A very different economic recovery

Recent output figures have been poor, so there is little danger of the economy 'overheating' just yet. What is needed is still more investment in infrastructure, education and 'value-added' areas of the economy

Dr Gerard Lyons

As so many of my fellow economists failed to predict the Lawson boom and its consequences in the late 1980s, there appears to be a desperate desire not to be caught out again. Although no-one is saying the economy is enjoying a 'Clarke boom' just yet, there are dire predictions of what is about to happen. Analogies with the Lawson period are being drawn. The press gleefully writes about a recovery in the housing market. There are concerns about strong monetary growth, and the same people who were warning last year that inflation is about to rise are still crying wolf.

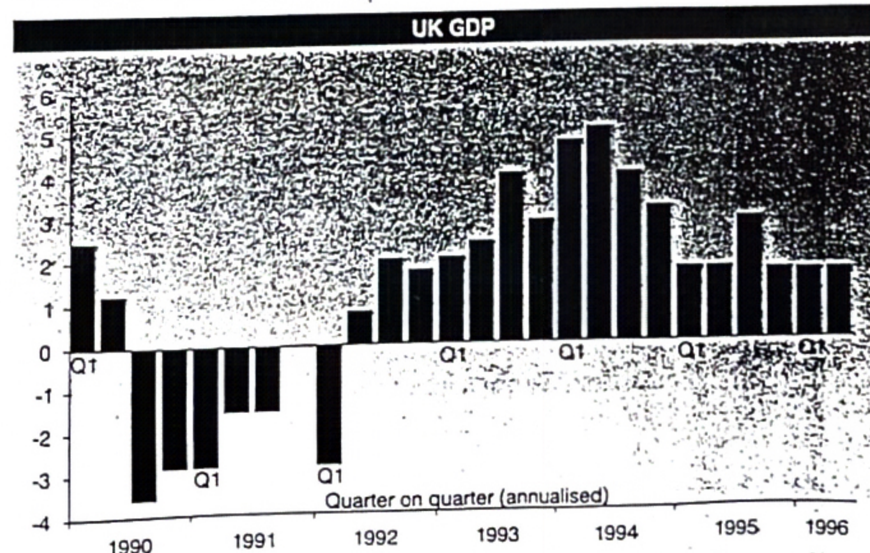
I was one of the few economists to criticise the Lawson tax cuts at the time. Then I called for credit controls, and expected a sharp rise in interest rates and in the current account deficit. Comparisons between now and then are misplaced. This is not a repeat of the late 1980s. This economic cycle is very different, and not just here in the UK, but in all industrialised countries.

Then, the UK was one of many countries that went on a borrowing binge. Japan did it on an epic scale, and its financial sector is still adjusting to the consequences, but Britain and America also borrowed heavily. Just as the UK shared in the global credit binge then, it has suffered in recent years, along with other major economies, from worldwide disinflationary pressures.

Consequently there is no locomotive for world growth. This is particularly evident in the UK's main export markets on the Continent, where demand is weak, inflation low and fiscal policies tight. The deflationary mentality of the Maastricht Treaty means that exporters should not expect a strong rebound on the Continent.

Against such a background, it requires domestic factors to boost the UK economy. Even though UK rate cuts have boosted domestic demand, the recent economic picture has been disappointing, as disinflation has prompted a very different type of recovery. There has been a lack of a genuine feelgood factor, as firms have had to downsize and cut costs.

Extra layers of management that companies added in the late 1980s boom were no longer needed when growth slowed. New technology has lowered the cost of capital, further encouraging a labour shake-out. Global competition has reinforced this need to cut costs. Even though South-East Asia accounts for only a small proportion of world trade, developments there have had an important indirect impact on events in the West. Ten or 20 years ago, South-East Asia produced low-cost, low-quality goods. Now goods produced there are still low cost, but quality has improved. Thus companies in the West, already facing strong competitive pressures at home, are also anticipating future competition from abroad, reinforcing their need to cut costs.



In the late 1980s, with wages and asset prices rising sharply, people were prepared to pay higher prices. Not now. Faced with sluggish wages and greater uncertainty, people now expect value for money. Retailers are forced to keep prices down to maintain market share. This has fed through the supply process, with producers keeping factory gate prices down to stay in business. There has been a structural shift. Companies can no longer rely on boosting margins by higher prices. Instead, competitive pressures point to a continuous process of cost-cutting whenever possible. The longer inflation remains low, the more inflation expectations will decline and the more ingrained the cost-cutting process will become.

It is hardly surprising therefore that the recent performance of the British economy has been far from impressive. Since the start of last year, the economy has under-performed, 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 companies are using existing capacity and employees more efficiently. Thus, there is plenty of scope for the economy to grow before inflation bottlenecks appear.

Manufacturing misfortune

The manufacturing sector has hit on difficult times. This will continue for a few months, but there will be a rebound. But even when the bounce-back comes, there is no guarantee it will be that strong. More worryingly, higher domestic demand could be met from imports, triggering a deterioration in the UK trade balance. That, at least, may have shades of the late 1980s.

Two factors have triggered difficult times for manufacturing: first, an inventory adjustment as companies had to shed excess stocks built up on misplaced hopes of stronger demand. Although this adjustment should be completed soon, companies are unlikely to make the same mistake of overestimating demand twice. Second, export demand has been weak, largely on account of weak economic activity on the Continent.

Recent output figures have been poor. In April to June, output was 0.2% below that of the first three months of the year, and only 0.5% above the level of a year ago. This is some way from an economy that is overheating. Even though these two problems persist, there has been a recent improvement in business optimism. The CBI's quarterly trends survey show a significant improvement in business sentiment in July, but optimism is still lower than in April 1995.

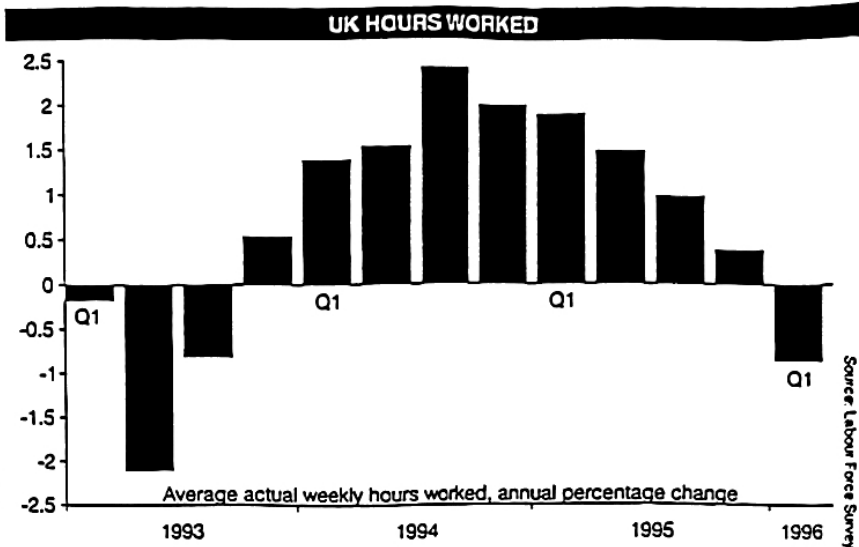
Yet investment intentions remain poor. This, too, should not be a surprise, as investment has been the Achilles' heel of the economy. This is disappointing, for despite recent sluggish output, UK manufacturing is

in a favourable competitive position. The UK is one of the most competitive countries in Europe, with manufacturing labour costs only lower in Greece, Portugal and Ireland. Hourly costs are less than half those in Germany. This has helped attract sizeable inward investment. The UK has won almost 40% of Japanese inward direct investment in Europe, which is encouraging, but it begs the question why we cannot do it ourselves, particularly as the UK's overall level of investment is less than the economy requires.

Investment by the manufacturing sector fell sharply during the recession, declining 25.8% between 1989 and 1993. Although such investment rebounded in the last two years, it is still a sizeable 15% below the level seen at the height of the Lawson boom. There is no sign that it is about to gather momentum, despite the UK's competitive position and the high profits the corporate sector has enjoyed. Indeed, manufacturing sector investment has fallen by 6.8% in the last two quarters.

One encouraging aspect of the economy has been a steady fall in unemployment. The UK's unemployment rate is 2.1m, which is the lowest rate since March 1991, and is 7.6% of the labour force. Although this is still high, it is below the unemployment rate seen on the Continent, where the deflationary mentality of the Maastricht Treaty has been put into effect, with fiscal policy remaining tight.

The fall in the UK employment rate should not be misinterpreted as a sign that the economy is growing too strongly. Even the latest Bank of England quarterly *Inflation Report* acknowledges that the unemployment rate may not be the best guide to labour market trends. Measures of employment have been less encouraging this year, with the Labour Force Survey showing that employment fell by 34,000 in the second quarter. Part-time employment has



accounted for the bulk of the rise in jobs since the trough in output in 1992. This shift in the labour force away from full-time to part-time jobs means that a better measure of how tight labour conditions are is total hours worked. And, as the graph shows, this has been relatively stable over the last year.

After sterling left the Exchange Rate Mechanism in.September 1992, there was a significant and welcome shift in policy, with a tighter fiscal stance curbing excessive demand while lower interest rates and a fall in sterling gave a big boost to manufacturing. Yet this policy prescription has not lasted. Even though interest rates are at 5.75%, they are not as low as they could be, given the absence of inflation. Nonetheless, the government's tough inflation target and the Bank of England's concerns may make it difficult for the Chancellor to reduce rates again by more than 0.25%. Much depends on fiscal policy as well. There is no case for tax cuts. But if the Chancellor does choose to cut taxes in his November Budget then, alongside low interest rates and a housing market recovery, this should ensure a further improvement in the feelgood factor.

Growth should rise over the next year and the recent mixed picture should be replaced by higher output. With the exception of a possible deterioration in the trade balance, it is premature to make comparisons with the late 1980s. There is much spare capacity and labour in the economy, which should ensure that inflation remains low. The economy needs to remain competitive, thus benefiting from further inward investment. As welcome as this is, we still need to invest far more in infrastructure, education and in value-added areas of the economy, whether it be finance, services or industry.

Dr Gerard Lyons is chief economist of Dai-Ichi Kangyo Bank (DKB) International.