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# Two decisions

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The US Federal Reserve (the Fed) chair Janet Yellen in her testimony on February 10 told the US Congress that conditions had changed after the December 15 interest hike, which was the first in seven years.

Last month, Bank of Japan imposed a negative interest rate on the banks' excess reserves kept with it. The purpose was to encourage banks to lend more and get the economy out of recession. The Eurozone growth was just at 0.3% in the last quarter of 2015, with inflation still below the target rate of 2%. The quantitative easing policy of European Central Banking does not seem to be working. The ECB has indicated more easing. So too, the Reserve banks of Australia and Canada have indicated possibility of easing monetary conditions.

The Fed chair calmed the markets with assurance that there would be no increase in interest rate.

Yellen quashed all expectations that the Fed would continue its journey towards normalization of monetary policy, which seemingly looked certain when the bench mark interest rate was raised from near zero to 0.25%, just 55 days ago.

The US stock market immediately rallied.

But it was short- lived. There was no assurance that Fed could go back to the seven-year old cheap money policy. Markets are now addicted to easy money. Obviously markets are dissatisfied.

**US domestic conditions**

The US unemployment rate is below 5%, the target rate for policy makers. If unemployment falls further, economy will heat up. The Fed's role is to stand ready to fight inflationary pressures. In

December, the signs of recovery were firmer than ever before. So, the Fed decided to normalize monetary policy.

The Fed Chair told the US Congress on Wednesday that had the Fed delayed raising the rates for too long “it might have to tighten policy relatively abruptly in the future … Such an abrupt tightening could increase the risk of pushing the economy into recession”.

The US economy has, however, slowed down since December interest rate hike. The growth in the fourth quarter of 2015 was just 0.7% as against 2% in the previous quarter. Less consumer spending, lower exports due to the steady strengthening of the US currency overtime since mid 2015, in anticipation of normalization of interest rate, and fall in investment in the oil sector were the main reasons.

Certainly, inflation is still below the Fed target rate of 2%, with December inflation: 0.73%; and for the whole year: 0.12%.

Critics blame the Fed for a hasty preemptive strike.

**Faltering China**

The Chinese stock market debacle in the first week of the New Year started it all. The already deteriorating conditions of 2015 were further deepened by the debacle.

As investor confidence sank, fears of devaluation reminiscent of August 2015, led to large outflow of capital in January. The latest figures show nearly US$100 billion flowed out of China in January. Investors are continuing to pull out funds to seek safer havens.

China’s reserves have fallen to US$ 3.2 trillion, though a very formidable level.

If China had not quit the much publicized pegged exchange rate regime, any fall in the value of domestic currency consequent to large capital outflow would be welcome. It would promote greater exports and facilitate recovery.

But under flexible exchange rate regime, fall in the currency value indicates declining economic health of an economy, a situation no economy could be proud of!

But since August decision to float the currency, which was hailed by IMF as a first step towards becoming a world reserve currency towards joining the select group: the British pound, the US dollar, the euro and the Japanese yen, there is no let up in the economic downturn of China.

China is uncertain: should it allow the currency to fall further under its much applauded flexible exchange rate regime or prevent its fall?

China is now defending it, by selling US$ from its huge reserves for propping up the renminbi.

**The Irish Tourist**

Professor Barry Eichengreen of University of California at Berkeley in his syndicated column in the ***Guardian*** this week says China missed the bus.

“Countries can exit a pegged rate smoothly only when there is confidence in the economy, encouraging the belief that the more flexible exchange rate can appreciate as well as weaken”.

When China embraced flexible exchange rate regime in August 2015, the economy was already shrinking. Three days of devaluation amounting to 2% was defended on the ground that China would not have a pegged currency anymore.

China needed a weakening currency for reviving export- led growth.

China should have taken the decision to adopt a flexible regime when the economy was flourishing with confidence running high, not when faltering.

Eichengreen says Chinese policymakers are in the similar position of the Irish tourist who asks for directions to Dublin and is told: “Well, sir, if I were you, I wouldn’t start from here.”

So, there were two decisions.

The reader can judge which one was premature.