Europe's low interest rates set to continue

Interest rates across Europe have fallen to low levels. In the UK, interest rate cuts have allowed the recovery to gather momentum, but the same is not true on the Continent. There, the tightness of fiscal policy has restrained demand and points to a weak European recovery.

The latest sign of this came from the European Commission last week. Governments throughout Europe have failed to take up £16 billion allotted over the last decade through the European budget for regional aid.

Not spending allotted money on areas that need it highlights the deflationary mentality of fiscal policy throughout Europe. The fact that this underspend has been going on for years suggests this mentality is well instilled in the consensus economic policy-making process and it will be difficult, and take some time, to change.

To take advantage of regional aid each national government has to match from its own budget the amount it receives from Brussels. That is, if the £16 billion in regional aid had been used, then national governments would have had to have spent an extra £16 billion from their own budgets.

At a time when governments are desperately seeking to keep expenditure down to achieve the Maastricht convergence criteria of low budget deficits, they are reluctant to spend extra.

The first lesson to be learnt from this carries worrying omens as to what is likely to happen when European Monetary Union occurs. Within a single currency area, one monetary policy operates across all countries. But the same interest rate will not be appropriate for all countries; for some it will be too high. To minimise the adverse consequences of this, it is necessary to have a flexible labour market and an effective regional fiscal policy to allow countries to respond to economic shocks. The unemployed are likely to migrate from poor to wealthier regions. To prevent this social dislocation and to offset economic weakness in poor regions, there need to be fiscal transfers from richer areas. If not, there is absolutely no flexibility to respond to economic shocks. Yet the latest news hardly augers well for an effective regional fiscal policy.

Governments will remain under pressure to keep budget deficits down after a singly currency is born, and thus the unwillingness to spend on regional policy now is unlikely to change. This will reinforce regional disparities, resulting in pockets of high unemployment across Europe.

Much discussion on fiscal policy focuses on the need to reduce public spending and budget deficits, whilst ignoring completely the role it can play in short-term demand management. It is necessary to have a sustainable medium-term fiscal policy, where the budget deficit is under control and financeable, but it is also necessary to take account of the economic cycle. If an economy is weak it is counter-productive to stick with a tight fiscal policy. This, unfortunately, is the case across much of Europe. Rather than being counter-cyclical and offsetting weakness in the private sector, fiscal policy is pro-cyclical, reinforcing the weakness in private demand.

This is the second lesson highlighted by the unwillingness of governments to take up regional aid. There is an absence of effective demand across much of the Continent. As high unemployment forces cautious consumers to refrain from spending, it requires governments to kickstart their economies. Current fiscal policy highlights why growth has been so sluggish across much of Europe.

Where does this leave the UK? Exporters cannot count on a strong recovery on the Continent. Although many countries on the Continent need a fiscal boost, they are unlikely to receive it. Thus it is ironic that there is still so much pressure on the Chancellor to cut taxes at a time when the British economy does not need it.

Continued tight fiscal policies on the Continent mean that with growth weak and inflation subdued, interest rates across Europe will remain low for some time, and certainly ahead of Monetary Union.

In such an environment, UK rates will remain low, even though this week's quarterly Inflation Resort from the Bank of England will highlight future risks. Although inflation is low and set to decelerate in coming months, the Bank will be cautious, repeating its message that at this stage of previous recoveries, policy mistakes have been made. Since its previous Report three months ago, the Bank will say there is a higher probability of inflation missing its 2.5% target.

The biggest risk to higher UK interest rates is not from inflation, but from politically motivated tax cuts. Yet in an environment where European governments are striving to keep fiscal policies tight, it is hard to imagine Chancellor Clarke jeopardising the chances of low interest rates by opting for excessive tax cuts.

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ECONOMICS WEEK

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Sunday 4th August 1996
Sunday Business