

## Proper conduct of monetary policy

Tuesday, Feb 7, 2012

By *Dr. Sadiq Ahmed*

The Bangladesh's macroeconomy is going through rough seas.



Angry investors bring out a procession in front of the Dhaka Stock Exchange building recently after a massive fall in stock prices. The benchmark index of the Dhaka bourse suffered a massive blow yesterday also, plunging by 225 points. Analysts say two years of lax monetary management during fiscal 2010 and 2011 have played havoc on the stockmarket. Photo: STAR.

It is imperative that all efforts must be geared to steadying the economy rather than letting it be consumed by the turbulent economic weather.

The immediate macroeconomic challenges are to sharply lower the rate of inflation from the present double digits to the more tolerable 5 percent range and to stabilise the nominal exchange rate. The two tasks are interrelated. Exchange rate stability requires that the inflation rate be brought down to the 4-5 percent level so that the differential between US and Bangladeshi inflation rate is minimised. So, arguably, tackling the inflation rate is the most fundamental macroeconomic task at the present time.

I have written a lot on the subject of inflation control and the proper conduct of monetary policy. I have also done some serious quantitative research using modern time series

econometric analysis. The upshot of all this research is that inflation in Bangladesh cannot be reduced to the desired level without substantial monetary tightening. Two years of lax monetary management during fiscal 2010 and 2011 have played havoc on the macroeconomy and the stockmarket. The unsustainability of that past excessive rate of growth of money supply (22 percent per year) and domestic credit growth (28-29 percent per year) is now as obvious as the fact that the sun rises from the east.

So, I am delighted that Bangladesh Bank (BB) has shown the courage to call a spade a spade and for the first time in the past three years, has initiated implementation of a proper monetary policy that restricts monetary and domestic credit growths to levels that are sustainable in the sense that these are consistent with a stable macroeconomic environment. However, the ability to properly implement this monetary policy depends heavily on support from two other economic actors: the treasury and the business community.

The treasury is particularly a critical player. Proper coordination between the monetary and fiscal policies is always a challenge for a developing country like Bangladesh where the central bank lacks independence. This coordination should be provided by the finance minister who also heads the monetary policy board. What should be the prudent rate of monetary expansion to manage inflation and how the associated growth of domestic credit should be distributed between the private sector and the treasury (bank borrowings to finance fiscal deficit) are policy choices that are inter-linked and must be properly assessed and implemented in a coordinated manner.

Unfortunately, this is not yet the case in Bangladesh. The reduction in the rate of growth of domestic credit that is required to maintain a prudent expansion of money supply means that both public and private sectors will have to adjust their use of domestic credit economically and more efficiently. But over the past months, uncontrolled treasury borrowings from BB have made it very difficult to implement the required monetary policy correction.

More borrowing by the treasury means less credit available for the private sector. Interest rates are rising to reflect this reality. While some increase in interest rates is unavoidable to implement the prudent rate of monetary expansion, the level of this increase can be kept to a manageable limit provided the treasury restrains its borrowing. Accordingly, fiscal management must be strengthened and coordinated with monetary policy management to

reduce inflation.

The other key actor is the business community. Many business sector players including commercial banks made huge profits from the asset price surge of 2008-2010 that was partly supported by excess liquidity in the economy owing to slack monetary management. The business community did not complain then and enjoyed the short term gains from monetary policy mismanagement through soaring real estate and stock prices.

They did not recognise then that this excess liquidity will also spill over in terms of fuelling generalised domestic inflation and exchange rate instability. Now that BB wants to correct its past mistakes and implement a prudent monetary policy to help restore macroeconomic stability, the business community is up in arms and complaining bitterly about high inflation, about the rising price of foreign exchange and rising interest rates. Efforts are also underway to exert political pressures on BB to ease domestic liquidity so that interest rates come down.

The business community's concerns with high inflation, the rising price of foreign exchange and rising interest rates are valid and mostly justifiable. But the problem lies in their demand to expand domestic liquidity. The business sector has to understand that high inflation and the rising price of foreign exchange are inter-related and are caused by excess domestic liquidity. If they want to see lower inflation and a stable exchange rate in the coming months, they must not put pressure on the government and the central bank for easing domestic liquidity. Instead, they should advise the government to strengthen fiscal management. They should also cooperate with the government by paying taxes and by supporting efforts to reduce the unsustainable energy subsidies.

As I have written many times in the past, coordinated monetary and fiscal management that consists of monetary expansion in the 15-16 percent per year range combined with prudent fiscal management that keeps fiscal deficit in the 5 percent of GDP range and restricts domestic bank borrowing to no more than 3 percent of GDP has the best hope of restoring macroeconomic stability.

The remaining 2 percent of GDP deficit financing must come from foreign sources. If this is not possible for political reasons, then either the tax effort should be increased or the fiscal deficit should be reduced to fit the available foreign funding. In cutting expenditures, much of

the adjustment should happen in the current budget mostly from cutbacks in subsidies. Putting all the burden of fiscal adjustment on development spending is not advisable as this will reduce economic growth down the line.

The writer is the vice chairman of the Policy Research Institute of Bangladesh. He can be reached at [sahmed1952@live.com](mailto:sahmed1952@live.com)