Shouting from the rooftops about low inflation

The Bank of England pulled few punches in its advice to the Chancellor during the week. In its quarterly Inflation Report the Bank called for both higher interest rates and a tighter fiscal stance. Such tough talk might be justified if inflation is about to surge, but it is not. The inflation outlook remains good. Even the Bank acknowledged this, saying that the short-term prospect is for a further fall in inflation.

Recently the Bank has been too pessimistic about the immediate inflation outlook, but not now. The Bank believes immediate inflation prospects are good, with underlying inflation set to fall until the middle of next year, before it increases slightly.

The further ahead they look, the better the Bank's inflation forecasts have been. As the economy looks set to grow strongly over the next year, there is widespread concern that this will push inflation up. This has to be a risk, but it is important to put it in perspective. Despite its tough talk the Bank is not concerned about inflation surging to 10%, or even 5%. Their concern is that there is a greater probability of underlying UK inflation being above the Government's 2.5% target in two years' time. How times change! Only a few years ago most economists and politicians would have been shouting from the rooftops if UK inflation was below 3%.

As the Bank's research shows it can only take two to three years for interest rate changes to affect the economy, this explains the Bank's cautious advice to the Chancellor. The Bank is merely trying to establish its credibility by advising the Chancellor on how to achieve the tough 1%-2.5% inflation target the Government has set itself. At this stage of the previous recovery, policy mistakes have been made and the Bank's tough talk is a clear signal to avoid politically motivated policy easing.

A number of factors have helped reduce UK inflation recently. The economy has been growing below trend, not helped by an inventory overhang and sluggish European growth, and there is still spare capacity in labour and product markets. Even though the economy will grow strongly over the next year this does not mean inflation will rise. This economic cycle is very different from previous ones. Inflation has been much lower over the past three years than its average of 8% over the past 30 years. As this has been against a background of low inflation in most other industrialised countries the Bank says this "shows the UK's recent performance to be less remarkable".

Since January 1990 UK inflation has averaged 4.3%, higher than all other G7 countries with the exception of Italy. The fact that the UK has shared in a global environment of disinflation should not lessen our inflation achievement. Furthermore, the recent UK inflation performance has improved and in June headline inflation was only 2.1%, lower than in three other G7 countries. Global disinflationary pressures will continue.

Not only does this reduce the possibility of an external inflation shock but it is difficult to see the UK bucking this international trend, even though sterling, wages and monetary conditions need to be monitored closely.

The volatility of inflation has fallen to its lowest since the 1940s, suggesting the UK is adjusting to a stable and relatively low rate of inflation. This could dampen inflation expectations and, in turn, curb wage pressures, which is a key area of concern in the wake of recent industrial action. A rise in real wages would push costs higher, and, by boosting consumption, would allow a greater opportunity for retailers to rebuild margins. The authorities would not be able to accommodate this and would have to raise rates. Yet there is no sign of any such wage problem. A change in labour behaviour appears to have taken place. Even though unemployment fell at an early stage of this cycle, real wages are growing substantially less than in the previous recovery.

A flexible labour market has probably led to a fall in the natural rate of unemployment, below which wage pressures re-emerge. There are many reasons for this, but an important one is that as part-time and temporary unemployment has risen, the penalty attached to losing a full-time job has increased. Consequently those in full-time jobs are happy to stay where they are and accept lower wage growth.

Even though wages should remain subdued, domestic demand will be the powerhouse of the economy this year. After the events of the late eighties it is easy to see why this triggers worries amongst policy makers. But such fears are misplaced. The economy is far from a credit boom. It does however, justify the Bank of England's call for a tight fiscal stance.

To relax fiscal policy through tax cuts would give an unnecessary boost to spending. There is a further argument in keeping fiscal policy tight as the Bank's own analysis highlights how blunt a policy instrument interest rates can be. It is one thing for the Bank to argue that monetary policy has to be forward looking as it effects inflation with a lag, but some industrial sectors are hit hard and some of those industries comprising small firms are affected the most.

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