World Wide Web of rates is holding – just

Globalisation has been one of the buzz words of the 1990s. It was certainly in evidence in the last two weeks, as problems in US financial markets triggered fears in other countries. Fortunately, a US stock-market crash has been averted for now but the dollar fell sharply against the Deutschmark and yen. Sterling was pulled down in the dollar's slipstream, not helped by continued disagreement about interest rates between Chancellor Kenneth Clarke and Bank of England governor, Eddie George.

The US stock market has had a charmed life in recent years, as low interest rates and an increasing return on capital have helped the US corporate sector. Thus the Dow Jones' volatility in recent weeks was not a surprise, as a long overdue correction was necessary. At one stage a crash loomed, amid pessimism about future corporate earnings and fears that higher inflation would trigger a series of US interest rate rises.

In stepped US Federal Reserve Board Governor Alan Greenspan to ease market nerves and dampen the fears of equity market bears and bond market hawks. In a lecture last Thursday, Greenspan talked tough on inflation. Talking tough is not the same as acting tough, but Greenspan hopes he will not have to prove that.

Although the US economy has been strengthening during the first half of the year, Greenspan expects it to slow. He is right to do so. High debt levels and high long-term interest rates, as well as the stronger dollar in recent months, could eventually trigger a sharper slowdown than expected. But this slowdown could take some months to be seen.

This is where a problem may arise. Continued economic momentum and a rebound in US output may trigger inflation fears, requiring Greenspan to act. Forthcoming data on employment, second-quarter growth and employment costs will be critical. The US Federal Reserve will probably have to raise official rates in August but no aggressive increase in US interest rates is likely. In fact, an August increase could be reversed early next year.

A solitary increase should ease inflation worries, keep bond yields down and allow the stock market to stabilise. Only if buoyant growth actually triggers higher inflation would US interest rates have to rise sharply to slow the economy. That is when the US stock market could collapse but in practice it shouldn't come to that.

In setting monetary policy the US Federal Reserve Board has to turn a blind eye to stock-market conditions and focus on inflation. When US rates rose in February 1994 it weakened financial markets around the world and business confidence in many countries suffered, as higher global long-term interest rates hit investment plans.

This time, the transmission mechanism from events in the US has been the dollar. As the US stock market fell so too did the dollar. If the dollar's fall is sustained it will have a profound impact, particularly in Germany.

A stronger Deutschmark is the last thing the Germans want. It will exacerbate competitiveness problems and could trigger more of job cuts. German business confidence has fallen and bank lending and monetary growth have slowed. All this points to a German repo-rate cut this Thursday, as the Bundesbank meets before its summer break.

There could be more German cuts later this year and, if the Deutschmark remains strong, a cut in the key discount rate from 2.5% to 2.25% cannot be ruled out. With growth weak, inflation low and fiscal policy tight, interest rates will remain the shock absorber for the German economy.

This will create a favourable environment for European interest rates and will make it easier for the Chancellor to side-step the Bank of England's misplaced inflation worries as he presses for another interest-rate cut, possibly at the 30 July monetary meeting. A base-rate cut to 5.5% could be the last but UK rates should remain low for some time.

This will help UK financial markets, but they will watch developments overseas nervously. Not only will a close eye be kept on US markets but Japan will also receive close attention. Japan is the world's biggest saver and exporter of capital. If America raises interest rates Japan could follow. This could dampen the outflow of much needed liquidity to stock and bond markets around the globe.

If there is a Japanese general election before year-end this could trigger a politically motivated rise in rates. Higher rates in Japan could always encourage the cautious Japanese investor to keep his money at home.

Whatever happens in the next few months, global deflation will force interest rates everywhere to remain at relatively low levels for some time.

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