Good news for the pound, but bad news for the economy

Having raised rates once the key question is will the Chancellor do it again? The financial markets certainly think so and it would be wrong to not factor in this possibility. Like an addict looking for his next fix the financial markets will not be satisfied with one rate increase.

Any poor inflation news, however temporary, or evidence of strong economic growth will be cited as reasons to raise rates again. And the very fact the Chancellor raised rates will do little to curb inflationary expectations. Instead it is feeding them. The thinking in the financial markets is that if the economy is growing so strongly that the Chancellor has to raise rates only eight months before an election then there must be an inflation problem. If so, a quarter point increase is not enough and rates will have to rise further. The Bank of England has been set a tough inflation task, keeping underlying inflation below 2.5%. This year it has been stubbornly around 2.8% to 2.9%. Given their remit, they felt they had to argue for a rate hike. And they could yet demand more.

If I had been advising the Chancellor last Wednesday I would have told him to leave rates alone. But following the previous week's strong third-quarter growth figures a tightening was always possible. The Bank of England, the Treasury and the financial markets do not believe the economy can grow strongly without triggering inflation. But these worries are misplaced.

This is nothing like the Lawson Boom. The economy has been growing below trend for the last two years and manufacturing activity is still sluggish. Instead of being worried by the economy's rebound the Chancellor should have welcomed it and allowed it to blossom.

A similar debate has taken place in the US in the last few years. There the markets have continued to fear strong US growth and a fall in the unemployment rate to 5.2% would trigger inflation. It hasn't. US inflation remains low. Even without last Wednesday's rate hike, UK inflation would have remained low. There are ample spare resources in the economy, particularly in the labour market. In a disinflationary global environment, stronger growth doesn't guarantee higher inflation.

By raising interest rates the Chancellor has ignored these concerns. Instead of sitting back and seeing how strong the economy could grow, Mr Clarke risks slowing it down too much, particularly if rates rise again. Fearing higher rates, businesses may think twice about investment. Exporters will be hit by sterling's strength. Consumer confidence will fall.

All these are reasons for Mr Clarke to resist market pressure to raise rates again. Also, the latest rate hike has not pushed mortgage rates up but another one would.

Monetary policy is now very tight. Real interest rates, after adjusting for inflation, are 3.9%. This compares with 2.25% in a US economy that has been growing more strongly than ours. Sterling's appreciation will compound the problem. This should persuade the Chancellor to wait and assess the impact of this rate hike, before considering tightening again.

Now, following the rate increase, there are suggestions the Chancellor is preparing for big tax cuts in the Budget. But I doubt it. Large tax cuts would be politically motivated and not economically justified. A tight fiscal stance is needed to bring the budget deficit under control. Furthermore, as the Chancellor raised interest rates to curb the strength of domestic demand it would be hard for him to justify cutting taxes.

If Mr Clarke genuinely feels that domestic demand is growing too strongly the solution is not higher interest rates, but higher taxes! It should certainly not be higher interest rates and tax cuts. That is an inappropriate policy mix. Tax cuts would make the budget deficit worse and boost consumption when it didn't need it. Higher interest rates would push sterling and borrowing costs up, weakening exports and investment.

The best policy for the British economy is a relatively tight fiscal stance, to curb the budget deficit, offset by an accommodating monetary policy. This policy worked well in recent years, as interest rate cuts following sterling's ERM exit allowed people and companies to restructure their balance sheets, paying down debt.

Although domestic factors dictate UK interest rates it is important not to lose sight of global trends. These suggest there is still no locomotive for the world economy and global interest rates will remain low, encouraging speculators to buy the pound.

Canada last week cut rates to a 33-year low, but then they have a sluggish economy. The US Federal Reserve, meanwhile, resisted market demands to raise rates during the summer and now, following signs of an economic slowdown, expectations there could even turn to the prospect of a rate cut next year. Japan shows no sign of raising rates from 0.5%. Continental Europe, our biggest export market, has weak growth, low inflation and tight fiscal policies and this points to low interest rates for some time. The recent improvement in optimism about the German economy may prove short-lived, forcing the Bundesbank to cut rates again in the new year. This would further help the pound.

The best hope is that current market sentiment will change. Good inflation news, a cautious Budget or indeed lower interest rates overseas are all possible. If so, the Chancellor may be able to get away with just a one-off rate hike, allowing sterling to soften and minimising the damage to the economy.

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The Chancellor made a big economic mistake by raising interest rates last week says **Gerard Lyons**