

A missed opportunity

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Bangladesh has secured many development achievements, including poverty reduction and growth acceleration. The gross domestic product (GDP) growth rate is on an upward trend. Importantly, this growth acceleration has been possible without destabilising the macroeconomy. Macroeconomic indicators show that both domestic and foreign debts are on a sustainable path. Fiscal deficit is contained at or below 5.0 per cent of GDP and inflation rate has been coming down.

One worrisome issue though is the stagnation in the private investment rate for over six years now, despite the very favourable macroeconomic environment. Some have argued for relaxing the monetary policy stance in order to stimulate private investment. This advocacy it seems has caught the imagination of policymakers at the Bangladesh Bank (BB). The BB's latest Monetary Policy Statement (MPS) for July-December 2016 has fallen trap to this view. Although the proposed relaxation of the monetary policy is relatively modest, unfortunately it is in the wrong direction. It also misses out on a major opportunity to bring down the inflation rate that remains stubbornly high relative to global inflation rate, which has serious negative consequences for exchange rate, real interest rates and poverty reduction.

It is important to base any policy analysis with evidence. Figure 1 shows the recent trends in private investment rates (private investment as a share of GDP), private sector credit growth and real average lending interest rates (nominal average lending rate minus rate of inflation).



Common sense interpretation of the facts suggests that there is no obvious correlation between any of these three variables. During fiscal year (FY) 10-FY16, private investment

rate has remained nearly flat at around 22 per cent of GDP, irrespective of the behaviour of growth of private credit and the pattern of real interest rates. Thus, for example, private credit growth has ranged from a high of 26 per cent to a low of 11 per cent, but even these wide swings have made no difference to the private investment rate. Similarly, the real average lending rate has fluctuated between a low of 2.0 per cent to a high of 7.0 per cent, but this did not influence the private investment rate.

This lack of sensitivity of private investment rates to private credit growth and real interest rate suggest that neither is a constraint to private investment in the present conditions. There are other more dominant factors. Research shows that these dominant factors include the high cost of doing business (as reflected in the Doing Business Indicators of the International Finance Corporation (IFC)/World Bank Group), difficulties of procuring land, the high rates of corporate taxation, the severe shortage of energy, especially natural gas, inefficiencies of trade logistics, especially transport cost, and availability of skills. In this environment, trying to stimulate private investment through a more expansionary monetary policy will not succeed as in the past, but could have serious negative consequences for macroeconomic management.

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Monetary policy stance needs to make good economic sense

Sadiq Ahmed in continuation of his economic analysis—MPS July-December 2016

The stickiness of domestic nominal interest rate is a related point that merits attention in order to examine the case of lack of sensitivity of private investment rates to private credit growth as well as real interest rate. This is illustrated in Figure 2. While private sector demand for credit has come down drastically in recent years creating a serious surplus liquidity situation, nominal bank lending rates have not come down as much owing to the

stickiness of the spread between deposit and lending rates. This average spread of about 5.0 per cent is very high and is fast approaching the average nominal borrowing rate.

The high spread is an indication of the inefficiencies in the banking sector. In particular, it reflects the large share of non-performing loans (NPLs). Nominal lending rates reduction does not require monetary expansion but instead could be achieved by lowering the incidence of NPLs through better supervision and improved banking sector governance.

The risks of expansionary monetary policy were dramatically exposed during the disastrous experiments in fiscal year (FY)10-FY11, when monetary expansion (M2) averaged 22 per cent per year and private credit reached average rate of 25 per cent per year (as is indicated in Table 1). Excess liquidity did not increase private investment but instead fuelled inflation (crossing double digit), put pressure on the balance of payments (exchange rate depreciated by almost 20 per cent) and land and stock prices soared. Thankfully, corrective actions were started in 2012 that restored macroeconomic stability.

Although the liquidity growth targets in Monetary Policy Statement (MPS) 2016 July-December are not as dramatic as in FY10-F11 (Table 1), they nevertheless are on the wrong footing. The policy direction is not reflective of the needs of Bangladesh. The MPS does not address the fundamental problems of tackling inflationary pressures and avoiding the continued appreciation of the real exchange rate. The inflation challenge is illustrated in Figure 3. Core (non-food) inflation fell substantially between October 2012 and December 2013 in response to the correction of the monetary policy. Since then there has been a mild upward trend, which gathered momentum since July 2015. A part of the reason is the demand pressure emerging from the civil service wage hike. Importantly, inflation in Bangladesh is amongst the highest in the South-East Asia region, and substantially higher than its major trading partners in Europe and America.



Even as global inflation has come down dramatically to the 2.0-3.0 per cent range, there is little justification for Bangladesh to inflate at the 6.0 per cent rate. Global commodity prices have fallen substantially, providing a major opportunity for countries to reduce their domestic inflation through proper conduct of fiscal and monetary policies. By failing to take advantage

of this opportunity, Bangladesh Bank seems to be missing the boat. Additionally, the decision to further relax monetary policy and aim for higher growth in M2 and private credit in the face of rising trend of core inflation is counter-intuitive. The evidence suggests that the higher growth of liquidity will not likely help private investment or gross domestic product (GDP) growth but may simply feed into inflation.

High inflation has serious negative consequences. It adversely affects poverty reduction and hurts the fixed income group. It keeps the domestic real interest rate needlessly high. Importantly, it continues to appreciate the real exchange rate, thereby hurting exports. An indication of the real appreciation is provided in Table 2 that shows the inflation differential between Bangladesh and the USA. Since the taka is pegged to the US dollar and is virtually unchanged at around taka 78/US Dollar since 2013, the inflation differential simply serves to appreciate the Bangladesh currency in real terms against the US Dollar. Furthermore, with the nominal appreciation of the US dollar against major global currencies including the Euro, the appreciation of the Bangladesh currency in real terms against the Euro is even more pronounced.

The MPS 2016 July-December is a short-term statement of monetary policy stance. For the next round, the Bangladesh Bank policy makers should reflect on the evidence and convince themselves that the intended policy stance of the MPS makes good economic sense in the face of the available evidence. At the present time, there is no evidence that M2 and private credit growth needs to expand to support private investment and GDP growth. On the other hand, inflation control and exchange rate management deserve much more policy attention than is reflected in this MPS. An M2 expansion rate of 12-13 per cent would be consistent with a GDP growth target of 7.2 per cent and an inflation target of 4.5 per cent. There is absolutely no sound economic rationale for targeting inflation at 5.8 per cent when all our external competitors and our export markets have much lower inflation. Concluded.