Good old policies do work

Thursday, Jun 23, 2011

By *Dr. Ahsan H. Mansur*

Despite plenty of criticism and skepticism, time has once again proved that appropriate orthodox policies work when it comes to

managing an economy. The most recent example can be seen in no other country but in Bangladesh. At the beginning of the year (January/February 2011), Bangladesh economy faced a number of emerging pressures in the external and the domestic financial sectors, which tended to destabilize the country's macroeconomic stability. This analysis briefly describes the emergence and sources of the twin problems, the policy response of the government, and whether the policy prescription of abolishing the interest rate cap and allowing the taka to depreciate — despite their orthodox nature and bitter taste — are working toward maintaining macroeconomic stability.
At the turn of the year, despite apparent stability in the near-term macroeconomic outlook, pressures were building up rapidly. While the attention of media and economic commentators was primarily on the collapse of the stock market, on the shortage of liquidity in the money market and on the rising inflation, imbalances were silently building up on the external front. Even when expansion of broad money (M2) has been running at 22% for almost two years–well above the 15.5% target set under the Monetary Policy Statement of Bangladesh Bank (BB) — and private sector credit expanding by 29%, surprisingly various associations and trade bodies were strongly lobbying for: (i) further injection of liquidity to engineer a recovery in the just corrected stock market; and (ii) inject more liquidity in the money market.

Respectable organization like the Bankers' Association of Bangladesh kept lobbying for allowing the banks to expand credit well beyond the prudential limits. The credit to deposits ratio at that time (in February) already exceeded 86% for the banking sector as a whole, well

beyond the normal healthy level of 75%-80%, exposing the economy and the banking sector to high degree of risk.

The easing of monetary policy stance characterized by the cap on lending at 13% and not adhering to quantitative monetary targets was perhaps appropriate at the inception of the global economic crisis in 2008-09, could not be sustained any longer. Not only the inflationary upward trend kept surging ahead and reached double digit levels, but a balance of payments crisis was also developing rapidly. BB might have been less sensitive about the inflationary pressure, attributing it to developments in food prices in theglobal market and arguing that since nonfood inflation was still on the lower side there was no need for tightening domestic demand through tighter monetary policy stance.

But like any other central bank, BB could not ignore the ominous signs of an impending balance of payments (BOP) crisis and it had to act. The signs of an emerging BOP crisis were visible in the surge in import payments and the outlook for further import growth o the basis of letters of credit (LC) data (Table 1).

Table 1: Phenomenal Growth of L/Cs during July-December 2011

(Millions of US Dollars)	FY 10 (H1)	FY 11 (H1)	FY11 (H1)-FY10 (H1)
L/C Opening	11161	16013	43%
L/C Settlement	8576	12152	42%
Outstanding L/C	10799	16253	51%

Source: Bangladesh Bank

Despite strong export performance (exports growing by more than 40%), import payments outpaced export growth substantially and in the first half of FY11, the deficit in the trade account balance widened by 25.2 per cent to $3.4 billion. At the end of December, import payments already increased to US$ 13.7 billion, growing by 37 per cent over the corresponding period. At that time, the outstanding import LCs (opened but not settled) amounted to $16.2 billion which would translate into import payments within the next three to four months. Import LCs was being opened at the rate of $4.0 billion a month. At this pace, under unchanged policies, import payments for FY11 would have increased by more than 55% to $35-40 billion (Table 2).

Table 2: BOP Outlook FY 11 (With and Without Policy Change)

BOP Outlook			
Items (Millions of USD)	FY 10	FY 11 (Unchanged Policy)	FY 11 (With Policy Change)
Trade balance	-5152	-13000	-9676
Export f.o.b.(including EPZ)	16236	22000	22405
Import f.o.b (including EPZ)	-21388	-35000 to -40,000	-32082
Services	-1237	-2436	-2252
Income	-1487	-1764	-1627
Current transfers	11610	12000	12212
Of which : Workers' remittances	10987	11280	11536
Current Account Balance	3734	-5200 to -10,200	-1344
Overall Balance	2865	-5320 to -10,320	-1468
Source: Bangladesh Bank and Author's Calculation			

Coupled with additional deficits of more than $4.0 billion on account of services and income account payments and taking into account the inflow of workers' remittances at the stagnant level of $12 billion, the external current account deficit would be about $5.0-10.0 billion in FY11 compared with a surplus of $3.7 billion in FY10. This large swing in the external current account by more than $8.0-13.0 billion was certainly not sustainable and would have caused exchange market crisis.

Due to this growing instability in both the money and exchange markets, BB had to take a few unpleasant but absolutely necessary steps to contain demand for imports. BB, for the first time in two years, abolished the 13% cap on the lending rate and allowed interest rates to be determined by market forces. At the same time, in order to make imports costly and protect foreign exchange reserves, it also allowed the exchange rate of the taka against the UD dollar to depreciate through market forces. To restrain credit expansion and enforce prudential regulations, BB instructed all commercial banks to reduce their lending to deposits ration to no more than 85% by end-June. To further tighten the monetary policy stance, BB also increased both the repo and reserve repo rates.

The policy prescriptions are bitter. Lending rates have already shot up by 2.0-4.0 percentage points to 14.0-17.0% levels in recent weeks. The increase in the lending rate is helping banks to mobilize savings by offering higher deposit rates and the deposit rates have also gone up commensurately. Banks are also under pressure to reduce their lending level or increase deposits to bring the lending to deposit ratio to less than 85% by end-June, as mandated by BB and the only way banks can maintain their current levels of lending is by increasing deposits through attractive deposit rates. The

exchange rate of the taka has steadily depreciated from Tk 68.40 per US$1.0 to close to Tk 74 by early June, entailing a depreciation of about 8.0%.

The shift in economic policy has predictably come under criticism from different quarters. Business community is complaining about high interest rates, lack of availability in credit under the tightened money market conditions, and banks refusing to open LCs due to shortage of foreign exchange in the interbank market. Many are arguing that the liquidity crunch is constraining import demand growth, a large part of which attributable to industrial inputs and capital machineries, thereby choking off the growth momentum. The critiques, including the Bankers Association of Bangladesh, would like to increase the lending to deposits ratio further to 90% for conventional banks and 95% for Islamic banks– well beyond the global prudential standard of 75-80%–to accommodate the growing needs of the economy.

The critical questions now are whether the shifts in BB policies are working and whether the critiques of BB have merit in their arguments? Let’s first examine the validity of the criticisms against BB’s policy. If nothing was done, credit expansion to the private sector would have increased by another 5.0-10.0 percentage points to 35.0-40.0% range. The pace of LC opening at the rate of $4.0 billion a month would have continued through the remainder of FY11, supported by a sharp drawdown of foreign exchange reserves of BB if the exchange rate for were to be kept at its original level of Tk 68.4 or so.

Under this hypothetical scenario, by end-June 2011 (after three to four months) foreign exchange reserves would have come down to less than half of its current level of $10 billion. At that point BB’s foreign exchange reserve coverage would have come down to only 1.5 months of imports at end-FY11 from more than five months of imports in FY10.

Then the big question would be how BB would maintain macroeconomic stability and stem continued domestic demand pressures and import growth to avoid running out of reserves? The bitter pills at that point would have been certainly much stronger and the abrupt contractionary nature of the policy measures would have entailed a massive slowdown in economic activity.

Are the policies of Bangladesh Bank working? A review of the latest BOP data through

March and data on LC imports through April 2011 indicate that import growth has slowed down markedly and the based on the LC outstanding, the level of imports is projected to be about $32 billion instead of the earlier trend of reaching $35-40 billion by the end of the fiscal year. The slowdown in LC opening is remarkable: coming down from a peak of more than 60% in January to a moderate pace of 11% in April. Similar trend is visible in the growth of LCs settled. The external current account deficit is now projected to be limited to about $1.0 billion compared with more than $5.0-10.0 billion projected under unchanged policies.

As regards the question whether the tightened policy stance adopted by Bangladesh Bank is hurting growth, my counter question will be: Is not 50% growth in import payments in one year more than enough for any economy? Growth of import payments beyond the 50% level in FY11 is simply not affordable for Bangladesh and would destroy its macroeconomic stability. Containing excessive domestic demand through tighter demand management policy is an old orthodox policy; it is unpleasant to take the punch bowl away when the party is in full swing, but that is the primary responsibility of any responsible central bank.

The good old policies are working. However, it is still to be seen whether the relatively mild dose prescribed by BB so far will be enough to bring down domestic liquidity and private sector credit expansions to appropriate levels, which are still growing at 22% and 29% rates respectively, well above what should be consistent with BB’s inflation target and the objective of macroeconomic stability.

(The writer is Executive Director, Policy Research Institute of Bangladesh and he can be reached at amansur@pri-bd.org)