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Two central bank actions

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Two central bank actions this week are a study in contrast.

The Reserve Bank of New Zealand (RBNZ) raised its benchmark interest rate, the official cash rate (OCR) again this month to 3 percent from last month's 2.75 percent. On the other hand, the Reserve Bank of Fiji (RBF) decided last week to keep its benchmark interest rate, the overnight policy rate (OPR), unchanged at 0.5 percent since 2011.

The OCR and OPR reflect the money market tightness or otherwise. They are determined by open market operations by central banks. Changes in interest rates charged by lending institutions on all loans, including mortgage rates will reflect changes in benchmark rates.

By raising OCR to 3 percent on April 25, RBNZ has confirmed its monetary tightening stance for another month for fighting inflationary conditions. A continuous five-year period of low interest rate and rapidly rising immigrants from Asia have been found to be responsible for rise in prices of land and built up properties and of non-tradable services. The latter include labour, water, electricity and services, which are not internationally traded. Recent data reveal immigrants rose by 32,000 for the one year period ending March, causing immense pressure on housing in Auckland and Christchurch, resulting in housing shortages.

Rise in OCR last month led to a rise in Kiwi dollar. That is hurting exports. Although the strong currency has made the prices of imported goods cheaper, RBNZ is more worried about inflation in the non-tradable sector.

Although annual inflation is still low at 1.5 per cent, RBNZ is anxious to keep expectations of price rises contained. It is likely OCR would be 4.50 percent by year end.

Fiji's monetary policy

The RBF's economic review for the month ending April says that Fiji's gross domestic product grew by 3.6 percent in 2013; and economic growth in 2014 is projected at 3.8 percent which is based on positive investment activity. The latest news is the international credit ratings agency, the Standard and Poor's has raised the country's rating outlook from stable to positive. Ratings of countries range from triple A to B minus. Fiji currently has a B rating. Fiji's foreign and local currency issuer credit ratings stand at BB. If things progress at the same speed, S& P will upgrade Fiji to B plus.

Since inflation is falling, and foreign reserves are at a comfortable level: FJ$1,667 million (sufficient to cover 4.5 months of goods and non-factor services), RBF has decided to continue its expansionary monetary policy stance. The OPR at 0.5 percent will be maintained for some more time.

An analysis

New Zealand has a flexible exchange rate regime. Free market forces of supply and demand determine price of the Kiwi dollar. The central bank has to target only price stability. The Policy Targets Agreement (PTA) signed between RBNZ and Minister of Finance lays down that inflation should be kept between 1 and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 percent target.

On the other hand, Fiji has a fixed exchange rate regime. Therefore, RBF has one more objective to pursue. Its twin objectives are: price stability and exchange rate stability. While price stability relates to controlling inflation, exchange rate stability needs maintenance of adequate level of reserves to defend the Fiji dollar. Less level of foreign reserves would force country to devalue its currency as it happened in 2009. There is no PTA of the NZ kind but general guidelines are: inflation be not more than 3.5 to 4 percent; and adequate level means reserves for covering 5 months of imports. Further, RBF is expected to promote conditions conducive for economic growth.

Experience indicates preoccupation with price stability means monetary tightening with higher interest rate, which attracts capital inflows. Consequent rise in exchange rate hurts export competitiveness. It is argued that for price stability and export growth, domestic expenditure should be reduced and more domestic savings generated for funding investment and imports.

The opposite view is central bank should have a broader set of objectives: instead of giving primacy to inflation, RBNZ should additionally focus on promoting growth of the economy in general and exports in particular.

There is a growing support for the view of IMF chief economist, Olivier Blanchard that monetary policy that focuses on inflation targeting ahead of all other aspects of economic management is past its use-by date.