

## Why is Bangladesh Bank so timid?

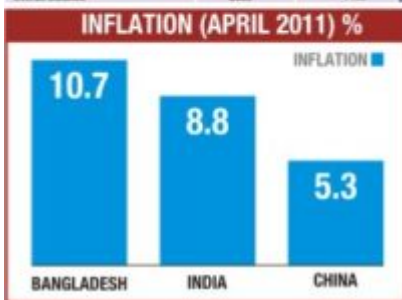
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MONETARY POLICY MEASURES (JAN 2010 TO APRIL 2011)				
	Current Reserve Requirement (%)	Number of Changes in Reserve Requirement	Reverse Repo (%)	Number of Changes in Interest Rate
Bangladesh	19	2	4.25	3
India	24	3	6.25	8
China	21	11	6.25	4

Source: Bangladesh Bank, Reserve Bank of India, People's Bank of China

BALANCE OF PAYMENTS OUTLOOK, FY11		
(\$Bn) (Millions of \$Bn)	FY 10	FY 11 (Prj)
Trade Balance	-5152	-9676
Export (a.b. including EPZ)	16236	23405
Import (a.b. including EPZ)	-21388	-33082
Services	-1237	-2252
Income	-1487	-1627
Current transfers	11610	12212
Of which: Workers' remittances	10967	11536
Current Account Balance	3734	-1344
Overall Balance	2965	-1488



On May 3, the Reserve Bank of India raised interest rates by half a percentage point. This represents its ninth hike in just over a year. At the time of raising the interest rate, inflation was cited as the primary concern for the economy. Similarly, a closer look at the monetary policy stance of China would reveal that the central bank has intervened four times over the past year to cool down the economy. This naturally poses a question as to why Bangladesh Bank (BB) and our policy makers in general are so hesitant when it comes to adopting a tighter monetary policy stance, which is so important for maintaining macroeconomic stability.

As economic growth picks up, economies generally tend to become overheated. The overheating is usually measured in terms of inflation (consumer price index and wage

pressures), asset price developments, and external sector imbalances. In China and India, policy makers are concerned about the overheating of the economy as inflation rates are considered to be higher than their respective policy targets. Authorities in both countries are also concerned about property prices (more so in China since property prices in India came down at the time of global economic meltdown). Accordingly, both countries have adopted tighter monetary policy by increasing intervention interest rates and continuing with further tightening of policies to ensure macroeconomic stability.

Inflation in Bangladesh is now running at a pace higher than that of India and at double the inflation rate of China.

Land and real estate asset prices in Bangladesh are unquestionably inflated, exceeding most of its comparator countries. One katha of land selling at \$1 million in Gulshan Avenue cannot be justified in terms of discounted present value of the future stream of income. Stock prices, with price-earning ratio reaching about 35 at its peak in January 2011, have already gone through a bubble and burst cycle and not yet settled.

Unlike China and India, Bangladesh is also experiencing a somewhat difficult balance of payments situation. A sharp rise in import (more than 40 percent) and other payments associated with services and income accounts will swing the external current balance from a surplus of \$3.7 billion in fiscal 2010 to a deficit of more than \$1 billion in fiscal 2011. This sharp deterioration, arising primarily from import payments, is surely a sign of excess demand in the economy.

Just because China and India have better performance in terms of higher real GDP growth rates than Bangladesh does not mean the Bangladesh economy is not yet overheated. Infrastructure bottlenecks are certainly much worse in Bangladesh and are binding constraints for its economy than in the other two countries.

Thus, creating domestic demand through loose monetary policy would create much more inflationary pressures and external imbalances in Bangladesh than in China and India. We must take note of the situation that expansion of credit to the private sector in Bangladesh at about 29 percent far exceeds that of India and China. Same is the case with expansion of broad money in Bangladesh. Furthermore, Bangladesh is much more vulnerable to balance of

payments shocks since we do not have the level of FDI inflows and level of external reserves (relative to our needs) are far below that of China and India.

Compared with the Reserve Bank of India and bank of China, BB raised its two key rates by a mere quarter of a percentage point in (April/March). This represents only the third time that BB has increased the interest rates since 2009; and before that, it increased the reserve requirements twice during the same period. In broadly the same time period, RBI increased the intervention rates and reserve requirements by 12 times and the BOC by 15 times. While economic growth is desirable and welcome, one must also be cautious to ensure its sustainability. Currently, the demand pressures in the economy must be contained, if there is a desire to restore stability in the money market. In order to ensure macroeconomic stability, the central bank must take up a much more proactive fight against inflation. Inflation is the worst enemy of the poor and the most distortionary form of taxation.

Representatives of the business community and some populist policy makers often do not like the tightening of monetary policy and the consequent high interest rates. But they need to understand that an excessive amount of credit expansion is not good for the economy. For sustainable industrial expansion, what really matters is adequate credit and real interest rates (not nominal) at reasonable levels. If the Indian economy can expand at about 9 percent with 17 percent credit expansion for the private sector, why would Bangladesh need 29 percent credit expansion to achieve 6.7 percent real GDP growth?

International experience shows that in countries with high inflation, often, the business community ends up paying very high real interest rates, which ultimately chokes investment and growth. To those who propose appreciation of the exchange rate to contain inflation, I will simply say, please do not play with fire if you do not have experience with fire fighting.

An appreciation of the exchange rate in an artificial manner would simply lead to loss of reserves and export competitiveness, and push the country into a balance of payments crisis. While continuing government's all out efforts to improve supply, it is only through tighter demand management policy that Bangladesh will be able to contain inflation. We must realise that the value of the Bangladesh taka is eroded by inflation in the domestic economy and value of the taka can only be protected by containing inflation and not through an artificial appreciation of the taka exchange rate.

In order to fight inflation, BB should be more aggressive with its monetary policy. The policy of abandoning the cap on lending rate has certainly pushed up the interest rate, but it is having its desirable effects in containing import growth and gradually helping to restore balance of payments stability.

Higher interest rates will also enhance the attractiveness of the taka as an asset and help stabilise the exchange rate. BB's recent interest rate liberalisation and stricter imposition of prudential rules, although late, are working slowly, with some signs of that are already visible in both the money and exchange markets.

This is not the time for BB to relax its fight against inflation. The inflation data for April, with headline inflation reaching 10.67 percent, indeed call for stronger action on the monetary front. To the critiques of BB's recent tighter monetary policy stance, I will urge that let BB work on its most important mandate of price and macroeconomic stability. This is not the time to inject liquidity into specific markets (stock market) or sectors (small and medium enterprise, public enterprises or agriculture) through administrative interventions.

For example, the Bangladesh economy and the government certainly cannot afford an injection of Tk 5,000 crore (Tk 50 billion) in the name of Bangladesh Fund to engineer a recovery of the stock market. The stock market needs reforms, enhanced transparency/accountability and the regulators need credibility. No amount of liquidity injection can achieve that.

The fight against inflation and for macroeconomic stability must not be lost. Policymakers in Bangladesh need to take lessons from experience and the policy strategies of India and China in their fight against CPI and property price inflation. It would be interesting to see whether BB continues along its timid route and gets distracted by its critiques, or adopts a more forceful approach like its Chinese and Indian counterparts.

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