

“Contest” between central banks



By DR TK JAYARAMAN

THE world has been witnessing a strange contest between central banks: which will be the first one to raise its policy interest rate further to a next high; and by how many basis points more?

Having missed the bus, the monetary authorities now feel so desperate that they have to stop the rising price level any how. Global inflation is going out of hand. It is not just inflation due to high money supply, which was resorted to meet the impact of black swan event (BSE) of COVID-19 during 2020-21. But another 2022 BSE, the ongoing Russia-Ukraine War since February 2022 and the resultant fall in availability of critical inputs, petroleum crude and liquefied natural gas for domestic production of manufacturing goods and transportation and wheat and food grains for sheer survival, due to supply chain disruptions, are all leading to decline in world trade. The third BSE lurking around the corner for last six months is recession: not just stagnation in output, but continuously falling aggregate demand and decline in output with loss of incentives to produce, leading to loss of jobs.

The International Monetary Fund (IMF) released its routine, bi-annual World Economic Outlook (WEO), just a day prior to their October 2022 joint biannual meeting of IMF and the World Bank, which was attended by finance ministers and central bank governors. The WEO October 2022, carrying the subtitle: “Countering the Cost-of-living Living Crisis” presents the situation of slow or no growth, with high inflation. It forecasts that global growth is expected to slow down to 3.2 per cent in 2022 from 6.0 per cent in 2021 and to decrease further to 2.7 per cent in 2023.

Weakest growth profile

The WEO 2022 presents the “weakest growth profile since 2001 except for the global financial crisis (2007-08) and the acute phase of the COVID-19 pandemic (2019-21)”. Global inflation is forecast to rise from 4.7 per cent in 2021 to 8.8 per cent in 2022 but to decline to 6.5 per cent in 2023 and to 4.1 per cent by 2024. The inflation forecasts for the advanced economies for 2022 and 2023 are the US: 8.1 per cent, and 3.5 per cent, Eurozone: 8.3 per cent, 5.7 per cent; and emerging market economies (EMEs) are India: 6.9 per cent and 5.1 per cent; and China: 2.2 per cent and 2.2 per cent.

Giving priority to growth in the midst of inflation, the British government headed by the former Prime Minister Liz Truss, who resigned in early October, 2022 had decided in favour of tax cuts. The policy reversal and the change in the government on October 26 2022, with the new Prime Minister Rishi Sunak were welcomed by the markets. The rise in bond yields came down; and the pound appreciated. The finance minister has proposed tax increases and tighter public spending “to restore the fiscal reputation” of the country. The Bank of England has also raised the interest rate to 3 per cent to fight inflation, which recorded the highest at 11.1 per cent in 41 years. The policy rate

of interest is 3 per cent which is likely to be increased soon.

End of easy money policy era

Current global situation is a product of easy money policy pursued by central banks for long years with low interest rates for meeting the Great Recession (2008-2009) following the financial crisis of 2007 and subsequent delays including the taper-tantrum years (2013-15) in getting back to normalisation of monetary policy. The Russia-Ukraine conflict since early 2022 and the supply-chain bottlenecks and rising oil and energy prices, have led to inflationary pressures which needed fire-fighting solutions from central banks, in the form of monetary tightening. The Nobel Laureate Milton Friedman’s dictum, inflation is a monetary phenomenon anywhere and everywhere continues to hold good.

The US Federal Reserve (the Fed), delayed its response to rising inflation ever since March 2021, when the targeted rate of inflation of 2 per cent was breached. The Fed continued to keep the policy rate low well beyond March 2021, as close to 0.25 per cent on the belief that signs of rising domestic price level were transient due to transitory factors. When inflation signs became “real”, the Fed woke up. That was late. Only after 12 months, in March 2022, nearly after 12 months, the Fed raised it by 0.25 per cent. The policy rate was further raised in May to 0.75 per cent, and steadily thereafter by month to month by 75 basis points: in June: 1.50 per cent, July: 2.25 per cent; September 3.0 per cent. The Reserve Bank of India (RBI) too, which is one of the central banks of EMEs watching more of what is happening in the US, a chief source of short term capital inflows delayed its response.

The US Fed’s efforts towards reducing the size of the balance sheet of \$US8.97 trillion (April 2022) and four increases in the policy rate from near 0-0.25 interest rate in March 16, 2022 to 3.0 per cent in September 2022, and early this month 4 per cent are now part of anti-inflationary measures. It has also been indicated that there would be more increases, at least thrice, each by 75 basis points well into 2023. These indications have led to reversal of capital outflows back to the US. Thus, in the current world, the US is a safe haven in the midst of rising global inflation. Consequently, the US dollar has appreciated by more than 13 per cent in the last six months.

Challenges to emerging economies

This has created challenges for emerging market currencies including the Indian rupee, as well as major currencies, the yen, pound sterling and the euro, which have all depreciated considerably against the US dollar. Growing inflationary pressures have also impacted sovereign bond yields. Since August, the cost of borrowing has more than doubled for many. Monetary tightening would lead to rise in the cost of government borrowing, if the governments prioritize growth over controlling inflation.

The WEO October 2022 reports, the US share in world merchandise exports is only 8 per cent. However, the dollar’s share in the payment of world exports is 40 per cent, as prices of most of the traded commodities are denominated in US dollars.

For many low-income countries struggling to reduce inflation, the weakening of their currencies has made the fight harder, as payments have to be settled in the US currency. The IMF has estimated the pass-through of a 10 per cent dollar appreciation into domestic inflation would be around 1 per cent. The current account deficits be-

TABLE 1 (In %)
Major and Emerging Economies: Growth and Inflation Rate Forecast for 2022 and 2023

Regions/ Countries	Real GDP Growth Rates			Inflation Rates		
	Actual	Projections		Actual	Projections	
	2021	2022	2023	2021	2022	2023
World	6.0	3.2	2.7	4.7	8.8	6.5
USA	5.7	1.6	1.0	4.7	8.1	3.5
Eurozone	5.2	3.1	0.5	2.6	8.3	5.7
Japan	1.7	1.7	1.6	-0.2	2.0	1.4
UK	7.4	3.6	0.3	2.6	9.1	9.0
Canada	4.5	3.3	1.5	6.9	4.2	2.0
China	8.1	3.2	4.4	0.9	2.2	2.0
India	8.7	6.8	6.1	5.5	6.9	5.1
Brazil	4.6	2.8	1.0	8.3	9.4	4.7
Russia	4.7	-3.4	-2.3	0.7	13.8	5.0
South Africa	4.9	2.1	1.1	4.6	6.7	5.1

Source: IMF WORLD ECONOMIC OUTLOOK OCTOBER 2022

TABLE 2
Exchange Rates of Major countries and Selected Asian Countries: October 21, 2021 and October 21 2022 (Respective Domestic currencies per one US Dollar)

Region/Countries	2021, Oct 21	2022, Oct 21	Depreciation (%)
Eurozone (Euro)	1.16	1.05	9.48
UK (British Pound)	1.4	0.89	35.51
India (Rupees)	74.76	82.84	10.81
Australia (Aus \$)	0.75	1.60	113.3
Canada (Can\$)	1.23	1.39	13.01
Singapore (Sin\$)	1.34	1.42	5.97
Malaysia (Ringgit)	4.15	4.73	13.98
Japan (Yen)	114.26	151.49	32.58
China (Yuan)	6.34	7.24	14.20
Russia (Rouble)	70.99	61.50	13.37
Pakistan (Rupee)	174.66	220.84	26.44
Sri Lanka (Rupee)	199.16	366.98	84.26

Source: IMF WORLD ECONOMIC OUTLOOK OCTOBER 2022

come larger due to rise in import costs. That made the rupee weaker. The Indian rupee touched a new low at `83 per the US dollar on October 19 and as on October 28, it is hovering around `82.74.

Would central bank intervention in the market to prop up the currency help? Or would the depreciation or free fall be allowed? As for the first, the central bank intervention, in the current situation, selling dollars would be justified only for reducing high volatility. The limit to such an intervention is determined by the availability level of the country’s foreign reserves. As regards allowing a free-fall in currency values, experience indicates such a step has been found ineffective, and market players would prefer to wait for further fall. This is due to the presence of asymmetry in information.

The IMF advice

As the IMF in its WEO October 2022 advises that in the short run, monetary policy should aim at restoration of price stability; and fiscal policy aims to alleviate the cost-of-living pressures more with direct cash transfers to the poor. Thus, the governments should have a tight fiscal stance aligned with monetary policy. Structural reforms are purely national in character. They should support the fight against inflation by improving productivity and easing

domestic supply constraints.

The European Central Bank (ECB) for 19 member countries in the euro Zone raised its policy rate by 75 basis points on October 27 to 1.5 per cent, the highest since 2009 with more hikes likely in the immediate future, in case inflationary pressures do not abate. Inflation in the euro zone reached the highest at 10.7 per cent in October rising from 9.9 per cent in September. It appears further hikes by 50 to 75 basis points are likely in December and beyond.

The Fed wants to anchor inflation expectations firmly. A clear message to all economic agents would be that stability is the first and foremost goal, when overall economic activities have not declined, but inflationary pressures are persistent.

The dilemma

All central banks, except the Fed face the problem of depreciation of their currencies against the US dollar. The US is the only country, which can afford the luxury of fighting the inflation fiercely; its currency happens to be the sole reserve currency of the world. There is no alternative reserve currency. The British pound sterling has lost all its glamour; it is no longer a reserve currency in the inflationary world; and too the euro presently, with the high import dependency of the Euro Zone on oil and natural gas. The euro is now on par with US\$.

Among the non-perishable physical assets, which act as substitutes for the fiat, paper money issued by the national government, which is held in trust by its citizens, gold is the most preferred one as a hedge against inflation. The black gold, the petroleum crude is a flammable product and hence risky and too dangerous to store as a form of wealth. Obviously, it is not a substitute for gold. So, all governments prefer to hold US dollars and financial assets which are denominated in US dollar. The US is the safe haven, as of now as has been for past 50 years or more, for all rich individuals and nations, including the well known world criminals and mafia groups and not to speak of the past fallen dictators.

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