



Saturday September 21, 2013

## US money policy relieves many

**T.K.JAYARAMAN**

America's central bank, the Federal Reserve (the Fed) took a decision on Wednesday, September 19, which surprised everyone. The world anticipated that the Fed would discontinue its cheap money policy, which was pursued through regular purchase of bonds during past five years, or at least begin some sort of scaling back over a period of next few months.

The Fed's decision was to persist with bond purchases. It pleased many. That included stock and bond markets; currency markets and governments of emerging economies, all at the same time, of course, for different reasons.

Indeed, it was one of those rare decisions which made so many feeling relieved.

For emerging economies, it was a reprieve.

The purpose behind the Fed's decision is to continue soaking the US economy with liquidity. The bonds purchase is at the rate of US\$85 billion a month or about US\$1.2 trillion per year, which was started in late 2012. Earlier, they had three phases of what was known as quantitative easing.

The Fed made it clear that for some time it would maintain the cheap money policy and a low interest rate. The policy interest rate, known as the fed funds rate is the rate at which banks can borrow from each other to tide over temporary shortage of funds. It is a close zero percent for past five years. The objective is creation of jobs for reducing the American unemployment rate below 6.5 percent.

### **Reasons behind the surprise action**

Soon after his decision on Wednesday, the Fed Chairman Ben Bernanke explained the reasons: (i) America's sluggish economy with growth rate forecasts cut to between 2.0 percent and 2.3 percent from the previous 2.3 percent and 2.6 percent; (ii) slow job creation and the fall in unemployment rate to 7.3 percent was more due to job seekers leaving the employment market or prematurely seeking retirement; (iii) unwillingness of the US

legislature to reach a consensus on debt ceiling; and (iv) tightening of financial markets, as reflected in rise in mortgage interest rates.

It looks now that the cheap money policy, which began in late 2008, would continue until new evidence emerges to merit a policy change.

Since there is no risk of inflation as inflation is still around 1 percent, which is less than official target of 2 percent, the Fed's decision presently seems appropriate. The Bank of England and the European central bank have kept their interest rates at 0.5 percent. So too the Reserve Bank of Fiji, while Reserve Bank of Australia has decided to continue its historically low rate at 2.5 percent.

### **Jubilant markets**

Cheap money means low interest rates for government debt. Investors are now switching on to shares and corporate loans for higher yields. The US stocks therefore shot up to record highs. The bond yields also dipped down, as the demand for corporate bonds rose. Gold markets too have a roaring time since traders expect the Fed's decision would be inflationary.

The emerging economies, Brazil, Russia, India, Indonesia, China and South Africa were also pleased. Noting interest rates in the US would remain low for a while, investors, especially foreign institutional investors are now returning to emerging countries for higher returns. The resumption of capital inflows would strengthen currencies of emerging economies, which would make their imports cheaper.

That made the exporters in the Eurozone happy.

Orders for German machinery fell in recent months, since the currencies of emerging economies, including India declined against the euro as well. So any rise in the value of Indian currency is sweet news to German industry and they expect exports to India would once again rise.

Among the emerging countries, India surely heaved a big sigh of relief. Its rupee went down by 25 percent in late August, the biggest drop amongst the depreciating currencies of all emerging countries: Reluctant to raise interest rates, cosmetic measures were taken by Indian bureaucracy, which included raising duty on gold imports and flat TVs.

The pressure is off, as there is now no urgent need to raise interest rates to attract inflows. Inflows will resume any way and the rupee will rise again.

### **Two choices**

Emerging economies should realise the Fed's cheap monetary policy cannot go on forever.

The postponement offers extra time to their policy makers.

India has to cut fiscal deficits and contain current account deficits, both are a close 5 percent of GDP.

It should begin structural reforms in full earnest. Attracting and retaining the non-debt creating foreign direct investment inflows of durable nature is critical. Placing reliance on destabilizing, volatile hot money inflows for bridging current account deficits is foolhardy.

The other choice is easy: postpone reforms and enjoy the large slice of US cheap money.

As elections are approaching, the major partner in the ruling coalition has begun offering goodies to the voters. The latest was a food subsidy scheme of US\$ 23 billion, which was approved in the midst of the currency crisis, when the rupee plunged to the lowest: 68.85 against US dollar!

With more goodies coming up, the subsidy juggernaut economy can saunter along until the next crash comes!