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Three central banks and their actions

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This week focus is on recent central bank actions.

On August 29, Reserve Bank of Fiji (RBF) decided to maintain the benchmark interest rate, known as overnight policy rate, at 0.5 percent. It is operative since October 2011.

Interest rates are pro-cyclical. If the economy is on an expansionary path, interest rate would rise. Optimism drives up borrowing. More borrowings by investors in anticipation of higher return would push borrowing costs up, given the money supply.

Upbeat RBF analysis

The RBF forecasts growth at 3.2 percent this year. There has been expansion in the sugar, tourism, timber and garment sectors. Because of high liquidity, lending rates are still low. The high liquidity is attributed to increase in foreign reserves. In a fixed exchange rate regime, money supply is influenced by rise in reserves.

The twin objectives continue to “remain intact.” Inflation was 1.9 percent in July while foreign reserves were around \$1.8 billion. Since the world economic environment is weak and inflationary conditions are benign, RBF deems the accommodative monetary policy stance appropriate.

Due to rise in optimism, bank credit has grown by 15 percent in the twelve months to July 2013. If investor confidence rises with elections heralding return to normalcy, credit flows would rise further. The concern would then be with containing inflationary pressures and the revival of pent up demand. .

Australian central bank action

The Reserve Bank of Australia (RBA) decided on September 3 to maintain its benchmark interest unchanged at 2.5 percent. The cutting cycle began in November 2011. Since then, RBA slashed interest rate by 2.25 per cent.

The interest rate is at its lowest level in 53-years. The exchange rate has come down to around US 90 cents per Aussie dollar. The RBA expects further depreciation encouraging its traditional non-mining exports.

The conditions are considered by RBA as favourable for a rebalancing of growth. Home prices are on the rise. Once the elections are over, business confidence would increase.

The cutting cycle seems to be over. So, the Rudd government could not get an election week rate cut gift.

Emerging countries are different

It is a different time for emerging economies: certainly it is a testing time for Reserve Bank of India (RBI).

India is in crisis.

During April -June, India grew only at 4.4 percent, less than the average growth rate of 8 percent during last ten years. The rupee went down by 25 percent in last two months. It is now around 68 rupees against the American dollar.

The government blamed it initially on external factors: the impending tapering of a cheap money policy in America. Eventually, they conceded that domestic factors were responsible: They are mounting domestic fiscal and current account deficits (CADs), both a close 5 percent of GDP.

The signs of imminent crisis were ignored because of capital inflows. The annual CADs were financed by capital inflows. Now that interest rates are likely to go up in America, reverse flows of capital have caused the rupee debacle.

Growth at any cost?

The blame rests on the government. It postponed reforms, especially those relating to foreign domestic investment, which are long term non-debt creating inflows. They cannot be pulled out so easily and quickly. Dependence on short term, hot moneys has landed rupee in trouble.

The mandate of any central bank is stability: both internal and external.

Falling rupee pushes up costs of oil and other commodities for which India is heavily dependent on imports. There is no other alternative for RBI left to contain demand and reduce inflationary pressures. Concern with inflation and dim long term growth prospects prompted RBI during recent months to raise short term interest rates. These measures were frowned upon by government.

The goal of government is different: winning the elections scheduled in May, not long term stability.

Last month, when the rupee fell steeply Indian Prime Minister at a function releasing the fourth volume on the history of RBI observed that it was time for revisiting "limitations of monetary policy in a globalised and fiscally constrained economy".

It was an open declaration of disapproval of RBI's actions.

The RBI Governor, Dr Subbarao, who was present at the function, retorted that it was “inaccurate and unfair” to suggest RBI was only focused on inflation. The Governor said the RBI was focused on inflation precisely because “it cared for growth”.

The new Governor, Dr. Rajan who took over from Dr. Subbarao on September 4, declared: “The governorship of the central bank is not meant to win one votes or Facebook 'likes.'”.

It looks he is ready to take unpopular steps including interest rate hike. It remains to be seen how far the government would allow him to do so.

That will determine how short the new Governor’s “honeymoon” would be.