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Stagnation and Lurking Inflation

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While the world economy is in doldrums, monetary policies adopted by central banks are expansionary. America's Federal Reserve has kept the Fed funds rate at 0.5% for a while. The benchmark rate of Bank of England (BOE) is also at the historically low level at 0.5% Last month, the 17-nation Eurozone's Central Bank cut its rate from 1% to 0.75%.

In addition, both Fed and BOE have added to money supply by purchasing bonds. Under quantitative easing (QE), instead of printing more notes, the new money is issued by way of deposit at the central bank. The objective is to depreciate the value of the currency and promote exports; and to boost the value of the assets and to lower longer-term interest rates for greater borrowing and investment.

As long as inflationary pressures are not felt, QE is safe.

Interest rates in the Region

Nearer home, New Zealand, which cut the official cash rate (OCR) in March 2011 after the Canterbury earthquake, has held it at 2.5% for 16 months, since there is no momentum in the domestic economy.

On the other hand, Australia has been fortunate. Its economy was powered by roaring mineral exports to China, to grow and recover faster than other countries. It was the first country to increase OCR in 2009. However, it had to cut interest rates four times between November 2011 and June 2012 as there was a slowdown due to Eurozone crisis.

On August 7, Reserve Bank of Australia (RBA) decided to leave OCR on hold at 3.5%.

In keeping with the worldwide trend, Fiji also kept its benchmark overnight policy rate at a historically low level at 0.5%, unchanged since October 2011. In Feb 2012, IMF Mission to Fiji felt Fiji's expansionary monetary policy appropriate considering the benign inflationary pressures.

Dim World outlook

In the US, unemployment rate is still high at 8.3% and growth is sluggish. In UK, latest data reveal recession deepened between April and June, with output falling by 0.7%. This forced BOE to cut its 2012 growth forecast to close to zero.

BOE Governor Sir Mervyn King said hopes had consistently been dashed. He added: "We are navigating rough waters and storm clouds continue to roll in from the euro area."

However, he dismissed calls for a reduction in the interest near term.

The worries of Australia are different. Capital inflows from everywhere, including Europe, seeking a safe haven, are pouring in. The resultant rise in Aussie dollar is not welcome, as rise in the currency affects exports.

How to bring down the currency value? RBA does not usually resort to intervention in foreign exchange market, selling dollar for weaker currencies. Acquisition of weaker currencies is not a welcome move.

It would wait: wait for a little bit inflation, a little bit heating up of the economy so that appreciation is halted?

Rising food prices?

In the meanwhile, reports on the world food front are alarming. The World Bank has issued a warning that exceptional drought in the US, current crop conditions in other grain producing regions, and inadequate monsoon rains in India would result in an increase in international food prices. Since stocks are low, and if harvests continue to be dependent upon global weather, the World Bank predicts prices would be vulnerable to higher volatility.

So we are heading for rough times.

As the presidential elections are around the corner, the US Fed would assume a less proactive posture. BOE is against any cut in interest rate. Thus, central banks in USA, UK and Australia are not in favour of cutting the already low interest rates any more.

The only good news one can expect to lift up the "animal spirits" to kickstart the world economy would be some positive, concrete action in the Eurozone, beyond mere words.

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