The rest of the world may cool UK rate fever

The UK remains on interest-rate alert despite good inflation news, writes **Gerard Lyons**

Will he? Won't he? Should he? Shouldn't he? While much of the country seemed to catch flu over the new year, financial markets continue to suffer from interest-rate fever. Temperatures run high ahead of each monthly monetary meeting as attempts are made to read the Chancellor's mind on interest rates.

The Bank of England wants higher interest rates, but the Chancellor appears to have over-ruled their advice at last Wednesday's meeting. This will not stop the financial markets anticipating a rate rise at February's meeting, following strong figures for fourth-quarter growth. The catalyst for the rate increase last November was strong GDP growth in the third quarter. If the Chancellor raises rates before the election he may as well link this to good economic news, such as strong growth.

Yet it is increasingly likely there will be no increase before the election. Not only is there strong political pressure for the Chancellor to leave rates unchanged, but there is a compelling economic argument as well.

Two trends are evident from recent data. First, the undesirable surge in the pound appears to have hit manufacturers hard. Latest data shows output was weak in November, and surveys indicate some caution about prospects among companies. Second, the much hyped 'boom' in consumption has not materialised. This Wednesday's retail sales data is likely to confirm the message from recent surveys that spending in the run-up to Christmas was healthy but not so strong that the Chancellor should be worried.

This was also reflected in good inflation news in December. Although the core rate, excluding mortgage-interest payments, is 3.1% and is above the Government's 1% to 2.5% target, it fell from 3.3% in November. Excluding the impact of indirect taxes inflation fell from 3.0% to 2.7%.

The Chancellor highlighted the impact of the strong pound in keeping inflation down but this is not the only factor. Domestic competition remains tough, with evidence of unseasonal price cutting in the high street in December. Price resistance has been a characteristic of the recovery and there is no sign it is about to change.

One feature of the US economy is the extent to which companies have used existing capacity and labour more efficiently in this cycle. Hence there has been no acceleration in US inflation, despite low unemployment. The same may be evident here. Thus the recent large fall in UK unemployment should not be frowned upon as a potential source of inflation. Instead it should be welcome.

Although many jobs created recently are full-time there still appears to be ample spare capacity in the labour market. Total employment has risen 1.1 % over the last year but is 2.2% below its spring 1990 peak. Similarly aggregate hours worked may have risen since last year but they too are well below their previous cyclical peak. A general upward acceleration in wages appears unlikely, and not only will this keep underlying unit labour costs low but it will limit the extent to which consumers tolerate any attempt by retailers and producers to raise prices.

Crucially there is still little evidence of a wage-inflation problem, despite the recent large fall in unemployment. Nationwide earnings are rising at 4% and this is consistent with an underlying inflation target of 2.5% if productivity growth, or output per head, remains at 1.5%. Yet productivity in the manufacturing sector is being depressed by the recent cyclical weakness of output and should soon recover, boosting overall productivity.

Despite this, the Bank of England will remain cautious and February's quarterly inflation report is likely to show that the City shares their concern, believing the inflation risks are on the upside. One can understand the Bank's concern but it is increasingly likely interest rates will not rise as much as the markets are expecting, even if the next increase is delayed until after the election.

It was reported last week that Labour will keep the Government's inflation target if it wins the election. This is not a surprise. There is certainly no reason for the target to be lowered. To have increased the target would have triggered criticism that Labour will be soft on inflation. In fact the opposite may prove to be the case. Financial markets traditionally penalise left-of-centre governments and are wary of new administrations. Hence Labour will need to prove they are tough and win over the markets.

Whoever wins the election there is no reason for overkill. Comparing inflation with other G7 countries, underlying UK inflation is close to the average and less than in the US, Canada and Italy. Core inflation is sharply lower in Japan, Germany and France but this is hardly surprising given the state of their economies. Taking account of the economic cycle the UK's present inflation picture is favourable.

Overall, financial markets in the UK and the US will remain on interest-rate alert, fearing higher rates soon. Although a US rate rise is possible and a UK hike cannot be ruled out both countries continue to experience relatively low inflation for this stage of the economic cycle.

This picture of low global inflation and interest rates is highlighted by recent developments in Japan and Germany, where during the last week central bank officials have made clear that interest rates are set to remain low for some time. Global trends may calm the temperature in the UK market.

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