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Two Economies: They are different!

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Australia and the United States, two industrialized countries are so different now.
One fears inflation. The other fears deflation.

Australia is the only advanced country to avoid recession. It was the only major economy to increase interest rate during 2009 for preventing the economy from overheating.

Australia's inflation is now around 2.5%, still below the central bank's target of 3%.
The US inflation is low, just around 1%.

Australia is forecast to grow at 3% in 2010. The American economy is limping, at an annualized rate of 2%, a rate too low to make any dent on the huge unemployment problem.

Australia's unemployment is low at 5%. America's is much higher at 9.5%.

All because of one emerging economy, China.

China's never ending appetite for mineral resources has been the propeller of Australian economic growth.

One is beholden to China. The other just loathes China, as the stealer of American jobs because of its deliberately kept undervalued currency. During the last campaigning days of the just ended US mid-term elections, both Republicans and Democrats displayed an unusual solidarity, when they lambasted China as a convenient scapegoat for domestic miseries!

A study in contrast

So, what did Australia do this week? What did US do this week?

On Tuesday, Nov 2 the Reserve Bank of Australia (RBA) raised the benchmark interest rate, known as official cash rate, to 4.75% from 4.5%. The RBA considered the measure necessary to cool off the economy, which was energized by Chinese imports. Rise in terms of trade (the soaring export prices over import prices) would be too inflationary for the economy.

On the other hand, on Nov 4 the US Federal Reserve (the Fed) decided to pour in the next six months, an additional amount of $ 600 billion into the economy. The US indicator interest rate, known as the Fed funds rate is already low, in the range of zero to 0.25%. Since the rate is so low, the Fed wants to soak the economy with more liquidity by buying the government bonds held by the public.

By pumping in money, the Fed believes the banks would start lending to businesses, especially the small businesses, which are now short of credit.

The Fed has done it before. The Fed purchased bonds and mortgage linked debts from the banks, amounting to US$ 1.75 trillion. With another addition in the next six months of another $600 billion, the liquidity would eventually rise to US$ 2.35 trillion.

The US Fed calls the exercise as quantitative easing 2(QE2).

Inflation and Deflation

Inflation erodes the value of money, which progressively buys less and less per unit. Inflation also works as a tax. It also discourages savings, as income earners would not like to lose the purchasing power of the income. They spend it faster as they know prices would be rising rapidly. It also discourages investment, as investors are uncertain about profits, as operating costs would increase with rise in wages and costs of raw materials.

Deflation means steady fall in prices. No doubt, everyone likes low prices. A steady fall in prices throughout an economy leads to postponement of consumption, which is not a good thing. Consumers wait as they expect better deals. Businesses would also wait because it is less profitable to produce goods or services that will bring a lower real return. These two factors feed on each other. A downward economic spiral then ensues. Businesses decrease production. They are keen to get rid of their stocks. In the process, they tend to lay off workers. Job losses are the result and incomes decline. Deflation is also bad for debtors, because they may have to pay back money that would be worth more than it was when they borrowed.

The dilemma

The results of the US midterm elections dealt a severe blow to President Obama's party. The electorate was angry about the slow working of government fiscal stimulus measures. With the loss of majority in the lower House of Representatives, President Obama's hands are tied.

In fact, as soon as the Fed announced on Nov 4 its QE2 measures, stocks rallied as investors now know the Democrats have no control over the House and Obama will have to pursue pro-big business policies, including new tax breaks and the likely continuation of the Bush tax cuts beyond the end of 2010.

The economists are divided on the latest move by the Fed.

Some believe that structural factors are more responsible for US unemployment. If jobs are taken away by Chinese manufacturers employing cheap labour, the US has to concentrate on high tech industries, where the US has comparative advantage.

The Fed chairman would not agree. Having researched the Great Depression and past recessions, he believes that it is the inadequate aggregate demand which is causing the problem. Though a Republican himself and first appointed by President Bush, he holds the view that expansionary monetary policy should be accompanied by expansionary fiscal policy as well.

In a major speech last month, Bernanke said:

"Overall, my assessment is that the bulk of the increase in unemployment since the recession began is attributable to the sharp contraction in economic activity that occurred in the wake of the financial crisis and the continuing shortfall of aggregate demand since then, rather than to structural factors."

However, Bernanke could not come out in the open in support of Obama's fiscal policies, since he has to maintain the central bank independence.

Some economists also believe that QE2 would help the economy grow by referring to the portfolio balance theory. Investors with excess liquidity would switch to higher yielding financial assets including stock from low yielding treasury bonds. This would further stimulate investment by firms.

This dilemma has now been resolved.

With the ascendancy of the Republicans, Obama has to look to the Fed.

Thus, the Fed alone would matter hereafter.

International reaction.

The emerging economies are unhappy about QE2. With QE2, the expected lower returns on dollar denominated assets would make funds flow to the emerging economies. In the process, their currencies would get stronger vis-a vis the American dollar. That would hurt their exports.

Is it not a "beggar thy neighbor" policy?"

Much before the mid- term elections, China accused the US of debasing the dollar by printing money and bringing down the value of the dollar. China has now been joined by Latin American republics. The Colombian Finance Minister spoke for most of them, soon after the Fed announcement on QE2: "We are now under the attack of relaxed monetary policy of the US."

The US Fed is aware of the importance of the US dollar as global currency.

For America, its national monetary policy is more important than its global currency policy.

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