



Monetary policy is working

Sunday, Jan 18, 2015

By *Dr. Sadiq Ahmed*



The government deserves a solid round of applause for successfully implementing a sound monetary policy for three years in a row. Following a period of wayward monetary policy management from 2009-2011 that fuelled inflation, pushed unsustainable spikes in land and stock prices and exerted pressure on the exchange rate, the Bangladesh Bank took corrective actions in 2012 that restored monetary discipline. This prudent monetary policy stance has been preserved since then. The results have been very positive and supportive of the overall development goals of Bangladesh. Inflation has come down, the exchange rate has stabilised and asset price correction has happened.

While this achievement should be celebrated, there is no room for complacency. The BB is in the process of formulating its next six-monthly monetary policy. During the consultation process several dissenting voices were aired arguing that the fight against inflation is over and the time is ripe for easing the monetary policy stance in order to push the GDP growth rate. This is a familiar argument aired every year with little or no supportive evidence provided for this prescription.

Since a wrong monetary policy stance can be very disruptive and costly to the economy, as witnessed during 2009-2011, it is imperative that the government must not be pushed into this type of populist prescription unless it is backed by concrete and convincing evidence.

Let me examine the merit of the argument in support of the so-called “easy monetary policy”. By this I presume the proponents are asking for increasing the rate of growth of money supply. The idea is to reduce the interest rate by increasing the supply of money, which then creates an incentive for investors to invest more and that in turn will support a higher rate of GDP growth. This prescription is founded on the following empirical assumptions. First, a correction of monetary policy stance since 2012 has adversely affected growth. As such there is a trade-off between growth and inflation. Second, monetary correction has increased the interest rate. Third, the rate of investment is constrained by the interest cost of credit. So, a lowering of interest rate will boost the rate of investment.

All these assumptions are empirically testable. While I have not undertaken rigorous econometric testing of these hypotheses (and neither have the proponents), I can provide some commonsense arguments why these assumptions are unfounded based on the recent Bangladesh experience.

Let me first examine the growth-inflation trade-off argument. Figure 1 shows the trend in inflation and GDP growth from FY2010 to FY2015. This captures the most recent experience in Bangladesh and nicely contrasts the two monetary policy stances pursued in Bangladesh: the expansionary phase — FY2010-FY2011; and the prudent phase — FY2012-FY2015. The average growth of money supply (M2) was 22 percent per year in the first phase and 16 percent per year in the second phase. The trend in inflation (solid line) shows a substantial upward spike between FY2010 and FY2011, responding to excess monetary growth, and since then a continued decline in response to the correction in the growth of money supply.

The trend of GDP growth is represented by the dotted line, which shows an increase in GDP growth in FY2011 (from 5.6 to 6.5 percent) and then a flattening out at around 6.0-6.5 percent. The dashed line shows the trend in the growth of non-agricultural GDP. Since agricultural GDP growth has very little to do with monetary policy, the trend in non-agricultural GDP captures better the impact of monetary policy. It shows a similar pattern, but interestingly there is a gentle upward trend between FY2013 and FY2015.

The main conclusion is that Bangladesh has been experiencing a healthy rate of GDP growth in the range of 6.0-6.5 percent of GDP during the Sixth Plan period and at the same time it has successfully achieved a significant decline in the rate of inflation. For this period, there is no evidence of a trade-off between inflation and GDP growth.

Regarding the relationship between monetary policy correction and interest rate, the results are shown in Figure 2. Despite sharp increases in the rate of growth of money, the average nominal lending and deposit rates were on an increasing trend during FY2010 and FY2012. Nominal average lending and deposit rates have been coming down since FY2013 even though monetary growth is sharply lower than in the expansionary phase. So, there is no evidence that nominal interest rates have gone up due to monetary correction; on the contrary interest rates have come down.

Economists will recognise that the reasons why nominal interest rates are coming down is first because inflation rates are coming down; what matters for saving and investment rates is real interest rate (adjusted for inflation) and not the nominal interest rate. The second reason is that the demand for credit is sluggish owing to political uncertainties and other constraints to investment — factors that have very little to do with monetary policy stance.

This brings me to the third contention that the private investment rate is sluggish because of high interest rates. We saw above that domestic interest rates are coming down in nominal terms. So the argument must be cast in terms of real lending rates. While inflation rate has decelerated substantially, the nominal lending rates have not fallen commensurately. Consequently, there is an upward pressure on the real lending rates.

However, the idea that monetary policy easing will lower real interest rate is not convincing. Lowering real interest rates through inflation is not a sustainable proposition as evidenced from the FY2010-FY2012 episode when nominal interest rates climbed with higher inflation. This is because depositors require a minimum real interest rate to keep deposits; otherwise they will shift to other assets. So, when inflation increases, banks are forced to raise the nominal deposit rate to maintain the deposit base.

A further reduction in real interest rate can be brought about sustainably by reducing the spread between the average deposit rate and average lending rate. As shown in Figure 2, the

spread is very high and a steady 5 percent, irrespective of monetary policy stance. The spread is high because of a number of inefficiencies in the banking sector including a high and growing ratio of non-performing loans. Banks tend to jack up their lending rates in order to cover these losses. All other factors that contribute to banking sector inefficiencies and/or lower their operating income (such as reserve requirements or supporting treasury functions), tend to increase the spread. The central bank should work closely with commercial banks and develop policies that can lower the spread.

Most importantly, the ability to achieve higher rate of GDP growth (accelerate from 6 percent to 8 percent) is constrained primarily by the rate of investment, the quality of labour force, technology and institutions. The rate of investment in turn is constrained by inadequate tax resources to finance public investment and for the private investment there are at least three binding constraints: energy, land and transport. On top of all of these factors, the ongoing political turmoil is a big deterrent to private investment. Unless these fundamental constraints are addressed, it will be difficult to increase the rate of investment.