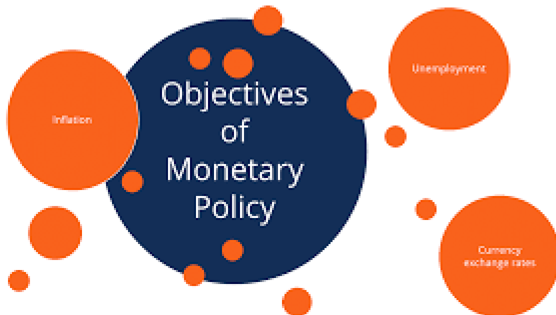

The monetary policy is working well

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By *Dr. Sadiq Ahmed*

It is now the time of the year when the Bangladesh Bank

announces the next six monthly monetary policy stance. In anticipation there are considerable ongoing deliberations and debate on the forthcoming monetary policy statement (MPS). Bangladesh Bank has established a rich tradition of extensive prior consultations before it announces the MPS. Nevertheless, public debate through the media is appropriate and most welcome. Yet, it is important that this debate should be based on facts and outcomes rather than on perceptions and speculations. It is in this spirit that I share with the readers my views on the monetary policy in Bangladesh.

My one time boss at the World Bank in Washington DC, Joseph Wood, a former vice president of the South Asia Region, had one favourite advice to his staff: “If it ain’t broke, don’t try to fix it”. This is a simple but profound statement. In our personal lives, professional career and also in public policymaking we often spend endless fruitless hours trying to find solutions to problems that do not exist. In the arena of policymaking, there are many issues and

challenges. But trying to fix Bangladesh's ongoing monetary policy runs against the sage advice of Joseph Wood. There are many problems in the financial sector, especially in the banking sector. But monetary policy for a change is running well on course and I do not see the need for changing this course. Let me elaborate.

The table shows the conduct of monetary policy in the past five years. It shows also the outcomes of monetary policy in terms of various indicators where it is expected to have most influence.

The results are follows:

Monetary policy was highly expansionary in the three years of FY2010-FY12. On average, broad money supply grew at a heady pace of 20.3 percent per year. Private sector credit grew at an unprecedented annual average rate of 23.2 percent. Inflation rate shot up, reaching a peak of 14 percent in March 2012. Stock prices soared in 2010, with the Dhaka Stock Exchange (DSE) index reaching an unsustainable peak of 8,919 points on December 5, 2010. While other factors were also at play, the rapid growth in private credit contributed strongly to pushing up stock prices.

Land prices also surged as excess liquidity found its way into land speculation. Demand for imports and foreign exchange soared, causing a huge pressure on the exchange rate, which rapidly depreciated from Tk 69.4/$ in July 2010 to a peak of Tk 81.9/$ in May 2012. The unsustainable bulge in stock prices soon burst, crashing stock prices to a low of 3,895 points on May 27, 2011, causing huge panic and social unrest among investors. The overall macroeconomy came under severe pressure until corrective monetary policy actions starting in January 2012 stabilised the economy by reducing the growth of domestic liquidity that fueled the instability.

The correction in monetary policy starting with the MPS of January-June 2012 has been carried forward further since then through end June 2014. On average the growth of money supply declined to 14.9 percent during FY2013-FY14. Inflation rate has fallen, the exchange rate has stabilised and stockmarket is stable, although the confidence factor that was shaken by the 2011 stockmarket crisis is yet to return. Land prices have normalised and even declined in real terms. The reduction in inflation has been impressive and is much better

reflected in the decline in non-food inflation whereby the rate fell from its peak of 14 percent in March 2012 to a low of 4.9 percent in December 2013. It is now stable at around 5 percent. This is a remarkable achievement.

What has been the impact of monetary policy correction on economic activity? Proponents of the so-called expansionary monetary policy argue that it supports the growth of investment and GDP, while a tightening hurts investment and GDP. The evidence provided in the table shows that there was indeed some increase in real interest rate after the correction of monetary policy. Real lending rate increased from about 4 percent to 5 percent.

But the impact of this increase on investment and GDP was minimal, if at all. On average the private investment rate was higher during FY2013-FY14 than during FY2010-FY12. Average GDP growth was slightly higher in the FY2010-FY12 period but this is partly because of the political turmoil in FY2013/14. Overall, the total investment rate was significantly higher during FY2013-FY2014 not withstanding a substantial slowdown in the growth of money supply because of an increasing rate of public investment based on higher public resource mobilisation.

Fiscal policy has been broadly supportive of monetary policy during the past two years. Public investment has increased even though the fiscal deficit has remained at around 5 percent of GDP. There is no evidence of crowding out because net government borrowing from the banking sector has remained below the credit expansion allowed by the MPS. On the contrary, private credit growth has fallen much shorter of the growth rate provided for in the MPS. This is because demand for private credit has been sluggish partly owing to restrictions on speculative investments in real estate and stocks. There is enough liquidity in the banking sector within the parameters defined in the MPS to support higher private investment. The demand for investment is not constrained by liquidity; it is constrained by other factors including incentives, law and order situation and political stability.

The evidence is clear that the monetary policy is working well in Bangladesh and there is no need to change its present course. The need for accelerating GDP and investment is unquestionable. But this cannot be brought about by a higher rate of growth of money supply or by higher growth of private credit. In an environment where the demand for private credit is much lower than supply and the banking system is flush with liquidity, it is ridiculous to ask

for a higher growth of money supply and private credit. Excess liquidity is driving down deposit rates rapidly, but lending rates are slow to adjust. This is largely explained by the inefficiencies in the banking system and a deterioration in loan portfolio reflected in growing incidence of non-performing assets, especially in the public banks. A basic problem is weak governance and corruption. These structural weaknesses in the banking system need to be addressed but they cannot be resolved by expanding the supply of domestic liquidity at a faster rate than what is needed to meet GDP growth and inflation targets.