

MPS January 2012: BB bites the bullet

Tuesday, Jan 31, 2012

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The latest Monetary Policy Statement (MPS) from

the coffers of Bangladesh Bank (BB) comes at the worst of times. The global recovery shows signs of petering out with premonitions of an impending crisis in the Eurozone that could engulf the entire world economy — developed, emerging, and developing economies. In its January release, International Monetary Fund (IMF) has further reduced its forecast of global growth. The IMF now expects the global economy to grow 3.3 per cent in 2012, according to an update to its World Economic Outlook, down from a 4.0 per cent September projection. Growth in world trade was already projected to decline by two per cent age points.

The twin forecasts indicate an external environment that is inimical to our export prospects — now the prime mover of jobs and income growth. After a superb performance of 41% growth in the last fiscal year, export growth for the last six months is down to 14.7% for July-December 2011 — still a respectable figure by any measure. However, the outlook for exports in the coming six months is subdued by adverse developments in the Eurozone and a rather anemic recovery in the US economy.

Nevertheless, the MPS looks like a bold initiative, well-crafted, and technically consistent with the goals set for the next six months. In reviewing the MPS in July 2010, I wrote about the inflation geni and the urgent need for curbing money supply (M2) growth. Indeed, for those who watch the Consumer Price Index (CPI) on a regular basis should know that the days of under 5.0% inflation rate is long gone. Since 2004, the rate of inflation has been on a slow but certain creep, ranging from 5.8% to as much as 9.0% between 2004 and 2010. In 2011, it finally reached the psychologically unacceptable double digits.

During all this time, the central bank has been fighting the inflation battle with only modest

success, though, to be fair, it can hardly be faulted for not trying. Generally, in its six-monthly MPS, it set the right targets for restricting money supply growth to curb inflation, but actual achievements were far from target — until the most recent six-month period, July-December 2011.

One could ask the question: did the BB try hard enough in the past with all the monetary ammunition in its bag? There are obvious trade-offs between the twin objectives of fueling growth and managing inflation. To be sure, it is a tough balancing act. Looking at the past failures at achieving the targeted broad money (M2) growth (see Table 1), with private sector credit registering growth rates of 24-26% in each of the past three years, it is a logical inference that monetary policy was tilted in favour of private sector driven growth even at the cost of some inflation. Growth was good and we even had a stock market bubble, thanks to the presence of easy money.

The trouble is, once the inflation geni is out of the bottle, it is tough to put it back in, without imposing heavy costs on the real economy. That precisely is the situation now, with more complications added to the macroeconomic scene from certain fiscal excesses of the past year coupled with adverse developments in the capital and financial account of our balance of payments, registering net foreign aid disbursements – for the first time in recent memory — reduced to a trickle.

Table1. Bangladesh Monetary Aggregates: Targets and Developments
(Half Yearly Growth Rates)

	FY10(Dec)		2011(June)		2011(Dec)		2012(Jun)
	Target	Actual	Target	Actual	Target	Actual	Target
1. Net Foreign Asset	4.2	14.2	4.2	5.2	-1.6	-8.6	-8.9
2. Net Domestic Assets	17.6	23.4	17.6	25.0	22.1	22.9	21.9
Domestic credit	17.9	24.4	17.9	27.4	20.0	25.7	19.1
Credit to the pub. sec.	25.3	12.0	25.3	33.6	28.1	62.0	31.0
Credit to the pvt. Sec.	16.0	27.6	16.0	25.8	18.0	18.0	16.0
3. Broad money	15.2	21.7	15.2	21.3	18.5	17.4	17.0
4. Reserve money	13.0	20.7	13.0	21.1	16.0	12.5	12.2

Source: Various issued of Monetary Policy Statements

So what is our central bank up to? For the first time, the target of broad money growth set in the previous biannual MPS was achieved, largely by squeezing private sector credit, tightening reserve money growth, and some drawdown of foreign exchange reserves to accommodate negative trends in current and capital account. The main slippage can be found in the management of credit to the public sector which overshot the target by 40% — the upshot of huge subsidies to the power sector stemming from commitments to high cost rental and small power plants which also required heavy imports of petroleum.

This performance in the immediate past gives a hint of what to expect in the coming six months. The new targets appear consistent with the ultimate goal of current monetary management – to tame inflation down to the single digits though no specific target is mentioned save for a reference to the 7.5% target set in the budget of fiscal year (FY) 2011/12. Setting the right monetary targets appears to be the least of BB's problems. Proof of the pudding is in the eating and that is where we see slippages of the worst kind resulting in money growth targets being repeatedly missed for the past three years, — until we come to the last six months when the targets appear more credible than before.

One can sense a realization on the part of BB that it is now time to get serious and bite the bullet, if so needed. Though much is made in the MPS about leaving enough space for private sector credit to stimulate inclusive growth, the fact of the matter is that the overwhelming burden of adjustment has been placed on the private sector including the banking sector through contractionary demand management. Whereas private sector credit was growing at a rate of 24-26% in the past two fiscal years, the plan is to whittle it down to 16% primarily by squeezing liquidity out of the banking system and letting interest rates climb to curb lending. This will understandably curtail import demand and reduce pressures on the exchange rate with foreign exchange reserves slated to remain at or near levels seen in December 2011.

What is beyond the control of BB of course is the quantum of government borrowing, indications of better coordination with Ministry of Finance (MoF) notwithstanding. With subsidies estimated at 3.4% of gross domestic product (GDP), fiscal deficit for the current fiscal year could approach 5.5-6%, and its financing remains a major headache for the fiscal and monetary authorities combined. The outlook for external financing continues to be grim so reliance on domestic financing remains the option of necessity. If the past is any guide,

BB's control over its targeted sharp reduction of growth in government borrowing from 62% in end December 2011 to 31% by June 2012 is tenuous. To the extent that there will be an attempt to sterilize some of the resulting monetization of the fiscal deficit, it will not be surprising to see Primary Dealer (PD) banks burdened with extra loads of low return Treasury bonds. This is tantamount to pulling the rug from under the banking system that provided the wherewithal for private investment for a long time. Solving the power crisis is a national imperative, but the costs must be carefully weighed. It need not throw the entire macroeconomic balance out of kilter.

To sum up, after several years of easy money policy that allowed broad money to grow significantly ahead of the output of goods and services (nominal GDP growth) — a policy that fueled growth with concomitant inflation — BB has found it imperative to put the brakes on money supply growth largely by restricting credit to the private sector. This policy of demand restraint could not have come at a worst time. Europe and North America, two of our major export markets, are courting demand restraint to ease out of their debt burdens at a time when unemployment rates are peaking in several member-countries of the Organisation for Economic Co-operation and Development (OECD). Fiscal austerity and demand restraint are the going prescription for distressed countries for coming out of the Eurozone crisis. Burdened by public debt at 100% of GDP, the US economy is on track to curb public spending with bipartisan endorsement.

Alas Bangladesh must take the same route to salvation albeit with unpalatable consequences. Private investment is likely to be the first casualty along with some collateral damage to the banking system. Growth comes next and BB has rightly scaled down its projection of GDP growth rate — 6.5% is more likely than 7.0%, for FY2012. But it will take a few more of these MPSs with tight monetary control to put the inflation gini back into the bottle. The danger is that this could sap the vitality and dynamism out of private enterprise in Bangladesh if it lasts too long. (Dr. Sattar is Chairman, Policy Research Institute. He can be reached at email: zaidisattar@gmail.com)