



From Fiji Times

## The knowns and the unknowns

DR T K JAYARAMAN  
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From left: The Westpac Bank, Reserve Bank of Fiji, ANZ Bank and Colonial Bank in the heart of Suva.

THE previous week this column noted that sustained recovery in America was subject to the employment figures expected on January 8.

What was feared happened. More jobs were lost in December; 85,000 more than in November, which saw only 11,000 job losses.

There were expectations that in the context of rising prices of crude oil and iron ore, central banks would resort to tightening measures.

Only China responded.

Australia was the first rich country to raise its benchmark interest rate ever since October.

After an unprecedented third month in a row of increases by the RBA by 25 basis points, it is 3.75 per cent.

Other rich countries are hesitating.

**Why the reluctance?**

Central bankers recall the bitter experiences of the 1930s in USA and 1990s in Japan.

Too early a restrictive policy action following the first signs of recovery on the horizon brought in a disastrous outcome, resulting in another slow-down.

They do not want a repeat.

Since mid 2008, the benchmark rate in US is near zero. Further, the US Federal Reserve (the Fed) has pumped hundreds of billions of dollars into the financial system.

Last week, Bank of England left the key interest rate unchanged at 0.5 per cent, which is the rate since March 2009.

Relying on the "Zarnowitz (Z) rule", it is argued that since recovery would be from a low level, inflation would not be a concern.

The Z-rule, named after the author, Prof. Victor Zarnowitz of the University of Chicago states that deep recessions are always followed by rapid rebounds.

This is because of catch-up spending on consumption of durables, investment and housing.

Not many agree.

There is fear of inflation due to rising fiscal deficits and public debt. During the former Fed Chairman Greenspan, it was low interest rates which led to uncontrolled credit expansion and asset bubbles bursting into financial meltdown.

Critics want the Fed to act now, in the classic phrase of another former Fed Chairman William Martin, "Take away the punchbowl just as the party gets going,".

There is such a growing distrust in the Fed that a book by the US Congressman Ron Paul, an unsuccessful Republican Presidential candidate in the 2009 primaries, has become instant best-seller. In his *End the Fed*, he attacks the Fed as an "immoral, unconstitutional . . . tool of tyrannical government".

## **A Chinese Surprise**

On January 8, the yield of the People's Bank of China (PBOC)'s three-month bills went up to 1.3684 per cent, by 4.04 basis points from 1.3280 per cent. This is the increase after August 2009, reflecting its concern for cooling growth and controlling inflation.

In the absence of a well-developed bond market, quite similar to Fiji, PBOC influences short-term interest rates through open market operations (OMO) in its three-month bills. PBOC sells three-month bills to mop up excess liquidity. The yield is the indicator interest rate.

Aside from interest rate changes, PBOC also uses reserve ratios. These measures put brakes on reckless lending.

### **Fiji's steps**

Under a fixed exchange rate regime, changes in foreign reserves lead to changes in liquidity. In April when reserves were low, liquidity was low.

Once foreign reserves reached a record level of \$1.1billion in September 2009, liquidity in the Fiji's banking system began to grow, reaching \$300million in November.

The Reserve Bank of Fiji took timely steps to control growth in liquidity. The RBF raised the statutory reserve ratio from 5 per cent to 7 per cent, effective December 7.

Banks are now required to keep higher amount of reserves. The RBF aims at a comfortable level of liquidity around \$200million without causing any upward pressures on interest rate.

The policy indicator interest rate stands at 4.25 per cent.

The IMF team which visited Fiji in November commended the RBF steps to absorb excess liquidity. It also suggested market-based instruments such as RBF Notes be used.

While small countries have to play safe, bigger countries have to weigh various options. Monetary policy actions become complicated in an uncertain world.

When price expectations swing widely: from deflation to inflation, policy changes are made on the basis of uncertain or "unknown" information.

Former US Secretary of Defense Rumsfeld won a "Foot in Mouth" award by the British Plain English Campaign in 2003 for "nonsensical remarks by a public figure", when fighting terrorism.

Economists are now quoting him. No more nonsensical.

"As we know, there are known knowns; there are things we know we know.

We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns the ones we don't know we don't know"

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*\* Dr TK Jayaraman teaches economics at USP. Views expressed are his own.*