Are higher global interest rates a thing of the past?

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Of late, interest rates globally have been at historic lows in many countries. The USA, UK and Europe have experienced rates of under five per cent for nearly a decade, however there may be some small rises in the future.

This article sets out to explore why this may be the case and whether it is likely to continue in the future. The article draws on economic data both from USA and Europe as well as international sources and theories from the Economics discipline in order to provide an explanation for current global trends in interest rates and inflation.

Introduction to the main causes of inflation and higher interest rates

Theoretical Explanations

There are many economic explanations for why interest rates may need to rise. Increases in prices and the rate of inflation often lead to interest rate rises. Inflation can result from increasing supply costs. Supply costs may rise due to increases in wages. In the UK for example, wage inflation has been kept low due to reform of trade union power and both in Europe and USA trade union membership has also declined. In addition the UK government has limited growth in public sector pay to two per cent over the next few years.

However there can still be inflationary pressure arising when there is little unemployment and skill shortage, as the USA is experiencing since unemployment there has recently gone under the five per cent level. Bootle[1] 2005 suggests that inflation may now be dead due to pay constraint being seen as acceptable by most workers. There have however, been higher wage claims for company executives though these represent only a small proportion of the total workforce.

There are also other causes of inflation besides wage increases. Costs on the supply side can also rise if for example, there is an increase in the price of raw materials, according to Sloman[2] 2005. The recent increase in the price of oil by 50 per cent for USA citizens led to small increases in interest rates from one to almost five per cent in 2005. However this has been less substantial than during the 1970s oil crisis and better contingency plans have been put in place. There have also been concerns over gas prices.

Price rises may also occur if interest rates are too low and there is a lot of cheap money available. People are more likely to borrow , demand and spend more money during these times. Friedman[3] suggests that inflation may therefore occur when there is too much money chasing too few goods. The quantity theory of money states that changes in the nominal money supply lead to equivalent changes in the price level. The theory is very much defended by monetarists today. However the theory should be taken with care, since there are cases of countries having high increases in nominal money but experiencing lower prices, see table 1 and the case of Japan over a 30 year period 1962 - 1992. Real variables adjust for changes in the general level of prices whereas nominal variables refer to values at the prices ruling when the variable

The increased price of raw materials can significantly affect inflation

Table 1: Nominal Money and Prices 1992 (1962=100)

	Japan	France	UK
Nominal money	2287	1248	3582
Prices	464	656	994
Real money	493	190	360
Real income	1282	266	195

Source Begg D 1994 Economics McGraw Hill

was measured. Some of the reasons for higher prices in the UK compared with Japan for example, could be a result of expectations of price rises arising from the vast amount of financial deregulation that was taking place.

The quantity theory of money has other limitations for the monetarists, as it states that MV=PT, (money times velocity of circulation equals the price times the number of transactions). However it is very difficult to measure money in the economy. Narrow measures such as MO which includes notes and coins may miss out important variables. On the other hand a broader measure such as M4 may prove difficulty in calculating all the components that are necessary to be included. Finally governments have had trouble in the past trying to restrict bank lending, often banks have found a way round regulation introduced by government.

However it is still important for government to ensure the money supply does not expand too rapidly. Government will raise interest rates to reduce the supply of money and take pressure off inflation. Further support for this policy is supported by the Fisher hypothesis which states that a one per cent increase in inflation will be accompanied by a one per cent increase in interest rates. Recent Policy has been successful in generating low inflation in Europe and the USA , see table 2.

Table 2 Inflation Rates for 2006 and 1992 in the USA and Selected European Countries

	2006	1991
USA	3.3 per cent	3 per cent
FRANCE	1.6 per cent	3.5 per cent
UK	1.7 per cent	5 per cent
GERMANY	1.6 per cent	4 per cent
ITALY	1.9 per cent	5 per cent

Source : *The World in 2006* Economist Publications and Sloman J 1994 *Economics*

However as shown in the table, success is also dependent on whether you look at the long or short term perspective. Inflation rates in the previous decade have been higher for most countries. Furthermore inflation in the UK 30 years ago hit 25 per cent. It then fell to ten per cent in the late 1970s and was over 15 per cent in 1980. In Italy in the same year inflation was 22 per cent and 14 per cent in the USA. In the mid 1980s it was under five per cent when the UK adopted stricter monetarist policies. In the late 1980s after tax cuts it rose again to eight per cent and then fell and has been just under six per cent since the mid 1990s to the present day. The last decade has seen continuously low inflation, but over a 30 year period things have been quite different. Evidence therefore suggests that on a decade performance inflation may seem dead, but further historical analysis may lead us to feel there is always the risk of the problem reoccurring. There has also been a correlated between interest rates and inflation. In the UK for example during the 1970s and 1980s when inflation was high, over 10 per cent at times, interest rates were also raised above the 10 per cent mark in order to combat inflation and greatly exceeded the 25 year lows that we have recently been experiencing.

Factors leading to the successful curbing of recent inflation

Most countries globally have followed the policy of the American dollar currency in order to help reduce inflation in other countries. According to the *World in 2006*[4] Hong Kong and some other Asian countries, along with Europe, have begun to raise interest rates in order to slow down spending and cool the housing market and thereby reduce inflationary pressures If enough action is taken early to reduce inflation via interest rate rises there is less of a need for interest rates to go excessively high. This therefore shows the importance of reducing the expectations of interest rates moving out of control.

There are also further pressures to maintaining low interest rates. There is also a slowdown in Chinese growth predicted for 2006. This is partly a result of the need for higher interest rates to reduce inflation risk arising from higher oil prices due to China's huge dependency on oil. Also the entry of China to the global economy has led to more competition and driven down prices. This needs to continue to help further reduce inflationary pressure.

Additional risk could occur from the fact that many countries may wish to reduce interest rates to avoid a slowdown in growth. Falls in global house prices could exacerbate the problem. Countries cannot reduce interest rates too quickly due to oil price pressures though many may feel forced to reduce rates soon.

Interestingly, recent improvements in growth have led to interest rate hikes in Europe which shows how countries looking more long term may not be tempted to reduce rates until the time is right, which is encouraging. A situation of higher interest rates later can be avoided by having prudent policies. The Federal

Reserve, the European Central Bank and the Bank of England therefore, seem to have been learning from past mistakes. However it has been evident that the European Central Bank and the Federal Reserve are adopting a different approach to the Bank of England at present. Growth in the EuroZone particularly in France, Germany and Ireland has begun to increase and is exceeding the UK growth rate, consequently rates have risen from 2 to 2.5 per cent. The UK has recently experienced a slowdown in consumer spending and the housing market and rates have fallen from 4.75 to 4.5 per cent in early 2005. European interest rates rose in 1992 following a crisis of the European exchange rate mechanism, when interest rates went up to over ten per cent to protect

If there is a lot of cheap money available, people are more likely to borrow and spend more

currency values, though the UK was able to reduce interest rates more quickly by leaving the system. This event provides further evidence that interest rate changes also influence currency values, as well as influencing inflation rates. The USA has opted for a tightening of monetary policy similar to the ECB due to falling unemployment and a more buoyant housing market.

The importance of expansion in global trade

There are other factors that have led to lower inflation. There has been a commitment by more countries to opening up markets and adopting sound economic policies. By joining the WTO countries are showing support for the above goals. The number of WTO members now exceeds 150 with Saudi Arabia set to join this year. The collapse of communism and the opening up of China to the world economy, offers benefits from specialisation, more choice and lower prices that can be delivered from the free market mechanism provided competition is properly regulated. Bhagwati[5] 2005 has suggested that globalisation and world trade have increased the flow of skilled workers, therefore helping to reduce costs and inflation further.

Finally, it is possible to say that due to economic policy coordination, people may begin to behave in a way that policy makers are predicting. Media coverage of the economy and the increased ownership of property across many classes of society have led to a greater understanding of how investment and the economy function. Economic policy can then be coordinated in order to predict human behaviour more correctly and then take the measures necessary to optimise wealth in society. Indeed it is more possible than before to consider the rational expectations of people, as knowledge of the economy becomes more widespread and methods taken to curb inflation can become more effective.

Conclusion

This article has shown the many pressures building up on inflation notably from higher oil prices and tightening of the labour market as well as increasing stock market values according to Orr6 2005.There is also some risk of higher inflation due to a time lag effect that may take place. Historical analysis has also shown inflation to still be a risk if a longer time period is considered. Factors holding down global interest rates and inflation include falling consumer spending and a moderate slowdown in Chinese growth. There is an element of fortune in getting all factors to balance. However many of the fundamentals for low interest rates and inflation remain intact.

The federal reserve is prepared to raise interest rates when necessary in a world where many countries follow USA interest rate policy making, thus fixing currencies with the dollar. More countries are adopting a labour market where salary increases are limited. Equally important is a flexible employment market and a more competitive world economy.

References

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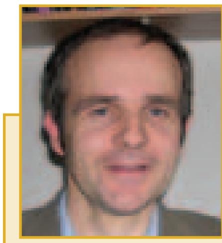

David Floyd is currently senior lecturer in international business at the university of Lincoln. He has also worked for the University of London and the University of Hong Kong. He teaches international business at post graduate and undergraduate levels and consultancy projects have also been undertaken for the DTI and United Nations.
"I would like to dedicate this piece to my late father John Floyd for his help and support in my academic career."