Servicing the inflation black spot

The key to Britain's inflation performance is the service sector. Inflation there is stubbornly high and a reduction is necessary before we can become confident about inflation prospects. Without this, any fall in British rates below Germany's this year is unlikely to be sustained.

Sterling's strength, sluggish monetary growth and the weakness of demand suggest there is strong justification for lower interest rates. However, the Bank of England remains concerned about underlying inflation and may be wary of undermining sentiment towards sterling through premature rate cuts. It may therefore require the financial markets to signal that they expect rates to fall before the Government feels confident about lowering them. If the markets discount a rate cut, sterling can remain strong. However, the futures market shows that the next base rate cut is not expected until the end of the year and, only then, after German rates have fallen.

Essentially, the markets do not think UK rates can go below those of Germany. This may appear remarkable when one thinks of Germany's problems but it reflects financial market confidence in the Bundesbank. Investors expect German inflation to fall eventually and non-inflationary growth to resume.

However, if Germany's problems persist, financial markets may allow UK rates to fall below Germany's. This would imply that investors regard sterling as a safer currency than the mark. It is important to realise that sterling's post-election rise was because of the removal of political risk. For sterling to appreciate further against the mark international investors need to be convinced Britain can become a low inflation country.

British inflation has fallen significantly in recent years. The Confederation of British Industry shows unit labour costs rising at their lowest rate since 1958. Underlying producer price inflation is growing at 2·8 per cent, its slowest since June 1969. Meanwhile, retail price inflation has fallen from 10·9 per cent in October 1990 to 4·3 per cent in April. This improvement is hardly surprising, given the depth of the recession.

In fact, the rise in Friday's inflation data for April was disappointing, even if due to one-off factors. It followed poor average earnings data on Thursday. It is difficult to draw too much comfort from British inflation being below that of Germany. Germany will only need to go through the painful consequences of unification once whilst we cannot rely on recessions to keep our inflation rate low.

The key test for Britain now is whether the improving trend seen in inflation over the past few years can be sustained once demand recovers. That is, will we be any closer to achieving non-inflationary growth?

We probably won't find the answer this year as growth will remain weak. The US economy is again losing momentum. Japan is heading for recession whilst European growth is stagnant. With world demand weak, oil and non-oil commodity prices are likely to remain low. This deflationary international environment provides a favourable backdrop for UK inflation.

ECONOMIC AGENDA

by Gerard Lyons

However, inflation in the service sector is stubbornly higher than elsewhere. This is clearly illustrated from Friday's RPI data, where service sector components rose strongly. For instance, the price of leisure services rose 8·6 per cent in the year to April, whilst catering was up by 6·1 per cent. Consumer price deflators give the same message. And the possibility is that service inflation is being underestimated. Service components account for 35·8 per cent of the Retail Prices Index, whilst the service sector accounts for two-thirds of the economy.

The stubbornness of service sector inflation is not just a British phenomenon, although it is higher here than elsewhere. It is seen in most industrialised countries. In France service sector inflation is 4·2 per cent compared with consumer price inflation of 3·2 per cent. The respective figures in Germany are 5·7 and 4·6 per cent; and in the US 4·2 and 3·2 per cent. There are two main reasons for this: productivity tends to be lower in the service sector; whilst service sector output is often localised, and therefore not subject to international competition.

Indeed, it is not necessary that the price of a haircut in London should be the same as one in New York. By contrast, one would expect that, after allowing for the costs of transport, the price of shampoo should be similar. If not, it would be in someone's interest to take advantage of the price differential.

The price of tradeable goods is important for international competitiveness. But it would be wrong to ignore the problem of service sector inflation. Stubbornly high service sector inflation will continue to boost retail price inflation. This will directly influence inflationary expectations, forcing wages up, even in the tradeable goods sector. People still need their hair cutting.

Therefore, we have a problem. If service sector inflation remains stubbornly high, it will make it difficult for the Government to reduce headline inflation and achieve the convergence criterion for monetary union. And it could undermine confidence in sterling.

The worry is that Government policy may not be successful in reducing service sector inflation. When sterling was last in a fixed exchange-rate regime in the 1960s, inflation was higher in the service sector than elsewhere in the economy. And this is likely to remain the case now, with sterling fixed in the ERM. The reason for this is that an exchange rate target succeeds in lowering inflation by squeezing the tradeable goods sector. It does not directly affect the service sector.

This will pose more of a problem now than in the 1960s because the size of the service sector has become more important relative to the rest of the economy.

Either service sector inflation will have to be tackled or, once again, the cost of reducing inflation will have to be borne by the manufacturing sector. For this to occur, we would need a large rise in manufacturing productivity. This could be achieved through investment. More likely it will be achieved by a contraction in manufacturing, with further labour-shedding there.

But if manufacturing bears the strain, services will grow in importance, and the problem of service sector inflation will become more acute. Service inflation will not be curbed by squeezing manufacturing. Instead, wage growth in the service sector must fall, or productivity there must rise. It is a supply-side problem. And although the Government cannot tackle it directly, it should be monitored closely.

I think the first step is for the Government to overcome the measurement problem and publish an inflation measure designated specifically to the service sector.

A useful lesson may be learned from Japan. The Bank of Japan felt sufficiently concerned about this problem that it constructed a corporate service price index. It is measured quarterly and is closely watched by the Japanese authorities. It tries to tackle the measurement of service inflation from the corporate side, the components including insurance, real estate, transport and advertising.

If the Government is to achieve its goal of non-inflationary growth, it would seem sensible to identify the most latent area of inflation and monitor it accurately.

Dr Gerard Lyons is Chief Economist of DKB International, the London-based sudsidiary of the Dai-Ichi Kangyo Bank.

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