

What BB's Monetary Policy Statement did not state

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Bangladesh economy has had its sights on 7.0-8.0% annual gross domestic product (GDP) growth for the better part of this decade – elusive though it has been. This is the kind of growth rate that, in a decade or two, catapulted several Asian economies into industrial and commercial power houses of the world. Few analysts will doubt that Bangladesh indeed is at the doorstep of such a breakthrough, if only it could get its act together, in power and infrastructure for a start. On its part, Bangladesh Bank has played a critical role in creating and sustaining the right environment for money and credit to grease the wheels of the economy and move it to a higher growth trajectory.

Last month, our central bank announced its sixth Monetary Policy Statement (MPS) since it started making these coherent twice-a-year policy statements about the state of money supply and credit as it impinged on the economy. The regularity with which these announcements have been made since 2006 gives them the sanctity of another public policy vehicle to watch – like the budget, industrial policy, import and export policies. These announcements are meant to take some uncertainty out of the policy environment and leave clear signals to investors about the stance of monetary policy and prospects for public and private credit growth in the near to

medium term. To a large extent, this institutional development has been the outcome of Bangladesh Bank (BB) independence reinforced by the amendment to the Bangladesh Bank Order 1972. How meaningful and effective such monetary policy stance is depends of course on whether or not the fiscal house is in order – which is the realm of the Ministry of Finance. It is fair to say that at least for the past five years, the government's fiscal deficit and its financing modes have been consistent with debt sustainability and largely non-inflationary. From fiscal year 2002-03 (FY03) through FY08, budget deficits have remained in the modest range of 3.0-4.0 per cent of GDP, and domestic financing – the more troublesome component – has never exceeded 2.0 per cent, the balance being financed through concessional external aid. As we all know, the latter is the cheapest source of budget finance available. It is the domestic financing part that is at once costly, crowds out private investment, and could fuel inflation if sourced excessively through government borrowing from the central bank. Our central bank is entrusted with the role of creating an environment for achieving rapid sustainable output growth with commensurate price stability. It is in pursuit of this goal that the latest MPS reiterates that monetary management is targeted to facilitate GDP growth of 6.5% in FY09 with a Consumer Price Index (CPI) inflation rate of 9.0 per cent. In light of global developments, BB has already revised its GDP growth projections for FY09 to 6.0 percent and inflation is on a downward trend thanks to declining import prices. What does this all mean for monetary management? A few twists and wrinkles have appeared on the horizon which the MPS does not seem to have adequately addressed. First, the simple rule of monetary accommodation would require our money supply (broad

money, M2) to grow at a rate equal to the sum of projected GDP growth and its deflator (a broader measure of economy-wide price inflation). This will be equivalent to the growth of nominal GDP. Taking CPI inflation as a reasonable proxy for GDP deflator, one can see the required provision of money supply to be around 15% now (6.0%+9.0%), against the BB's target M2 growth for FY09 at 17.5% until June 2009. Again, current inflation, which is largely externally driven, is on a downward trend thanks to crumbling commodity prices globally. At this rate, inflation is expected to moderate around 5.0% by June 2009, which means that M2 growth target ought to be adjusted downwards. Against this backdrop, we have a situation where money supply (M2) is running at over a 20% clip. This is like sowing the seeds of future inflation. Today or tomorrow, this is bound to fuel inflation, as inflation is, in the end, a monetary phenomenon, though not for now. Just as our economy experienced a commodity price surge over the past three years emerging externally, the crumbling price level today is also an external supply shock which takes the wind out of inflation for now. But that cannot last if monetary management is lax. There are strong signals that monetary restraint might be warranted down the road if the inflation menace is to be kept under wraps. Here lies the dilemma of the country's central bank: maintaining price stability through prudent monetary management while promoting economic growth with healthy credit expansion. There are times when the two goals could run counter to each other. Setting money supply (M2) target is only one part of the equation. The other part is made up of domestic credit – public plus private. The problem is that despite its newfound independence, it is not clear if

there is greater coordination between BB and Ministry of Finance in setting targets for the mix of deficit financing. History suggests that BB has greater control over managing private credit volumes than those of government credit which are set in the budget. FY09 budget stipulated Taka 135 billion (13,500 crore) worth of government borrowing from the banking system - a 30% growth over the previous year - an amount that will be directly added to the domestic money supply. In reality, due to shortfalls in revenue collection, there seems to be a surge in government borrowing which has already grown 23% in the first half of the fiscal year. The recent decision for providing fertiliser subsidy amounting to Tk 27 billion (2700 crore) compounds the financing problem of the fiscal deficit if the government wishes to stick to the goal of achieving 90% Annual Development Programme (ADP) implementation by June 2009. This extra support is unlikely to be compensated by the reduction in subsidy to Bangladesh Petroleum Corporation (BPC) arising from falling petroleum prices. Result? Unless we see a major course correction, the signs are clear that public sector credit growth will outstrip BB's targets as government borrowing will go beyond FY09 budget estimates. That does not augur well for the private sector which seems to suffer from a perennial shortage of credit to meet trade and investment needs. Consider the fact that 19% of the 24% of GDP that makes up productive investment in the country is in the private sector. A surge in credit to government will surely crowd out private investment if BB is to keep overall credit growth within limits consistent with its monetary targets. That is not good for productivity, employment or growth, unless we make the assumption that every taka borrowed and spent by the

government will generate relatively more output than if it were spent by the private sector. To keep credit flowing to the private sector at the current rate while meeting additional demands from government will surely bust BB's target for both money supply and credit growth. On the other hand, credit restraint, which is the outcome of tighter monetary policy, cannot be popular with the business community which is perennially looking for more capital at lower cost. A liberal monetary policy with easy availability of credit is what they seek – always. Inflation outlook is seldom in their radar screen. The fact is that inflation hurts the poor more and we have 60 million of them who could do without another bout of inflation hitting them six months or a year down the road. It is upto BB to strike the right balance between the goals of long-term price stability and monetary accommodation for business, while responding to the government's budgetary obligations. That, we admit, is a formidable task. Clearly, there are three parties in this policy conundrum: the central bank, Ministry of Finance, and the private sector. On the whole, a tough balancing act awaits Bangladesh Bank. If public sector credit growth has become a loose canon in the game of monetary management, what options does it have but to put the breaks on private sector credit growth – which, by the way, has been also running high, at about 24%. Under the circumstances, credit restraint seems to be the only stance available. The MPS only hints at it without making any clear proposition. The reason for this might lie elsewhere. There is the global financial turmoil to be reckoned with. The last act in that event has not been played out as yet. Bangladesh financial sector has remained largely immune to the crisis, though potential impact on the real sector of exports and remittances cannot be completely ruled out over the

medium-term. When the world's richest countries are grappling with ways to provide economic stimulus, and fiscal stimulus is all they have, since monetary policy has fallen into the proverbial "liquidity trap" with interest rates at close to zero, can Bangladesh afford to go the other way and take a restrictive stance on monetary management? Perhaps circumstances dictate that Bangladesh Bank give itself space of some six months until the next MPS for a distinct change of stance, based on the evolving economic landscape.

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