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Banks Play Safe

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Two central banks in our region, the Bank of England (BOE) and European Central Bank (ECB) for the 17-nation eurozone, have all decided to play safe: they would be maintaining their current monetary policy stances unchanged**.**

While on August 30, Reserve Bank of Fiji (RBF) left its policy rate at 0.5% unchanged for the eleventh consecutive month, on September 4, Reserve Bank of Australia (RBA) decided to maintain benchmark interest rate on hold at 3.5% for the third month in a row. On September 6, BOE kept interest rates at 0.5%, now for more than three years, and ECB its rate also at historic low 0.75% for the third month.

In August, it was expected the recovery of world economy would be led by China despite uncertainties in Europe. The ECB President also assured the world that he would do whatever it takes to save the euro.

Dismal data

The latest economic data are dismal.

Euro crisis is prolonging with no action. In the eurozone, output is falling. In 2012, it is now estimated it would shrink 0.3% and Germany would grow only by 0.7%. Moody’s has lowered European Union’s AAA rating to negative. The British economy has just been forecasted to contract in 2012 by 0.7%.The Chinese economy is faltering. Its manufacturing fell to a nine-month low in August and growth will be less than 8%, the lowest in 13 years.

In America, this week attention was on divisive politics with national conventions of the two parties. In his speech at the annual meeting of central bank governors in Jackson Hole, Wyoming, on August 30, the US Federal Reserve chairman admitted that the economy "is obviously far from satisfactory," and the weak job market is a "grave concern" causing "enormous suffering and waste of human talent."

The impact of the European slide into recession, weak recovery in America and faltering growth in China is now hitting hard the rest of the world, including Australia. Soon, Pacific islands will catch the contagion.

End of the Mining Boom?

Australian economy, driven in the past by mineral exports to China, has grown slower. It grew at 3.7% in the second quarter as against 4.3% in the corresponding period last year. The decline in terms of trade has been responsible. The iron ore price fell by 34% from US$135 per tonne in July 2012 to US$ 89 per tonne in September 2012. Mining companies have postponed their investment and development programs, resulting in lay-offs.

So RBA decided to watch and maintain the same rate. If things get worse, there would be a cut next month.

The RBF in a press release, says that "global growth outlook remains clouded by underlying problems in the Eurozone and the associated flow-on effects on its trading partner economies and having picked up in the early months of 2012, growth in the world economy has since softened".

Limitations of monetary policy

Price stability is the responsibility of central banks. They target low inflation as their goal. RBA's target rate of inflation is 3%. RBF also aims low inflation. However, no central bank could be mandated about the rate of economic growth, since fiscal policy, the driving force of economic growth is the responsibility of ministry of finance.

Yet, central banks and ministries coordinate their policies. At best, monetary policy is expected to be supportive of the economic recovery as it has to be watchful of inflationary pressures.

There are two aspects of economy. One, where goods and services produced are in real terms; and the other is where they are in money values. Money is neutral with respect to the real economy. In the long run, changes in money affect only prices, not goods and services in real terms, although monetary policy does affect real variables the short run.

However, recent experiences have shown that loose money policies in the US, UK and Europe have met with limited success, even in the short run. Already interest rates are low.

Two months ago, politicians in Australia clamoured for a large cut in interest rate. Stephen Kirchner of University of Technology Sydney Business School wrote that we cannot buy additional economic growth through monetary policy.

Obviously, real variables have remained unaffected.

Kirchner recalls the US economist, John Taylor's findings that official interest rates are largely explained by the current and past state of the economy and that the remainder that cannot be explained is the discretionary component of monetary policy. And it is usually very small. Therefore, it is the economy that drives monetary policy. Not the other way around.

So, when will the recovery begin?

Only when business confidence, a real variable, returns.

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