Box A: Changes in Short-term Interest Rates in Industrial Countries

From early 1997 until recently, there had been a widespread tendency among industrial countries, albeit a gradual one in some cases, towards higher policy interest rates. In some countries, this was aimed at restraining incipient inflationary pressures arising from strong demand, and in others it reflected attempts to limit falls in exchange rates. Leaving aside Japan, where short-term interest rates were at the extremely low level of 0.50 per cent until September 1998, and then cut further to 0.25 per cent, the countries fall into three groups:

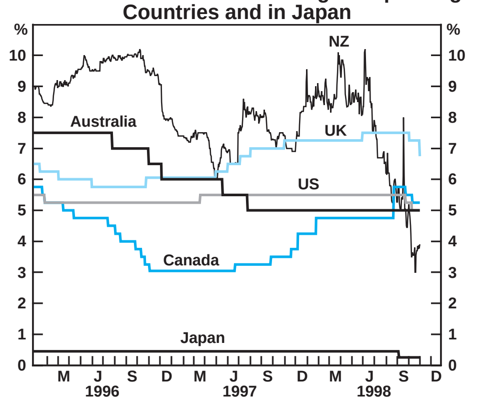
- the English-speaking countries (United States, United Kingdom, Canada, New Zealand and Australia);
- the Euro 11 – i.e. the eleven countries that will adopt the Euro on 1 January 1999 (Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Finland, Portugal, Ireland and Luxembourg); and
- the Scandinavian countries (Sweden, Norway and Denmark).

English-speaking countries

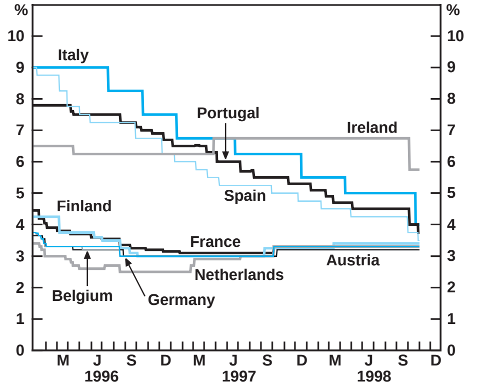
All English-speaking countries, including Australia, had eased monetary policy during 1996 against a background of below-average growth and low inflationary pressures. But by the first half of 1997 all had started to raise interest rates, except Australia, where two further cuts in interest rates were made in May and July 1997 (see Graph).

The US Fed increased interest rates only once – in March 1997, from 5.25 per cent to 5.50 per cent – but it retained a bias towards tightening at most Federal Open Market Committee meetings through to July 1998. Canadian interest rates rose in five steps between mid 1997 and early 1998, from 3.0 per cent to 4.75 per cent, and then to 5.75 per cent in August as the Canadian

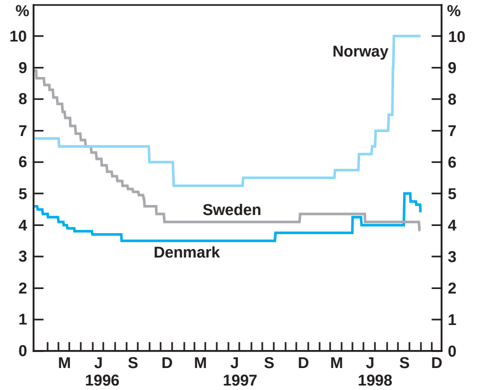
Short-term Interest Rates in English-speaking Countries and in Japan



Short-term Interest Rates in Euro Countries



Short-term Interest Rates in Scandinavia



dollar came under pressure. The UK tightened on six occasions between late 1996 and the end of 1997, lifting rates from 5.75 per cent to 7.25 per cent. Amid signs that inflationary and wage pressures might have been stronger than earlier thought, the Bank of England made a further tightening of 0.25 percentage points in June 1998.

While most of the increases described above reflected concerns about emerging inflationary pressures as economic activity picked up, the increases in New Zealand interest rates which began in the middle of 1997 were associated with a fall in the exchange rate of the New Zealand dollar. Like the Australian dollar, the New Zealand currency came under downward pressure from the middle of 1997 following the outbreak of the Asian crisis, and the increases in interest rates acted as a counterweight to prevent too rapid a fall in the Monetary Conditions Index – the exchange and interest rate composite used to guide monetary policy in New Zealand. Between mid 1997 and mid 1998, short-term interest rates in New Zealand rose from around 7 per cent to about 9 per cent.

The four countries which raised interest rates in 1997 and into 1998 have all reduced them recently. In New Zealand, where interest rates began to fall in late June 1998 as signs became clearer that the economy was in recession, short-term interest rates have since fallen to around 3.5 per cent. The US eased in late September and again in mid October, on each occasion by 0.25 percentage points, reducing the Fed funds rate to 5.0 per cent. These easings were in response to turmoil in US financial markets. Canada quickly followed the US on each occasion, effectively reversing half the August rise in rates. The UK eased in both early October and early November, by 0.25 percentage points and 0.50 percentage points respectively, to 6.75 per cent.

Euro countries

The decision by 11 European countries to adopt the Euro as the single currency at the start of 1999 means that their policy interest rates need to converge by that time. At the start of 1996, short-term rates in the 11 countries ranged from 3.40 per cent to 9.0 per cent. Through 1996, interest rates in all 11 countries fell (admittedly by different amounts) as, like the English-speaking countries, they responded to softer economic activity (see middle panel of Graph). In 1997, however, Germany, France, the Netherlands, Finland, Belgium, Ireland and Austria raised interest rates as economic activity in these countries picked up and inflationary pressures increased. More recently, those at the high end of the range have implemented cuts so that rates now range from 3.20 per cent to 5.75 per cent.

Through the first half of 1998, the expectation was that short-term rates in these countries would eventually converge at the weighted average – 3.75 per cent. But with inflationary pressures turning out to be less intense than earlier thought, expectations in recent months have swung to favour convergence towards the bottom end of the range.

Scandinavia

The path of official interest rates in the Scandinavian countries is shown in the bottom panel in the Graph. Like other industrial countries, they too eased through 1996 and then began to tighten in the second half of 1997. Sweden reversed its tightening in June 1998 – cutting rates by 0.25 percentage points to 4.10 per cent – as inflationary pressures turned out to be less than earlier expected. It eased further in early November, to 3.85 per cent.

Norway and Denmark, on the other hand, raised interest rates substantially further in 1998, mainly in response to exchange rate pressures. In the case of Norway, rates were raised from 5.50 per cent to 10 per cent, while in Denmark they rose from 3.75 per cent to 5.75 per cent. Since then, Denmark reversed some of this, cutting rates in three steps to 4.40 per cent, but Norway has left rates unchanged.