NEWS

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UK growth will be strong but the danger is lack of balance

Economists are the only ones talking about overheating at this time of year. As most of the country tries to protect itself from sub-zero temperatures, the financial markets are worried that the economy is growing too quickly and will soon overheat, triggering higher inflation and rising interest rates.

There was no rest for Bank of England Governor Eddie George over the holiday. Interviewed in the French press he repeated his previous concern that the economy may be growing too fast for its own good and he hinted strongly at the need for higher interest rates. It must have seemed like a different world for French readers, as their economy remains in the doldrums and talk of inflation is, like the summer, for them a distant memory. The main problem for France, like the rest of the Continent, is high unemployment.

Unemployment in the UK is still too high, but it is now falling sharply, reflecting the strengthening pace of economic growth.

What then will happen this year? The main issue is whether such strong growth will continue, and if it does, will it trigger problems?

First, the economy should grow strongly, but it is unlikely to boom. I expect growth of 3.5% this year. Weakness on the Continent, the pound's strength and the reluctance of UK firms to invest all remain constraints on growth, despite the buoyancy of consumption.

So far this has been a different type of recovery. Since sterling's departure from the Exchange Rate Mechanism in September 1992 growth has been modest and inflation subdued. Despite falling unemployment, there has been no acceleration in wages and job insecurity has characterised the recovery.

Second, growth will be unbalanced, driven by the consumer. The 'feelgood factor' is finally re-emerging as the labour market improves and house prices rebound. Hence the acceleration in growth towards the end of 1996, as the recovery moved into a different phase, driven by higher consumer spending. Much of this reflects pent-up demand, as a lack of confidence and spending power had previously deterred people from buying higher-priced items. With confidence returning, people are now spending. This has triggered fears of a repeat of the late Eighties, as consumer credit, mortgage and bank lending have risen. There are some similarities, as improving employment conditions boost real income, people are more willing to take on new debt and building society windfalls help confidence just as tax cuts did then. But this is not a repeat of the Lawson boom. Yet, it does highlight a recurring problem for the economy. Too often, recoveries have been unbalanced, led by consumption and lacking investment.

The rise in consumption could trigger a take-off in investment but there is no guarantee it will. Even though there has been sizeable inward investment this does not disguise the fact that the overall level of investment in the UK is still too low. It begs the question why British firms do not invest more at home. The possibility of higher interest rates and a new Government may at best delay, and possibly prevent, a much-needed rebound in investment.

Third, the UK is unlikely to buck the global trend of low inflation. But the financial markets will remain worried. This is not only because of the UK's poor inflation track record but partly because the Government's inflation target is too low. The original inflation target of 1% to 4% seemed tough when initially announced, but was sensible. Lowering the target so that underlying inflation has to be below 2.5% was too tough. No allowance is made for the state of the economic cycle, where a small rise in inflation should be tolerated if it is the consequence of an acceleration in economic growth.

The economy needs room to breath. Monetary policy is already tight, when interest rates are measured against inflation and considering the pound's surge. Despite this, a further rise in interest rates appears likely.

If Chancellor Kenneth Clarke tightens policy before the election he will want any rate hike to be linked to 'good' economic news, such as the release of strong fourth-quarter growth figures in February. Whether rates rise before the election, or not, there is every possibility of an incoming Labour government tightening policy to prove they are tough on inflation. But if rates rise, they are unlikely to increase by more than the financial markets have already discounted.

Inflation risks always need to be monitored. The biggest unknown is at what stage strong growth will hit supply bottlenecks and whether consumers will then tolerate retailers and producers raising prices. In the US in the last few years similar inflation fears proved misplaced and the same is likely to be the case here.

Fourth, if there is a problem this year, it is likely to be in the balance of payments. In recent years the trade deficit has not been a problem, but this is hardly a surprise given the extent to which growth was subdued. But now domestic demand is rising, imports will increase. The UK's low rate of saving and investment means a high propensity to import. If the trade deficit does deteriorate early in the year then, hopefully, this should take some of the shine off the pound. Despite market sentiment, the economy is still far from booming and can do without a stronger pound.

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ECONOMICS WEEK

A deteriorating trade deficit rather than inflation may be the result of unbalanced growth, says **Gerard Lyons**