Sustaining growth momentum

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Bangladesh has shown a lot of promise and resilience by pushing ahead with the national development

agenda. Poverty has declined fairly rapidly since 2000 and economic growth is on an upward trend. While higher growth is a welcome development, events over the past 12 months suggest that the macroeconomy is coming under strain.

They are reflected in (i) rising rate of inflation which has now crossed the double digit level; (ii) instability in the stock market; (iii) growing imbalance in the trade account of the balance of payments (goods and non-factor services); (iv) depreciation of the taka; (v) rapidly growing subsidy bill of the budget; (vi) growing deficits of public enterprises; and (vii) difficulties in mobilising foreign financing.

Based on international experience there is broad consensus that macroeconomic stability is essential for sustained economic growth. It is, therefore, imperative that the government take quick actions to correct the situation.

Policy options will emerge from a proper diagnosis of the underlying problems. Let us first look at the double-digit rate of inflation. World and domestic food prices have gone up. It is tempting to take this inflationary pressure as the outcome of global developments. However, world food prices are only a part of the problem; the other factor that has increasingly become dominant is growing domestic liquidity owing to unprecedented growth in money supply by 22% during FY2010 and FY2011. This has been fueled by high growth of private credit and more recently by the growing bank borrowing by the Treasury and the public enterprises. Public sector borrowings are the combined result of growing subsidy bill,

primarily from electricity, fuel and fertilizer, and the inadequacy of foreign financing of the budget.

The problems in the stock market are the result of excessive euphoria of private investors who failed to properly evaluate risks and make right investment decisions, the thinness of the stock market, weak regulations and oversight of the Securities Commission, excessive domestic liquidity during the bull-run period and weaknesses in the conduct of corrective policies.

The imbalance in the trade account is due to the spillover effects of excessive domestic liquidity in the demand for imports, rising global commodity prices, growing demand for heavily subsidised fuel and fertilizer, growing imports of capital goods for power and other infrastructure and over-invoicing of imports. This growing demand for capital for imports has not been matched by availability of foreign financing from official sources or from direct foreign investment. On the other hand, the growth of earnings from remittances, the second largest source of foreign exchange, has slowed. As a result, reserves are coming under pressure and the exchange rate is depreciating.

The large bank borrowings by the Treasury and the public enterprises are the consequences of subsidies and price controls. The three main contributors are electricity, fuel oil and fertilizer, which account for a whopping $4.1 billion worth of subsidies (almost 4% of GDP). The subsidy bill has expanded substantially over the past few years owing to rising global fuel oil prices and due to the power purchase agreements with high-cost rental power companies. With a tax to GDP ratio of only 10.6%, it is obvious that spending 37% of the tax collections on energy subsidy alone cannot be sustained. Public enterprises supplying electricity, gasoline and fertilizer are accumulating huge deficits owing to the growing gap between cost of production and prices they are allowed to charge consumers. These deficits are partly funded through budget subsidies and partly through bank borrowings.

What is the way out? The solution lies in much more coordinated management of the underlying macroeconomic policies. On the monetary policy front the monetary growth rate must be brought down from 22% to a level that is consistent with a lower rate of inflation. There is a debate, however, about the strength of this tightening effort. The Bangladesh Bank has set a target of 18% growth rate of broad money (M2) for FY2011-12. My calculations

show that in order to achieve an inflation rate of 5-6% the monetary growth rate must be reduced to no more than 15-16% per year.

I have also looked at the trade-off between monetary growth and GDP growth on the one hand and between GDP growth and inflation on the other. I do not find any empirical evidence that a growth rate of M2 by 22% has any positive impact on GDP growth or on investment. Indeed, a growth rate of M2 of 15-16% is consistent with achieving 7% GDP growth while also helping reduce inflation to 5-6%.

The ability of Bangladesh Bank to reduce monetary growth rate to even 18% will depend upon both a tightening of credit for the private sector and restrained borrowing by the public sector. For the private sector the interest rate must be allowed to go up to the level required to lower private credit growth from 25% per year in the past two years to the 17-18% that is adequate for supporting economic growth at the 7-8% level. For the public sector, interest rate signals do not work and the deficits of the Treasury and the public enterprises are automatically financed through the banking. In this environment, the government needs to ensure through its conduct of fiscal policy that it is made consistent with the targets of monetary policy.

Fiscal policy reforms require raising taxes by closing the loopholes in income tax, especially by introducing capital gains taxes for gains from stock markets and real estate transactions; introducing a well-functioning property tax system; lowering subsidies by allowing more frequent and speedy pass-through of energy prices; mobilising larger volume of foreign financing of the budget, including flexible budget-support borrowings; strengthening public expenditure planning and management; and reforming public enterprises.

On the balance of payments front, the pressure on the trade account can partly be offset by promoting direct foreign investment in all sectors of the economy, but especially in energy, transport and manufacturing. For the longer term, Bangladesh needs to diversify its export base much more aggressively than now. While an easing of the infrastructure constraint will help, the incentive structure for exports needs to be substantially improved by lowering trade protection through a reform of the complex system of tariffs and supplementary duties.

Most these reforms involve trade-offs. A tightening of monetary policy will raise interest rates

and the private sector lobbies will protest. Beneficiaries of higher trade protection will similarly raise their voice and oppose the reforms. The beneficiaries of the tax loopholes are politically powerful and will oppose its removal. Similarly, beneficiaries of fuel subsides will oppose higher prices. Additionally, there is a misleading perception that passing on higher fuel prices will fuel inflation. By not passing on these higher prices the Treasury and public enterprises are borrowing from the banking sector to finance their deficits that is contributing to the rapid expansion of money supply which is fueling inflation. The tax imposed on the ordinary citizen through higher inflation (the inflation tax) is regressive and the hurts the poor much more than higher energy prices.

There are no easy solutions. It is up to the government to either bite the bullet or stay with the status quo. Unfortunately, while the status quo may appear politically easy in the very short-term it is a far worse option for the long-term. The macroeconomic framework will become inconsistent with the growth target and something will have to give. What gives ultimately may cost the country much more than the short-term political discomfort from taking corrective actions now.

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