Paying attention to macroeconomic fundamentals

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Just as mathematics teaches us to be logical, macroeconomics teaches us to think holistically about the economy. The ongoing stock market crisis in Bangladesh is a good example

of how economic management could go wrong if serious attention is not given to fundamental macroeconomic variables that have substantial implications for macroeconomic outcomes including in the stock market. I applaud the Finance Minister for his courage and forthrightness in accepting responsibility for some of the mistakes made, instead of the traditional practice of passing on the blame to somebody else. Other players involved in the stock market debacle need to do the same. Instead of demanding the resignation of the Finance Minister, as some investors and political leaders have done, I believe we should help him and the country to understand the factors underlying the crisis, learn from this experience, take corrective actions and move on.

The Finance Minister has announced the government's plan to do a full investigation of the crisis. I do not intend to second-guess that investigation. Yet I cannot but help draw the attention of the policy makers to the fact that there is a need to seriously rethink the conduct of monetary and financial sector policies and also to related tax policies, all of which have played a role in the present debacle in the stock market.

Irrespective of whether or not there were market manipulations and whether or not the SEC is competent and took the right policies, things would have gone wrong in the macroeconomy including the stock market due to the inappropriate conduct of monetary and financial sector policies. Tax policies similarly have implications for the present difficulties in the macroeconomy. They played a role in the overheating of the stock market and land prices and contributed to the stagnation of the investment rate that is constraining gross domestic

product (GDP) growth.

The average growth rate of money supply (defined here as broad money including currency, demand and time deposits or M2), has been 22 per cent per year over the past 24 months. This rapid expansion of money supply over such a long period is unprecedented in the recent history of Bangladesh, even though the growth of real GDP has remained in the 5.0-6.0 per cent range over the past 10 years. In a typical monetary programming exercise, the demand for money has to be worked out to check for consistency between demand and supply. This is done in two steps. First, the price level is held constant to estimate the demand for money in constant prices and then the price level growth (inflation target) is brought in.

The income elasticity of demand for money is a measure of how the demand for money grows in constant prices in response to the growth of real income. In a developing economy like Bangladesh, where the coverage of banking sector is still limited in rural areas, it is natural to expect an increasing monetization over time and as such to expect a growing demand for money that exceeds the growth of real income. So, it is likely that the income elasticity of demand for money will exceed 1.0 and possibly be in the range of 1.3-1.6.

There is another element affecting the demand for money. Holding idle money has a cost, often represented by the interest rate and the rate of inflation. So after allowing for this negative effect, the total elasticity of demand for money is not likely to exceed 1.5 under most optimistic assumptions about monetization of the economy. In this case the demand for money in constant prices will grow at the rate of the growth of real GDP (6.0) per cent per year) times the elasticity of demand for money (1.5), which yields a growth factor of 9.0 per cent per year.

In a developing economy like Bangladesh there are unemployed resources. Even so, there are many supply rigidities as well as the possibility of imported inflation through import prices. Therefore, it is normal to expect that some inflationary pressures will persist. So, allowing for a rising price level is not unreasonable. The policy question is how fast a rise in the general price level is desirable, given that inflation tends to hurt the poor more than the rich. Not surprisingly, in Bangladesh as elsewhere the usual political economydecision is to keep the inflation rate as low as feasible. In the present times the target inflation rate for Bangladesh is in the 5.0-6.0 per cent range.

A whole host of factors impact on the actual inflation rate-nominal wages, nominal exchange rate, import prices, domestic prices of commodities, etc. The government does not have much direct influence on most of these factors except the nominal exchange rate, which has been fairly stable over the past few years and has not been a major determinant of recent inflation.

The government, however, has a very powerful instrument that has the most influence on the rate of inflation-control over the supply of money. Through a range of monetary policy instruments, the government can influence the growth of money supply. By keeping the supply of money broadly aligned to the demand for money (in constant prices) and the target rate of inflation, the government can keep the rate of inflation broadly under control. So, for example, with a demand for money growing at 9.0 per cent per year and an inflation target of 6.0 per cent, the growth in the supply of money should be aligned to 14-15 per cent per year.

With the supply of money growing at a much faster pace (22 per cent per year) than demand (14-15 per cent per year) over a two year period, it is hardly surprising that the excess supply of money has fed into higher inflation as well as excess demand for assets (especially stocks and land) and thereby has driven up the asset prices. This is a fundamental result that cannot be ignored even in a smoothly functioning stock market environment.

The pressures from an overly expansive monetary policy on stock and land prices have been aggravated by a number of financial sector and tax policies. One major distortion in the financial sector is the control over interest rates. Long-term lending interest rates are capped at 13 per cent and deposit rates at 10-11 per cent. A second contributing factor is the provision of directed credits at subsidized interest rates. A third factor is the treatment of capital gains from stock market and land holdings for tax purposes. The capital gains from stock markets is barely taxed while capital gains from land holdings mostly escapes the tax net, due to a combination of grossly unrealistic land valuation, low tax rates, improper land registration and assessment, and corruption.

It is easy to see how these distortions have combined forces with an expansive monetary policy and contributed to the overheating of stock and land prices. The incentive regime emerging from these policies can be illustrated by a simple example of investment choice facing a potential retail investor. The investor sees an annual rate of return of 10 per cent

minus taxes on fixed deposits as against 80 per cent growth in stock prices and 100 per cent growth in real estate prices with little or no taxation. It is very logical that money will go to stocks and land holdings. A similar logic explains the reported diversion of unsupervised loans given to farmers and small enterprises through the Bangladesh Bank and commercial bank directed credit programs. The commercial bank's portfolio behaviour is also explained by the incentive structure. Faced with fixed lending rate of 13 per cent and having the option of investing in stock markets, the choice of putting as much money as legally possible in stock markets is a rational outcome emerging from the policy regime.

There is also a feedback loop between stock market and land market prices. The huge capital gains made by wholesale investors from the initial floating and from the initial purchase of stocks that were cashed in for profit taking once the market picked up have partly been reinvested in land holdings, driving up prices in areas such as Gulshan Avenue to Manhattan levels or even above. Truly, land is a scarce resource and prices will go up but surely not at the pace that one has witnessed in recent months without the impetus provided by inappropriate financial and tax policies.

What is the way out of this rather messy macroeconomic environment?

First and foremost, the government ought to rethink its monetary policy and target it to control inflation primarily, instead of chasing broad-based development through monetary policy. The later task is better assigned to fiscal policy, at least at the present time when inflation is rising and asset prices are over-heated. This means the growth of money supply has to be brought down to the 14-15 per cent range and kept at that level until inflationary pressures have subsided and the growth of asset prices normalized. While it is understandable that monetary tightening has to be done in an orderly manner in light of the volatile stock market situation, but any attempt to protect stock market prices that are not supported by market fundamentals through continued pumping of excess liquidity as in the past 2 years will be unsustainable.

Second, the interest rates must be deregulated. The Bangladesh Bank can watch the trend and stand ready to intervene through monetary policy instruments rather than through direct caps. These interventions will need to balance inflation aspects with aspects of growth of economic activities. So long as inflationary pressures persist, a rising interest rate and

monetary tightening are inevitable and the political process must not intervene or else the result will be where we are today.

Third, the Bangladesh Bank must not run quasi-fiscal operations through its directed credit programmes. These programmes, if justifiable, should be managed by the Ministry of Finance through the national budget for the purposes of fiscal transparency as well as to prevent a conflict of interest between the regulator and the financial service provider.

Fourth, these programmes should be well designed and administered by proper institutions that have the experience and administrative capacity to manage these schemes. A proper monitoring and evaluation (M&E) framework must be in place along with adequate baseline data to evaluate the effectiveness of these programmes in achieving the desired objectives. Without these safeguards, the results are likely to be what has been reported in terms of diversion of funds to stock markets, etc.

Fifth, the issue of whether commercial banks should be allowed to continue to be active players in stock markets needs to be seriously reviewed in terms of international experience, corporate governance and prudential regulations. Quite apart from the issues of profit taking at the expense of the depositors and the diversion of funds away from genuine investment activities, the heavy exposure to stocks could pose serious risks to the health of the banking sector when stock prices decline.

Sixth, the taxation of capital gains from stocks and real estate transactions needs to be over-hauled. Capital gains from all sources including stock holdings must be taxed at the same rate as other incomes. Real estate taxation must be re-thought with a policy to bring property valuations in line with markets values for taxation purposes. Land and property ownership and registration and records should be streamlined and computerized and capital gain taxes on land transactions must be properly implemented.

Finally, retail investors in stock markets must understand that unlike land which will hold much of its value over the longer term due to its scarcity, stock prices cannot continue to grow forever since the supply of stocks is virtually unlimited as new investors try to come in

to claim a share of the pie. Initial gains in a thin market and with excess demand are no indication of prices in a growing and thicker market and where competition will drive down profit making. Investors need to pay attention to such fundamentals as price/earnings (P/E) ratio of stocks in the market and normally avoid buying stocks that have P/E ratios in excess of 20. Average stock prices (Dhaka Stock Exchange index) grew at almost 80 per cent annually in the past two years (between end December 2008 and December 05, 2010) before starting to decline, while the real economy has grown at around 6.0 per cent; excluding the rural economy, growth is still in the 8.0-9.0 per cent. From a macroeconomic perspective, such large gains in stock prices in such a short period of time are not sustainable. Inflation rate is rising and a monetary correction is inevitable. Global commodity prices are rising and would likely lower the terms of trade for Bangladesh reducing its income.

The clear implications of these fundamental developments are that the average stock prices would likely have gone down in the short term irrespective of what actually triggered the decline. Even as of January 24 after the recent corrections the average Dhaka Stock Exchange average price index is still 50 per cent higher than the level at end December 2009 and 144 per cent higher than the level at end December 2008. How much further prices will fall is an open question, but further reductions cannot be ruled out given the magnitude of rapid gains still in place.

Looking to the government and expecting it to somehow protect stock prices from falling and instead keep it growing is like expecting wealth to drop from the sky. While it is appropriate to demand that the government should fix its policies and investigate and punish any wrong-doings to protect public interest, it is entirely wrong and unreasonable to expect the government to keep on propping a stock market that is facing corrections owing to market fundamentals. When stock prices overheat, investors should expect a downward correction. That is the rule of markets. An informed investor should know when to go in and when to exit. If one doesn’t know how to play in the stock market, it is best to stay away. (The writer is Vice Chairman Policy Research Institute of Bangladesh. He can be reached at sahmed 1952@live.com)