



Fundamental macroeconomic reforms work better than out-of-box thinking

Wednesday, Jul 12, 2023

By *Dr. Sadiq Ahmed*

The global economy faced tremendous inflationary pressures in 2021-2022 that were further accentuated by the advent of the Ukraine War in February 2022. These inflationary pressures showed up in Bangladesh in the form of rising import costs that saw an acceleration in the import bill, causing an unsustainable increase in the current account deficit in FY2022. It also saw an acceleration in the domestic inflation rate and mounting subsidy pressure on the government budget owing to price controls of energy and fertilizer products.

Government Policy Response Based on Out-of-Box Thinking

Faced with these rapidly escalating macroeconomic imbalances, the government responded by using reserves to protect the exchange rate, imposing import controls to curb the growth of imports, increasing subsidies to cushion the rise in domestic energy prices, accommodating these subsidies by increasing fiscal deficit and resorting to greater bank financing of these deficits. It also maintained its control over lending rates (the highly controversial 6/9 interest rate policy) to boost private demand for credit as a means to increase private investment and GDP growth. The government defended this policy response as out-of-box thinking that was necessary to address macroeconomic imbalances without hurting GDP growth. The government also argued that macroeconomic imbalances are the result of external disturbances that will go away once those global pressures subside.

Policy Reforms Based on Macroeconomic Framework

Against this backdrop, I was invited by the Bangladesh Institute of Development Studies (BIDS) to make a presentation on macroeconomic management in a post-Covid uncertain global environment. I made this presentation on December 01, 2022, in the presence of senior government officials who were invited to the presentation. In my paper, I argued that Bangladesh was facing some serious macroeconomic imbalances that won't go away without deft macroeconomic management. I pointed out the risks associated with continuing the ongoing ad-hoc out-of-box thinking on policy responses and reiterated the need to address the imbalances using standard macroeconomic policy instruments that are best suited to tackle those imbalances.

I noted that macroeconomic imbalances have emerged from three sources: inflationary pressure; the balance of payments (bop) pressure, and fiscal pressure. Addressing these issues requires the use of at least three policy instruments that best relate to each of these areas: monetary policy instruments to ease the inflationary pressure; exchange rate policy to ease the bop pressure; and tax/ expenditure policy measures to ease the budgetary pressure. Their combined use as a coordinated set of policy actions can help avoid the bluntness of any single instrument and reinforce the effectiveness of each of the policy reforms.

Regarding bop management, I cautioned against excessive reliance on import controls. While selective import controls can play a short-term emergency adjustment role, the resort to

import controls as the main instrument of bop management was fraught with risks. First, it only works on the demand side. The supply-side incentives for exporters and remittances are lost. This absence of exchange rate-based incentives at a time when bop pressures are intense and growth of both export earnings and remittances are slowing down is a major policy gap. Additionally, control-based import management can cause serious supply disruptions, discourage domestic and foreign private investments, hurt exports, and lower GDP growth.

Concerning the exchange rate management, I argued that the exchange rate was highly over-valued as reflected in the appreciation of the real effective exchange rate (REER) by an overwhelming 57% between FY2011 and FY2022. Seeking to preserve this over-valuation of the REER is not only bad for export growth and remittance inflows, but the amount of reserves was also not adequate to sustain an over-valued nominal exchange rate. The net result would be a rapid loss of reserves. A more sustainable way of managing the bop would be to let the exchange rate be market determined. A uniform and flexible exchange rate combined with lower aggregate demand is the best and most sustainable way to manage the bop. A flexible exchange rate will boost exports and remittances and reduce import demand, which combined with demand management will stabilize the bop much more sustainably than import controls. This will also avoid the import constraint on private investment and GDP growth. Demand management by lowering private spending through increase in interest rate combined with higher taxes and lower fiscal deficit will help reduce inflation and avoid the exchange rate from over-shooting.

Regarding inflation management, I emphasised the need to eliminate control over the lending rate. Instead, the government should institute a market-based interest rate policy and use monetary policy to increase interest rates to the extent that private sector credit growth falls meaningfully. Additionally, the budget deficit should be reduced to lower aggregate demand and avoid bank financing of budget deficit to reduce the total growth of domestic credit.

Concerning fiscal policy, my suggested approach was to cut the fiscal deficit by increasing revenues through meaningful tax reforms and by reforming the State-Owned Enterprises (SoEs) in a way that will lower their financial losses and thereby reduce their budgetary burden. Meaningful tax reforms imply addressing the substantial institutional constraints to

an effective tax system in Bangladesh. This would be much more effective than setting ambitious tax revenue targets through ad-hoc tax measures.

Concerning expenditure management, I suggested that subsidies should be cut back sharply while spending on health, education and social protection should be increased. These spending will help lower the adverse effects of inflation on the incomes of the poor and the vulnerable

Government's Defense of Out-of-Box Thinking

The government officials responded that their current policy approach based on out-of-box thinking was better suited to the Bangladesh reality than the standard approach embedded in a macroeconomic framework that I was advocating. They argued that control over the exchange rate was necessary to guard against inflation. In their view, import controls would be adequate to restore the stability of the balance of payments, while preventing a large depreciation of the exchange rate. Control over interest rates was necessary to boost private sector credit to increase investment and support GDP growth. Subsidies were needed to cushion the spillover effects of higher energy prices, which in turn required higher fiscal deficits. According to government officials, bank financing of these deficits did not pose a threat to domestic inflation.

Results of the Out-of- Box Thinking

This out-of-box thinking approach to policy making was implemented over the past 12 months or so for the full fiscal year of 2023. What are the results?

Balance of Payments Outcome: Import and exchange controls along with a shortage of foreign exchange have sharply reduced imports and combined with continued good performance of RMG exports, the current account deficit has been substantially lowered. Along with this positive outcome, several negative results have emerged. First, there has been a run on the reserves that has depleted by a whopping USD11 billion between July 2022 and June 2023. Second, while RMG exports have grown, Non-RMG exports have fallen owing to the anti-export bias of trade and exchange policies. So, there has been a sharp fall in export growth in FY2023. The expected recovery of remittances did not happen due to

control over the exchange rate. A flourishing secondary market for remittances prevails outside Bangladesh where the exchange rate is 8-12% higher than in Bangladesh. Fourth, the capital account of the balance of payments has deteriorated substantially as import and exchange controls lowered foreign and domestic private investor confidence, which caused a drying up of private foreign credit, constrained the inflow of FDI and contributed to capital flight. Finally and most importantly, import controls and shortage of foreign exchange resulted in a substantial shortfall of industrial raw materials, energy inputs, and capital imports that lowered industrial production and curbed the availability of power supply. Despite the government's target to secure a GDP growth of 7.5% in FY2023, actual GDP growth is estimated by BBS at 6%.

Regarding exchange rate, notwithstanding the government's effort to protect the exchange rate from depreciating by injecting reserves, it has progressively depreciated with needless loss of reserves that could have been protected by letting the exchange rate be market-determined and using demand management to stem the slide in the exchange rate. The nominal exchange rate depreciated by 16% and the REER by 9% in FY2023, which is an unintentional but positive result since this correction was necessary to counter the large appreciation of the REER between 2011 and 2022. Even so, the REER still remains 48% appreciated in June 2023 over July 2011.

Inflation: Bangladesh's inflation continued to rise throughout FY2023 even as the global inflation rate fell sharply. Countries like USA, Canada, EU, India, Thailand and Vietnam all experienced substantial declines in domestic inflation rates in the first half of 2023. So, blaming Ukraine War and global inflation for domestic inflation is politically convenient but not factually true. Countries that saw sharp declines in domestic inflation benefited from the reduction in global energy prices, but they also took sustained demand reduction measures through targeted increases in the domestic interest rates. Since Bangladesh did not reduce demand and instead pushed demand growth through interest control and higher fiscal deficit, it did not experience a reduction in inflation despite the reductions in global energy prices and global inflation.

The stated objective of interest control was to push the expansion of private credit to support private investment. While private credit grew at a healthy pace of 11% in FY2023, this did not help the expansion of investment or economic activity. On the contrary, the private

investment rate fell to 23.6% in FY2023 as compared with 24.5% in FY2022. This faulty approach to interest rate management needs some serious rethinking. Private investment rate and GDP growth depend upon a lot of factors including cost of doing business, stable macroeconomic environment, adequate supply of power and other infrastructure, business confidence, trade and exchange rate policies, trade logistics, technology, and availability of skills. So, trying to push private investment rate and GDP growth through interest rate controls without addressing the other determinants is fraught with risks. Indeed, the private investment rate was higher in FY2019 (25.3% of GDP) when there was no control over the interest rate and has actually fallen since the adoption of the “6/9” interest rate policy.

Fiscal deficits: In the absence of meaningful tax reforms and reforms of the SOEs, the government’s ambitious revenue targets did not materialize. To moderate the adverse effects of the much lower tax revenue growth compared to the budget target, the government was forced to reduce energy subsidies through a combination of price increases and cutbacks in oil imports. While the increase in energy prices was a smart move, the reduction in oil imports caused substantial power outages that hurt private investment and GDP growth. Overall, the net result has been a rise in fiscal deficit, higher subsidies, low tax revenues, and cutbacks in social sector spending. A higher budget deficit was financed through greater resort to bank financing thereby contributing to an increase in domestic credit. The fiscal outcome added further pressure on domestic demand and contributed to inflationary pressure.

Moving Forward

There has been some important progress in the government’s rethinking of its out-of-box policy making, which did not yield the desired results. Starting in July 2023, the exchange rate has been unified at Taka 108/ USD and the government has announced its intention to let this rate be flexibly determined by market forces. The government has also abandoned its 6/9 interest rate policy and announced flexible management of the interest rate using standard monetary policy instruments. Both are welcome policy progress and consistent with macroeconomic fundamentals. However, how these policies are implemented will determine the outcomes.

The fiscal policy reform has not happened. The National Budget for FY2024 has again set an

unrealistic GDP growth target. The tax revenue target is similarly offtrack and is not based on a substantial reform of the tax system. No reforms are proposed for the SOEs. Consequently, the already high fiscal deficit proposed in the Budget could well be even higher owing to revenue shortages. Additionally, the Budget plans an even larger resort to bank financing of fiscal deficit than in FY2023. The combination of higher fiscal deficit and greater use of bank financing would contribute to inflationary pressure and could also exert pressure on the bop and the exchange rate. The current fiscal policy remains inconsistent with macroeconomic stability and needs to be urgently reformed.

Sadiq Ahmed, Vice Chairman, Policy Research Institute of Bangladesh

<https://www.tbsnews.net/analysis/fundamental-macroeconomic-reforms-work-better-out-box-thinking-662950>