



The conduct of monetary policy

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The conduct of monetary policy improved vastly in fiscal year (FY) 2012-13

when compared with the previous three years. Monetary policy was strategic and aligned to the need to restore macroeconomic stability. The quantitative targets for money supply growth, domestic credit and its distribution between public and private sectors were done properly and the implementation was monitored to stay the course. The results have been highly positive, reassuring that good policies work well for the economy. Specifically, the reduction in the growth of money supply and domestic credit lowered inflation, reduced the pressure on the balance of payments and stabilized the exchange rate. These results were achieved without any adverse effects on gross domestic product (GDP) growth, which continued to grow at a healthy pace of 6.0% per year.

This encouraging experience with the good results of FY2013 has helped build the confidence

of the Bangladesh Bank (BB) management team that a well-designed monetary policy with a clear articulation of objectives and targets and aligning monetary policy instruments to these targets is the way to go. This writer is heartened to see that the BB has decided to stay the course of maintaining monetary discipline in FY2014 despite the forthcoming elections. The most recent Monetary Policy Statement (MPS) for July-December 2013 seeks to keep money supply growth at 17%; domestic credit growth at 17%; public sector credit growth at 20%; and private sector credit growth at 16%. These targets are consistent with supporting a 6.0% growth of GDP; keeping inflation contained at 7.0%; and meeting the requirements of the private sector and the budget.

There have been several criticisms of the monetary policy from a number of reviewers. Let those criticism be examined here and responded to. One criticism is that monetary policy over the past 18 months has contracted too much and is constraining investment and GDP growth. Empirical evidence was earlier provided through several articles by this writer, about this criticism as not being based on sound economic analysis and data. The GDP growth of 6.0% achieved by Bangladesh in FY2013 is a healthy growth rate by international standards and also compares favourably with past growth rates in Bangladesh.

It is however true that this falls short of the targets in the Sixth Plan and is not fully consistent with the aspirations of Bangladesh to reach middle income country status by FY2021. The main reason for the shortfall in GDP growth rate from the Plan target is the shortfall in the investment rate. This shortfall is particularly serious for public investment but also true for private investment. The inability to achieve the Sixth Plan's investment target is explained by several factors including inadequacy of public revenues; the large energy subsidy; public sector procurement and other implementation problems; the inability of the public-private infrastructure initiative to gain momentum; fiscal incentives that are biased against investment in manufacturing and productive sectors as opposed to land and real estate transactions; inadequacy of foreign private investment; trade logistic inefficiencies; and the growing land constraint.

None of these factors have anything to do with monetary policy. Indeed the contribution of monetary policy to investment decisions remains supportive despite the required monetary tightening. Thus as opposed to the private sector credit growth target of 18% programmed for FY2013, actual private sector credit grew by a mere 11%. If one allows for foreign private

borrowing, then total private sector credit growth reaches 14%. The cost of credit has increased somewhat in real terms but it is still reasonable. The slack in private sector demand for credit is in part an outcome of some of the factors noted above. Additionally, the uncertainties in the business environment owing to ongoing political turmoil are a major contributing factor. Because of this slack banks are flushed with liquidity and it is ridiculous to ask BB to provide for a faster growth of private sector credit when demand cannot absorb the credit already available.

A second criticism is that the MPS allows for excess credit growth to the public sector as opposed to the private sector. This writer has already responded to the criticism concerning the private sector credit growth target. Regarding the target for public sector credit growth, this scribe would argue that this is also within reasonable limits despite this being an election year. The Ministry of Finance deserves credit for keeping the budget deficit within manageable limits. It is also making an effort to raise more resources from foreign official sources to finance public investment. For example, there is an encouraging growth in the use of official aid in FY2013. It is expected that this trend will continue in FY2014. As a result, the borrowing of the Treasury from banking sources as a share of GDP is contained within prudent limits and is lower than what was seen in FY2012. Of course there are several downside risks to the proper implementation of the FY2014 budget in view of political uncertainties. Nevertheless, the results of the FY2013 budget and monetary policy suggest that there has been a good coordination between the two. This better alignment of fiscal policy with monetary policy in FY2013 is a positive result.

A third criticism is that the MPS is too conservative in its growth assumptions to underpin the monetary policy. This writer would argue on the contrary. Instead of being critical, this scribe is encouraged to see that the MPS is based on sound assumptions about the external environment facing Bangladesh and domestic credit needs. In particular, the assumption that the domestic economy will expand by around 6.0% is a welcome departure from the more optimistic projections of 7.0% GDP growth of the FY2014 budget. The National Budget is a political document and is based on stretch targets for revenues, exports and development spending. There is nothing wrong in trying to reach out to these targets even though it is unlikely that they will be achieved. On the other hand, the MPS must set realistic targets for the expansion of money supply and domestic credit based on the best estimates of likely GDP growth. Otherwise, the excess liquidity will spill over and contribute to inflationary

pressure, thereby compromising the inflation assumptions.

While this writer is generally very positive about the current monetary policy stance, despite having some concern about the inflation target. A 7.0% inflation rate is too high. Inflation acts like a tax on money holdings. The proceeds from the expansion of the monetary base go to the Treasury as “seignorage revenues”. Available empirical evidence suggests that inflation tends to hurt the poor proportionately more than the rich. So, this writer does not like the use of the inflation tax beyond what is necessary to finance the expansion of economic activity. A 7.0% inflation target compares with 1.0-2.0% inflation rate in most of our major trading partners except India. This gap in domestic and Organisation for Economic Cooperation and Development (OECD) country inflation will complicate the exchange rate management by appreciating the Bangladesh currency. Swelling remittance inflows and slowdown in imports growth are already contributing to an appreciation of the taka against the US dollar. Continuing large inflation differential can therefore pose a major problem for exchange rate management over the medium term.