Dedicated followers of fashion should act now

Weak growth, low inflation and tight fiscal policies mean interest rates will remain low across Europe for some time. Thursday's decision by the Bundesbank to cut their key repo rate from 3.3% to 3.0% should be welcome. This easing was fully justified and provided the catalyst for much needed rate cuts elsewhere in Europe. Although domestic factors remain the main influence on UK rates, the chance of another base rate cut has improved.

Low inflation is the main justification for low interest rates. Often it is said that low inflation is a pre-condition for sustainable economic growth. This has been the message from successive Conservative Chancellors and even from Mr Blair. But for this to be true, the benefits of low inflation need to be passed on in the form of lower interest rates. If interest rates are kept too high whilst inflation falls then the stance of monetary policy is too tight and this can hamper growth.

In Germany inflation is now 1.6% and the discount rate is 2.5%. Adjusting official rates for inflation means that German 'real' interest rates are 0.9%. Real interest rates give a better guide to the stance of policy. In the UK, by contrast, interest rates are 5.75% whilst headline inflation is 2.2%. Thus 'real' interest rates are 3.55%. Far from being too low, on this analysis UK interest rates are too high.

Throughout the 1980s and 1990s monetary policy in Europe has been excessively tight. This was partly because the experience of high inflation in the 1970s led to the adoption of anti-inflationary policies. It was also due to the Exchange Rate Mechanism, which not only reinforced this deflationary mentality but meant many countries defended their currencies through high interest rates.

In the 1980s, Germany's real interest rates were 3.7%. In recent years, as the Bundesbank eased policy, real interest rates have dropped steadily and are now 0.9%, the same level as German real interest rates between 1960-67 and from 1974-79. The level of real interest rates seen in the 1960s is more appropriate for monetary policy now and not just in Germany but across Europe. The Germans have learnt this, but other countries have yet to fully follow suit.

Throughout the sixties most European countries had negligible real interest rates. Between 1960-67 Britain's real interest rates were 1.6% and from 1968-73 were only 0.1%. During the rest of the seventies a surge in inflation led to negative interest rates, rewarding borrowers and penalising savers.

Although the data immediately ahead of Thursday's Bundesbank meeting suggested the German economy was improving, the recovery is still weak and far below trend. Also, the need for structural change suggests the recovery will remain weak. In July last year the Bundesbank's research showed there is still a stable relationship between monetary growth and inflation. With money supply growth slowing and the inflation outlook good this justified the easing.

The Bundesbank would have been fully aware of the likely market reaction. In July, various Bundesbank officials hinted at an easing, helping the DM to weaken, only not to deliver a rate cut. The DM subsequently strengthened. A stronger DM is the last thing the German economy needs. There were two clear messages the Bundesbank wanted to send this time. First, German interest rates are set to remain low for some time. Second, they wish to see a weaker DM. I expect the DM to weaken. And if it doesn't, thereby causing problems for German industry, the discount rate, currently at an all-time low of 2.5%, could fall again.

The financial markets have been suspicious of the intentions behind the rate cut, with many believing the Germans cut rates just to help the French. But the Bundesbank is not going to undermine its credibility by cutting rates solely to help the French. Of course, there must have been some indirect impact, both because of the political pressure in favour of EMU and also because the Germans would have been keen to avoid a French currency crisis - particularly as problems for the franc would have boosted the mark. Since the start of last year financial markets have been too pessimistic about European interest rates and have consistently overlooked the strong domestic case for lower rates in Germany, and elsewhere.

Low German rates and the prospect of a softer DM is good news for other European countries. Many have followed suit with rate cuts. The French have been the main beneficiaries of the German move, as they have cut rates the pressure on the franc has lifted. But there is still pressure from the French Government to pursue a Japanese style monetary policy of extremely low interest rates but the Bank of France may resist.

The latest rate cuts improve EMU's chances but fiscal policies remain the hurdle. Even Germany faces problems. Last week the German Association of Cities and Municipalities warned that local government was on the brink of collapse. Other countries face severe problems too. By mid-October, ten European countries will unveil their 1997 budgets. Some budget plans may not be viewed as credible by the markets, potentially causing currency instability but it will add to the pressure for European interest rates to stay low.

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

The Germans are taking the lead in showing that 1960s-style interest rates are appropriate for Europe, says **Gerard Lyons**