Monetary policy flip-flops and burden of adjustment

Sunday, Feb 12, 2012

By *Dr. Zaidi Sattar*

The drama seems unending. Ever since the latest half-yearly Monetary Policy Statement (MPS)

was released late last month by the Bangladesh Bank (BB), it set off alarm bells across the business and financial sectors with the print and electronic media abuzz with views and comments, including some not so complimentary reactions from academic and professional analysts. Officials in the central bank have been doing their bit of firefighting in order to steer, at the very least, the financial institutions in the desired direction.

This can hardly be wished away as a storm in a tea cup. This time the ramifications for the economy run deep and pervasive. It appears that charting the right course for monetary policy was only the beginning of an arduous journey for the monetary authorities. Unlike many other MPS of the past, this one seems to have stirred up more dissent from the private sector actors. What transpired makes fascinating reading of the political economy of policymaking in Bangladesh.

To be sure, the January MPS was no sop to the private sector. After years of acquiescing to the private sector's thirst for more and cheaper credit with accommodating easy money policy while letting inflation all but get out of hand, the BB thought it fit to finally put the brakes on what could be described as unbridled money supply growth for nearly eight years. Yes, annual average inflation topped 5.0% in January 2004, and has been creeping upwards ever since, except for a brief respite in 2009, reaching the psychologically unacceptable double digits in 2011. Rate of money supply growth well in excess of the output of goods and services in the economy during this period is squarely to blame for the inflationary phenomenon. Blaming imported commodity prices for this debacle no longer holds water as

domestic inflation has been outpacing international inflation for most of the past decade.

While correctly arguing that it needs to restrain credit growth now, the MPS appears to have come out unusually hard on the private sector which was accustomed to a policy of little credit or foreign exchange constraint over the past decade. The public sector which actually unleashed a problem for the central bank last year by borrowing heavily from it was to share part of the burden of restraint, but time will tell how credible is the goal of whittling down public sector credit growth (a whopping 62% by end December 2011) by half. The imperatives of public financing of high cost rental power including imports of high cost fuel oil have contributed to a subsidy bill approaching 4.0 per cent of gross domestic product (GDP) against a target fiscal deficit of 5.0% of GDP. With foreign financing of the deficit now projected at well below the targeted 2.0% of GDP, substantial domestic financing of the fiscal gap has become an option of necessity. And the easy way is for the Government to borrow from its banker – BB — but that adds more fuel to the fire of inflation.

The upshot of all this is that the burden of macroeconomic adjustment envisaged in the MPS falls for the most part on the private sector rather than the public sector. The twin drivers of high growth — private investors and their financier, the banking sector — must now face the music of monetary restraint. This has riled up the private sector leaders enough to weigh in on policy makers with their influence; and influence they have in plenty, to turn around policies that could hurt their bottom line in the short term. We are told that some 70% of parliamentarians come from the business sector, and there is no dearth of business chambers and associations with close links to policymakers and powers that be. This symbiotic relationship betweenbusiness and politics in the country comes to the rescue of the private sector with the result that the MPS strategy of curbing private sector credit by letting interest rates rise to new heights arguably ended up with a short life span.

But there is one problem. At a time when official reserves at $9.2 billion are barely enough to cover 2.5 months of projected imports, the carrot of an International Monetary Fund (IMF) $1.0 billion Exogenous Shocks Facility (ESF) is enough to deter the BB from taking any steps inimical to the IMF requirements, such as putting caps on interest rates. Adhering to the IMF doctrine would require credit rationing, if it must be done, to be executed through the price mechanism (i.e. interest rate movements) rather than through direct controls on credit or its price — the interest rates. So, how to get around this problem?

An acute observer of the policy scenario can detect some flip-flops in the recent handling of MPS and its aftermath. First, no sooner than the ink on the MPS was dry, unofficial instructions from the BB went out to the privatecommercial banks to keep lending rates within a cap. Then came the news, published in local dailies, that the BB had not imposed any caps on lending or deposit rates. This was immediately followed by a decision of Association of Bankers, Bangladesh (ABB), the group of bank CEOs, to self-regulate themselves by observing self-imposed caps on lending and deposit rates. Bangladesh Association of Banks (BAB), the association of bank owners and the people who actually decide what rates to offer, meanwhile kept mum. Even a student of Economics 101 knows that given an oligopolistic market structure of the banking industry, such self-regulation is impractical to ensure and equally impossible to monitor — something the central bank in its infinite wisdom is proposing to do. Added to this is the latest commandment arising from the orifice of the central bank: capping deposit and lending rates is not enough, the spread between the two rates must be kept under 5.0%. The BB then goes further, opening a Pandora's box of controversial terms. As if rationing of credit was not enough, it would like to see banks channel lending into "productive" sectors, and credit for imports must cover only "essential" imports, not "luxury" imports.

How these various terms are to be defined and how compliance is to be ensured and legally defended is anybody's guess. All of this comes, as the BB officials argue, under the purview of "moral suasion", which has sadly become an oft-used jargon for the financial sector's regulatory watchdog. Critics would argue that this is carrying moral suasion to the point of absurdity. In all humility, I have to say that our central bank is taking more on its plate than it can chew. And yet, all of this might fail to placate the IMF mission that will be in town shortly.

All this confusion could give a sane economist enough headache to last a long time. It would be far better to relax in our easy chairs and watch a game of exciting winter cricket in Bangladesh thanks to the novel innovation of Bangladesh Premier League (BPL) and not worry whether the millions of dollars paid out to players were "essential" or "non-essential" import (of services) under the latest definition of the BB — which eventually might change any way.

(Dr. Zaidi Sattar is Chairman, Policy Research Institute of Bangladesh. E-mail: zaidisattar@gmail.com)