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Interest rate cuts by major central banks

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This week's column focuses on three central bank actions. They are of considerable significance.

This week, South Korea's central bank, the Bank of Korea (BoK) and Reserve Bank of Australia (RBA) cut their benchmark interest rates. Last week, it was the turn of European Central Bank for the 17- member Eurozone.

All the rate cuts are directed to step up the sagging domestic demand in the light of worsening economic conditions. The latter are now compounded by falling exports due to depreciation of the competitors' currencies, not by deliberate government action but by their central banks' own easy money policy actions.

BoK action

Exports of South Korea contribute 50 percent of its national output. In recent weeks, the Korean currency appreciated 20 percent against the Japanese yen. It is due to launching of Abenomics under the new Japanese Prime Minister Shinzo Abe. Japan has resorted to massive injection into money supply, under the name of quantitative easing.

Under the floating currency regimes, aggressive, expansionary monetary policy by one country lowers its own exchange rate automatically unless and until other countries adopt similar steps. Fall in interest rate and consequent lower returns on domestic assets as expectations of inflation lead to capital outflows and contribute to fall in the value of the domestic currency.

It is an offshoot of quantitative easing. America has been doing it since 2008, ever since its central bank has been adding to money supply by trillions. The US dollar has fallen against currencies, which has helped America to boost its exports level.

The Korean won has risen more than 8 percent against the US dollar over the past 12 months. So the action by BoK is not surprising. The cut in its benchmark rate from 2.75 percent to 2.5 percent is clearly a countermove against a weakening yen.

RBA Action

On Tuesday, May 7 the Reserve Bank of Australia cut its benchmark interest rate, known as the overnight cash rate 25 basis points to 2.75 percent from the previous rate of 3.0 percent. It is record low rate.

The purpose is obvious. The cut is aimed to boost the non-mining sectors, which are lagging behind the mining sector. The decision would help rebalancing the economy by lessening the upward pressure on exchange rate. The booming mining sector thanks to enormous Chinese appetite for Australia's minerals has pushed the Australian dollar high enough, hurting export competitiveness of manufactured goods in the South and east Australia. As a result, unemployment was a three-year high in the depressed regions. Australian dollar has been little changed "at a historically high level over the past 18 months, which is unusual given the decline in export prices and interest rates during that time. Moreover, the demand for credit remains, at this point, relatively subdued."

In the context of a favourable inflation outlook, RBA considered that a "further decline in the cash rate was appropriate to encourage sustainable growth in the economy, consistent with achieving the inflation target."

Since government spending is expected to decrease, interest rate cut would boost private investment in non-mining sector. The objective is to provide stimulus through all possible channels of monetary policy transmission mechanism on all fronts, including exchange rate depreciation.

The RBA decision to cut its rate followed another central bank decision.

The ECB action

Last week, European Central Bank (ECB), the common central bank for the single currency 17-member Eurozone finally reduced its interest rate for boosting economic activities. It was a much delayed action.

Possibly inspired by the two-decade old deflationary Japan's central bank action to resort to unprecedented injection of massive liquidity, ECB must have felt it to do more. It just brought the benchmark interest rate closer to rates in other recession ravaged countries.

The ECB interest rate stands at 0.5 percent, reduced from 0.75 percent. It is now similar to rates in USA, UK and Japan.

All the central banks have openly announced themselves to be on expansionary path. The US Fed policy has now fully embraced the third phase of Quantitative Easing 3, also known as QE infinity, as no amount is indicated, to pump in more liquidity in the system until the unemployment rate is brought down to 6.5 percent.

It is planned to inject each month about US\$ 45 billion to US\$ 85 billion. It has already helped the American economy to take advantage of fall in value of the American dollar. Exports have gone up from US 1.1 trillion to US \$ 2.0 trillion. It is expected to double up by 2015.

A bubble to rescue?

The inflation level is subdued. The Japanese inflation target of 2 percent will not be reached for a while. The European inflation is still below ECB's target of 2.0 percent. As long as inflation is still low, recovery is possible if the economy picks up.

For two days in a row, on Tuesday and Wednesday, the stock market was booming. The Dow index was above 15,000. It was unusual. There were no new reports of any upbeat nature. Yet the market behaved exuberantly.

The investor guru, Warren Buffet would say "it is good"

Since inflation is still low and since gold has no return, switch on to something better: the bond yield is poor with low interest rate, put your savings in stocks!

Some bubble is better than no bubble!