depreciation bullet by amortis- years off, the spokesman added. | ronment – which funds the DLR, will represent a major proportion

INDEPENDENT ON SUNDAY 28/AUG/95

Gerard Lyons Economics

Bank will relent on calls for a rate rise

THE next move in UK interest rates will be down. But not just yet. Easing will be delayed until next year. The Bank of England has yet to catch the bug forcing central bankers around the globe to cut interest rates. But it will catch it. The domestic and international environment is moving against the Bank of England's obsessive desire to raise base rates. Two developments during the last week highlight this.

First, official figures confirmed what most people have suspected for some time – the British economy has been slowing down during the first half of the year, to its lowest pace of growth for two years. Developments here are similar to the experience of the US, where the Federal Reserve cut rates in early July, reversing its February tightening. As the UK economy settles into steady growth, there seems little risk of an upsurge in inflation. Inflation will remain low.

Second, the Bundesbank lowered its discount rate from 4 per cent to 3.5 per cent on Thursday, triggering rate cuts elsewhere on the Continent. There could be scope for German rates to fall further, as industry there remains crippled by high costs and an uncompetitive mark. In July, German business confidence fell into negative territory for the first time since May last year.

Interest rate cuts overseas do not directly change the course of UK monetary policy. That will depend on how sterling reacts. Although it has firmed recently, its effective index is at 84.4 per cent of its 1990 value. Back in March, the Bank of England was concerned when this fell to 86, below the 87 to 91 range it had been in for the previous two years. So the British authorities will not feel compelled to change domestic policy. After all, that should be driven by what happens here in the UK.

Yet the British economy is clearly being affected by the same pressures that have persuaded other cental banks to ease policy. Disinflationary pressures are forcing firms to keep costs down and creating greater job insecurity. Acting independently the Federal Reserve, Bundesbank and the Bank of Japan have all cut rates since early July, thanks to a favourable inflation outlook.

This is good news for the world economy. The global outlook has been further helped by a bout of currency co-ordination aimed at reversing the dollar's decline against the yen and the mark.

Just as sterling's rate hit reached in the spring. Now it is at Y97, and it needs to weaken further.

In recent years, currency shifts were stabilising. They helped to correct economic imbalances. For instance, a dramatic shift is already underway in Japan's trade volumes, which should show up in a declining trade surplus in the next 12 months. But this year, currency movements became destabilising. Neither the speed at which the mark and yen appreciated nor the levels to which they rose were sustainable.

A number of factors contributed to the latest turnaround in the dollar, including a move by the Japanese Ministry of Finance to encourage further capital outflows. This

As long as the central banks do not fight yesterday's inflation battle, the outlook for the world economy can improve

British industry before our exit from the ERM, Japanese and German firms have suffered from the strength of yen and mark. In view of the importance of these economies, this was bad news for the world economy. It is important for Germany, traditionally the locomotive for European growth, to turn itself around.

But if Germany's problems are bad, those in Japan are far worse. Fortunately the authorities there have managed to pull the economy back from the brink of another recession and financial meltdown.

Japanese firms could not cope with the yen at around 80 to the dollar, the level it immediately prompted much talk of a Japanese "wall of money" about to flow out of Japan, boosting world bond and stock markets. Such talk missed a key point.

Despite the problems in the Japanese economy in recent years, there has continued to be a steady outflow of capital from Japan, as the country has recycled its large trade surplus. Only this capital outflow has occurred through different channels. It has not been Japanese portfolio investors but the Bank of Japan, big corporations and Japanese banks that have been putting money overseas.

Last year, for instance, the Japanese bought a record $29.6bn (£20bn) of US notes and bonds, up from a still high $17.1bn in 1993. This largely reflected the Bank of Japan recycling of dollars it had accumulated through intervention.

Japanese bank lending overseas has risen, helping to sustain growth elsewhere, particularly in south-east Asia. And Japanese corporations have continued to invest heavily overseas, as they shift more of their production to lower-cost countries. So before people expect a wall of money, they should appreciate that large capital shifts have continued to take place.

The Japanese economy still remains very weak. But it should be helped by further policy easing, including a £68bn fiscal boost to be announced in late September. This should give a fillip to the Japanese stock market. This in turn would raise the reserves of Japanese insurance companies and other portfolio investors, giving them more confidence to shift money offshore, into international bonds and stocks.

The key message from around the globe is that central banks need to be accommodating, shifting policy as the balance of risks changes. And in doing so they need to prevent currency instability. As long as central banks do this, and do not fight yesterday's inflation battle, then the outlook for the world economy can improve. The same international pressures that have forced the Americans, Japanese and Germans to ease should soon allow the Bank of England to abandon its call for higher rates and even consider easing next year.

Gerard Lyons is chief economist of DKB International, the London-based subsidiary of Japan's Dai-Ichi Kangyo Bank.

Hamish McRae is on holiday. *Economic statistics appear on page 4.*