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Is Australia on expansionary path?

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The much awaited decision of the United States (US) Federal Reserve Open Markets Committee (FOMC) on the future monetary policy was announced on Wednesday, July 31, (US time).

Two weeks ago, the Federal Reserve (Fed) chief in his testimony before US Congress comforted the markets (equity, bonds, commodity and currency) all over the world that Fed would not curtail the current programme of buying bonds for adding to money supply.

The programme, known as quantitative easing (QE) did not contain any timeline.

Formal decision

The formal decision by FOMC of July 31 put all doubts to rest. The Fed would continue buying $US85 billion in mortgage and Treasury securities each month for strengthening the economy "still challenged by federal budget-tightening."

The Fed announcement said that the pace of growth was only "modest." It did not use the word "moderate" this time, which was used previously describing the encouraging signs of recovery in housing and equity markets. Further, Fed noted rise in mortgage rates since June this year, after the Fed chairman's remark that the Fed would consider tapering of bond purchases by year end. Furthermore, the decision was influenced by the benign inflation environment. The core inflation is only 0.8 percent, which is well below the 2 percent target.

Low interest rate everywhere

The US benchmark interest rate is almost zero since 2008. Under QE, the Fed added US$3.6 trillion to money supply for holding down long-term borrowing costs for promoting investment, especially housing construction. Housing is a key component in the recovery process. The Fed confirmed the thresholds are still the same: easy monetary policy would continue as long the unemployment rate remains above 6.5 per cent and until inflation builds up to 2.5 percent.

The Fed's QE model (with low interest rate) is now followed in major developed countries: England, Eurozone and Japan. On Thursday, both Bank of England and European Central Bank decided to maintain their benchmark rates at 0.5 percent, which are all historically low rates.

Focus on Australia.

Will Reserve Bank of Australia (RBA) cut the interest rate of 2.75 percent?

Australia is facing the challenges posed by the end of the mining boom, consequent to China's economic slowdown with lower intake of Aussie mineral exports. Governor Glenn Stevens of RBA in a policy speech referred to the depreciating Australian currency. The currency decline is attributed to lower export earnings as well as reduction in RBA's benchmark interest to a historic low of 2.75 percent since May 2013. The lower rate was for promoting investment in non-mining sectors.

Since inflation is at a subdued level, below RBA's target band, Governor Stevens said he was not "running out of ammunition in the near-term," since non-mining sectors, including the housing sector, need further boost. He was hinting at further monetary easing with a possible cut in the cash rate.

Aussie dollar, under a floating exchange rate regime with perfect capital mobility, would depreciate if the interest rate is cut further. However, market expectations worked faster. Soon after Governor's policy speech and the US FOMC decision, the Aussie dollar fell below 90 US cents, its lowest level in almost three years.

It is the future expectations that cause the volatility in currency markets.

Unintended benefit

During the last three months, Aussie dollar depreciated by 15 percent. Any further interest cut would result in depreciation of currency, which is good for non-mineral exports and tourism. The RBA Governor hopes that it would not have "a major impact on inflation unless it results in a very large depreciation".

Monetary easing has an "unintended" beneficial effect.

It has worked in Japan after its QE. The yen fell 20 percent against the US dollar and its exports increased 7 percent since January this year. We have yet to enter the era of competitive depreciation. Remember Korea's retaliatory response to Japanese currency depreciation.

Implications for Fiji

There are implications for Fiji's tourism and remittance earnings. Falling Aussie dollar would make overseas travel for Australian citizens more expensive. Falling Aussie dollar received by Fiji citizens would bring less Fiji dollars than before.

However, imports from Australia, wheat and rice and medicine, should cost less.

In the meanwhile, the Business Council of Australia (BCA) wants government to float long term bonds for funding an Aus$750 billion infrastructure investment programme to make the country more competitive. The BCA defends such massive borrowing as "good debt" as distinguished from "bad debt", which is borrowing for recurring expenditure.

Well, this is one of those times: election time in Australia.

All sorts of ideas, “wild” and “non-wild”, do float during such times!