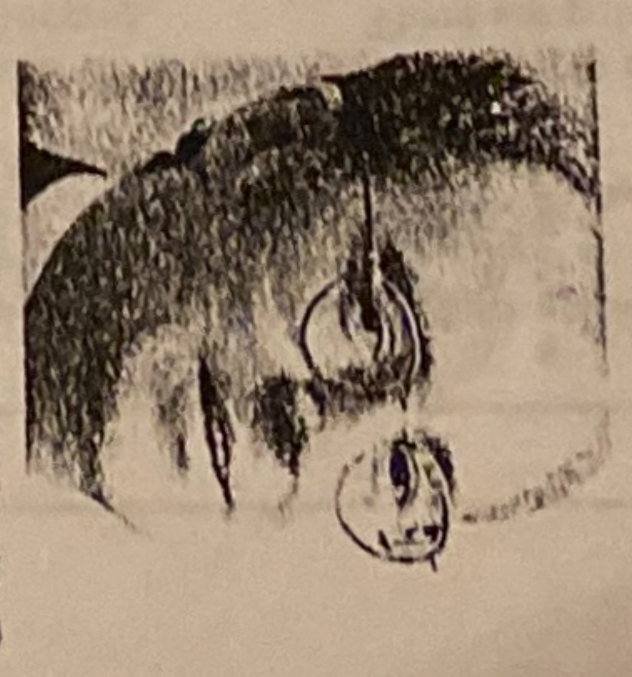
Clarke can afford to let the economy cruise on



ECONOMICS WEEK

This recovery is different. Calls for higher interest rates are misplaced, says **Gerard Lyons**

No wonder economics is often referred to as the dismal science. No sooner has the economy gathered momentum than there are countless calls from economists for higher interest rates.

Such demands could be understood if the economy had been growing at a rapid pace and was now about to accelerate. But it hasn't. The economy has been growing at only a sluggish pace and is now simply picking up speed. Rather than put his foot on the interest-rate brake, the Chancellor should sit back, ignore the worries of the backseat drivers, and enjoy the journey. It could turn out to be more trouble-free than many imagine.

Experience teaches us to be cautious about economic prospects, but there is already enough evidence to show that the UK is experiencing a very different type of recovery. Inflation has remained low and the economy may be able to grow at a far stronger pace than generally believed before inflation rises.

Memories of the Lawson boom still haunt UK policy makers and some of my fellow economists. It is understandable that people want to avoid a repeat of that experience. Thus, last week's news of a surge in retail sales in August, alongside continued strong monetary growth, has caused some alarm.

But this is not a repeat of the Lawson boom. In the mid-1980s the economy had already been growing at a strong pace before it received additional boosts from a relaxation of credit controls and large interest-rate and tax cuts. Even the rise in house prices now is merely a bounce from depressed levels, not a new bubble that will burst. But as the economy grows it is necessary to monitor five key inflation risks.

■ First, is there sufficient spare capacity in the economy to prevent inflation bottlenecks being hit? Since the start of last year, the economy has underperformed, despite misplaced talk of overheating. GDP has risen by an annualised rate of only 1.6% in five of the last six quarters. This is below the economy's long-run trend growth rate of 2%. Just as important, it is well below the economy's potential growth rate. Even though disinflation has held back the recovery it has also improved the economy's potential growth rate, as firms are using existing capacity and employees more efficiently. Thus there is plenty of scope for the economy to grow before inflation bottlenecks appear.

■ Second, commodity-price inflation is not a risk. Even when commodity prices have surged in recent years this has been absorbed in the supply process, with retailers and producers keeping their prices down. There is always the possibility of some temporary increase in oil prices and food prices, but this should not be a worry.

■ The third is the key area of pay. Not only do wages account for the bulk of a firm's costs, but the clearest demonstration of the disinflationary environment has been the extent to which wages have been squeezed. If wages do creep up, in excess of productivity growth, this would boost underlying costs and trigger inflation. But there is no evidence of this. There is still ample spare capacity in the labour market. And the natural rate of unemployment, below which inflation pressures surface, may be far lower than many expect.

Despite the postal and transport disputes this summer, wages remain well behaved, particularly in the private sector. However, if Labour wins the election they will find it difficult to control wages in the public sector.

■ Fourth, price resistance has also been a key feature of this recovery, as consumers have not tolerated price increases, forcing retailers to keep prices down. During the Lawson boom, with house prices and wages rising sharply, people were prepared to tolerate higher prices.

A key test of whether inflation will pick up is whether consumers will remain price-resistant. They should, particularly if wage growth is subdued. But if firms are greedy and push through higher prices then this, alongside the recovery in the housing market, could fuel inflation expectations. And this, in turn, will feed through into wage demands.

■ Fifth, the fear the Government will reflate the economy appears exaggerated. Interest rates have not fallen as much as they could have done, given the favourable inflation environment. Adjusting base rates of 5.75% for headline inflation of 2.1%, the level of "real" interest rates is 3.65%. This is very high. In Germany, real rates are only 0.9%. Although monetary growth is strong, this liquidity need not trigger inflation, given the spare capacity in the economy.

IN THE last six months the annual rate of inflation has decelerated from 2.7% to 2.1%. Although the Government's underlying measure of inflation has remained stubborn around its current level of 2.8%, it will drop below the 2.5% target zone in coming months, as good news on producer prices feeds through.

The Chancellor should not cut income taxes in the Budget. The economy is recovering and doesn't need them, and the poor budget position doesn't justify them. But the benefits of low inflation should be passed on, with the Chancellor gradually pushing rates lower to see how fast the economy can grow. He need not drive the economy recklessly, but may discover it can cruise at a pretty fast speed.

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