FIJI TIMES

Oct 1, 2016

Monetary policy review

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Advanced countries are striving hard to inflate their economies. They are pumping in money since 2009. They have adopted low interest rates. Yet, no success: weak growth; and low inflation.

The news is on hand food prices have declined for nine straight months in the US: a continuing food deflation in 50 years. The basket of groceries is now 10% cheaper than it was nine months ago, having fallen from US$ 114.86 in December 2015 to US$ $104.17 in September 2016.

Under bonds purchasing program (known as quantitative easing or QE), between 2008 and 2015, US Federal Reserve (the Fed) increased money supply by US$3.7 trillion. It formally ended QE, when there were signs of recovery: absence of two continuous quarters of negative growth in GDP. The Fed tried to normalize the interest rate in steps. It raised it to 0.50% in December 2015.

Between 2009 and 2015, UK added £375billion (US$ 550 billion). After BREXIT decision, UK would add another £70 billion. A late beginner, since January 2015 Eurozone pumped in US$600 billion.

The central bank benchmark interest rates are now at the lowest: Australia (1.5%); Canada (0.50%), Eurozone (0.00%); Japan (negative 0.10%); UK (0.25%); and USA (0.50%).

Price level is stubbornly low. Inflation year- on- year in August, in USA is: 1.1%; UK: 0.6% ; Japan: negative 0.6 %; and Eurozone: 0.2%.

Inflation is below the mandatory target of 2%, for the Fed and for other central banks. It is doubtful whether the Fed would raise interest in the near future

“One man's meat is another man's poison.”

Consumers may not like the rising price level. On the other hand, investors like it for more than one reason. Aside from fall in the real interest or the real cost of borrowing, inflation is an incentive to investors. Increase in investment expands production activities employing idle resources and of course, creating more employment.

Rise in price of goods, whether stored by shop keepers long before increases in excise duties or import tariffs, they are always happy. With new marked up price increases, profits rise, given the original costs.

The same thing applies to producers; when prices of raw materials rise, the cost of production rises but the major component, wages do not immediately increase. Under the pretext of matching the final price with cost push by raw materials, producers resort to additional mark up. Profits rise. Inflation becomes an incentive to invest more. Falling prices make investors unhappy. If the trend continues, they postpone investment until price level recovers.

Rise in prices calls forth more supply. In the short run, profit is the motivating force. The economics Guru, Adam Smith wrote in 1776:

“It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest”.

“I am smart”

Reganomics and Thatcherism have rejected fiscal policy to boost aggregate demand. Governments are now obsessed with money: money alone matters, as lubricant for growth. For them, if private sector is motivated by profit, encouraged by price rise or by low tax, everything will fall in place.

During the debate this week between the two American Presidential candidates, when Democrat Mrs. Hilary Clinton referred to her opponent’s reluctance to release his tax returns, hinting that he either paid less or no federal income tax at all, Republican billionaire Trump interjected: “I am smart”.

The primary purpose of monetary policy is for achieving domestic price stability and for influencing the exchange rate, where the countries have a flexible exchange rate regime. Fiji has a fixed exchange rate regime. So it cannot use monetary policy to influence exchange rate. The role of monetary policy is to maintain price level: fight inflation by raising interest rate and make credit expensive or fight recession by making credit cheaper.

A former Governor of Reserve Bank of Australia once argued eloquently that monetary policy alone cannot buy growth. It is only “the animal spirits” that can kick growth. That is the age old Keynesian remedy of the 1930s: fiscal policy.

Fiji situation

The Reserve Bank of Fiji Governor on September 20 told the Parliamentary Standing Committee on Economic Affairs that inflation is creeping up since April this year.

It rose from 0.8 percent (year- on- year) in March to 3.8% in April; 5.2% in May; 5.3% in June; 5.5% in July and 5.9% in August. We can expect more of the same with the oncoming festival season.

Aside from impact of TC Winston, the rising trend in inflation is due to rise in consumption lending: higher loans to private individuals (16.6%) and the wholesale, retail, hotels and restaurants (5.8%) sectors. Similarly, new and second hand vehicle registrations increased annually by 27.3 percent.

Further, real exchange rate is shooting up too. If domestic inflation is higher than trading partners' inflation, the competitiveness of Fiji's exports would be hurt. Furthermore, inflation hurts savings. The real interest is nominal interest minus expected inflation.

If the average savings deposit rate and time deposit rate are 0.90% and 2.79%, (RBFJune Quarterly Review) and if inflation is 5.3%, the real interest rates are in the negative territory: negative 4.4% for savings deposits; and negative 2.51% for time deposits. As a clear disincentive to save, it encourages consumption, adding to inflationary pressures.

Fiji has no specific inflation target. A target of 3% to 3.5% has been the guiding factor and the other target is foreign exchange reserves. A study co-authored with Dr Hong Chen of USP says the threshold level of inflation for Fiji, based on past trends in growth and inflation, is 3.6%. As long as inflation level is below this threshold level, the effects on growth would be positive and any higher level would adversely affect growth.

Borrowing from a former chairman of the Fed, William McChesney Martin, can we say:
"Should not RBF take away the punch bowl just as the party gets wild."

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