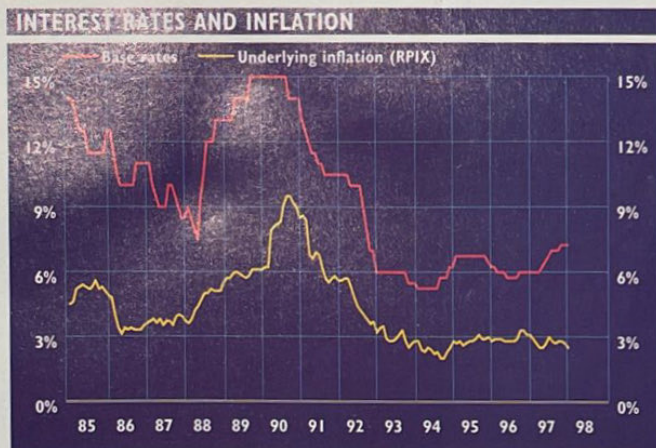
This peak is lower than last cycle's trough

Thanks to Gordon Brown transferring monetary control to the Bank of England, demand management is now back in vogue, says Gerard Lyons. This policy looks set to bring about a period of interest rate stability.

Demand management is back in fashion in the British economy. For those who are too young to remember, demand management used to be the mainstay of economic policy making, as Keynesian thinking heavily influenced decisions until the mid-1970s. Then, after Labour Chancellor Denis Healey introduced monetary targets in December 1976, monetarism was in the ascendancy.

Monetarism has gone through many shifts in emphasis, and is still of great influence and importance, although directly controlling the money supply is no longer a policy aim.



The intriguing aspect of current British economic policy is that it is not at the Treasury, but at the Bank of England, that demand management is making a comeback.

Since the election the Chancellor has endorsed almost every aspect of the previous Conservative government's macroeconomic policy. This is reflected in a tough line on public spending. As the economy is in good shape this has made it easier for the Chancellor to stick to his tough public spending plans. Yet there is no suggestion that even if the economy slowed he would relax his tough fiscal policy.

The Chancellor has a different emphasis on microeconomic measures than his predecessor, including the much-talked-about Welfare to Work and a 10p starting income tax rate. The improving government Budget deficit gives Gordon Brown greater flexibility to achieve his policy goals. If the Budget position continues to improve, this could allow the Chancellor to cut taxes, boost public spending or even repay debt. The emphasis appears to be on the latter, which may please the financial markets but not Labour's natural supporters.

The financial markets were also pleased by the Chancellor's decision to make the Bank of England independent last May. The Monetary Policy Committee now has complete responsibility for setting interest rates, in order to achieve a 2.5% underlying inflation target.

The government's anti-inflationary credibility was enhanced by the decision to grant the Bank independence. Yet one potential problem is that independence does not guarantee consistency between monetary and fiscal policy. So far this has not been a problem, but it could be.

Since last May, fiscal and monetary policy have both been cautious. While the government has stuck to the inherited fiscal plans, official interest rates have increased five times from 6% to 7.25%. The pound has been strong. This policy combination will slow the economy this year.

Trend growth in the UK is widely viewed as around 2.25% to 2.5%. On gaining office, Chancellor Brown suggested trend growth may be even lower than this, which would harden the case for higher interest rates. In fact, it is quite possible that the supply side changes implemented in the 1980s have boosted the economy's trend growth rate, and it could be nearer 3%. Last year the economy grew around 3.3%, although it was much weaker in the fourth quarter, not helped by a sharp slowdown in the manufacturing sector.

Hence the focus on demand management. The concern is that if domestic demand is too strong the economy will continue to grow above its trend rate and trigger higher inflation. This concerns the Bank of England and since May the aim of monetary policy has been to slow the economy to below trend, in order to remove overheating worries.

This year the Bank of England expects a sharp slowdown, before the economy rebounds to trend in 1999.

As one of the few economists to correctly predict the Lawson Boom, and its consequences, I can certainly understand why this stage of the cycle is a difficult one for policy makers. The last thing the Bank of England wants to do is relax its guard, only for the economy to overheat. As the Bank has constantly reminded us, at this stage during previous cycles policy mistakes have been made.

Yet this cycle has been different, and not just in the UK. The recent performance of the US economy shows healthy non-inflationary growth. Three factors have contributed to low global inflation through the 1990s: intense international competition, domestic cost constraints and, most important of all, a tough anti-inflationary policy stance.

The result is subdued inflation, the latest evidence in the UK being the achievement of the 2.5% inflation target in January, as retailers aggressively reduced clothing, footwear and household goods prices to maintain market share faced with price-conscious consumers.

While the Bank of England will remain vigilant about near-term inflation risks, the UK probably faces a prolonged period of interest rate stability. Base rates could stay at 7.25% for some time. This would mean interest rates have peaked in this cycle *below* the level at which they bottomed in the 1980s Lawson Boom. Then, rates rose from 7.5% to 15.0%.

Even though 7.25% may appear low, when one takes into account the actual rate of inflation, monetary policy is already tight. Underlying inflation, as measured by retail prices excluding mortgages, is 2.5%, while the broadest measure of inflation, the GDP deflator, is 1.9%.

The next move in base rates could thus be down. However, such a reduction may be someway off, perhaps later this year. Two preconditions will be needed for a monetary easing. First, a slowdown in the economy to below trend. Second, the prospect of continued below-trend growth in 1999. The Bank of England would need to believe the economy was not about to rebound in 1999, in order to respond to a slowdown this year by cutting rates. There is always a need to be vigilant against inflation. Yet there is every likelihood inflation will remain subdued, allowing a period of interest rate stability. ●

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