# Low inflation justifies further rate cuts

Base rates may fall in the next few months, but the case for easing is by no means clear-cut. Consumer spending and the housing market are improving, as previous cuts in interest rates and taxes feed through. Despite this, the economy continues to grow below trend and inflation remains low. Further cuts may be politically motivated but they will also be economically justified by low inflation.

The recent inflation performance has been good, with retail price inflation low and producer price inflation decelerating. Although there has been a rise in earnings it does not signal a rebound in wage inflation. Inflation should remain low. The European Commission, for instance, expects the GDP deflator, the broadest measure of inflation, to fall from 2.7% this year to 2.5% next, despite stronger economic recovery.

The Bank of England's quarterly *Inflation Report*, released last week, summarised the risks facing policy makers. In the next few months the economy faces downside risks and these could provide scope for rates to fall. However, the further ahead one looks, the risks change and, in the Bank's view, there is now a greater chance of underlying inflation being "modestly" above the Government's 2.5% target in two years.

The Bank is right to regard the downside risks for the economy as being highest in the next few months. Output is likely to remain sluggish, as firms continue to reduce excess inventories and exporters are hit by continued weakness on the Continent. In March, the Bank of England agreed to the 0.25 point base rate cut to 6% because the economy was weak. Further weakness would justify another cut this year. However, stronger domestic demand should feed through into higher output.

The Bank is now arguing for rates to remain unchanged, conscious that policy mistakes have been made at this stage in previous cycles. However, this cycle has been very different to those of the past, and not just in the UK. Disinflationary pressures have forced firms to boost productivity by using capacity and labour more efficiently.

Low labour costs are crucial to a continuation of the favourable inflation environment. In February, the Bank of England noted the improved flexibility of the labour market. This has been reflected in the rise in part-time work, which accounted for 28% of total employment last year compared with 25% in 1990 and 20% in 1980. There has been little rise in full-time employment since the recovery began in 1992.

The increased flexibility of UK labour has reduced the so-called "natural rate of unemployment", below which inflationary pressures appear. Significantly, the Bank expects this natural rate to continue to fall. If it does, then even the Bank admits: "Inflationary pressures throughout the forecast period [of two years] will be less than in the central projection."

Yet that central projection does not point to any surge in inflation. Over the next year the Bank expects inflation to be below 2.5%, before rising to just above 2.5% in two years' time, unless interest rates rise. That is an incredibly good inflation performance. Given its forecast, even the Bank of England is unlikely to advocate a sharp tightening of monetary policy in the next year or so, as the market fears.

The report also highlights the changing balance of growth within the economy. This is a potential worry, although it should not threaten the inflation outlook. Since official GDP figures began in 1948 the economy's trend growth rate has been 2.4%. Growth was at that rate last year but will be below it in 1996. Even though export growth slowed last year, exports were still the main contributor to GDP, reflecting improved competitiveness. Investment fell last year, highlighting the economy's persistent problem of low investment. In part this is because firms remain over-cautious and set themselves incredibly high target rates of return before they undertake investment. It has to be hoped that in a low inflation environment such high hurdle rates will be reduced, but I have my doubts.

Of course if misplaced fears of higher interest rates abate and domestic demand starts to recover then this should trigger some pick-up in investment, particularly as firms' profitability is high. Overall, the economy is shifting from export-led growth to consumer-led growth. Consumption should rise this year, helped by higher real earnings and rising personal disposable income. However, such a rise will not be on anything like the scale of the credit-driven Lawson boom. Thus fears of a repeat of that period are misplaced and the Bank of England's concerns about repeating previous policy mistakes are overdone.

There is always the danger that producers and retailers will attempt to boost margins and raise prices in the face of higher demand. However, I would expect the recent squeeze in retailers' margins to persist; as the Bank notes, in the past these margins have not varied systematically over the business cycle.

Financial markets are expecting three months to rise gradually over the next year, with a 0.75 point base rate hike by next summer. Uncertainty over economic policy after the election is partly to blame, but also the markets still need to be convinced inflation will remain low. Although the Bank and the Chancellor cannot ignore what the markets are saying, in the next few months they can let inflation be the judge and jury of whether rates need to rise or fall.

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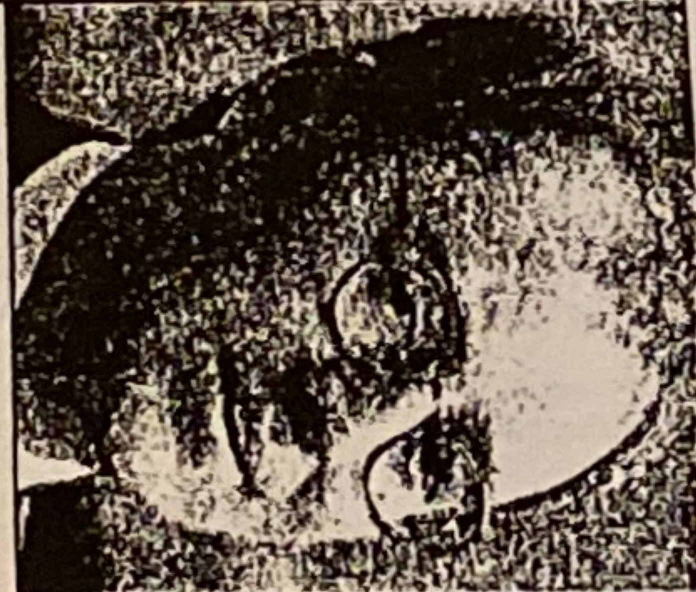

**ECONOMICS WEEK**

The Bank of England is reporting a good inflation performance with the prospect of further cuts in interest rates, says **Gerard Lyons**

Sunday 19th May 1996
*Sunday Business*