OPINION

GDP growth, monetary policy and inflation: reality check

MOHAMMED FARASHUDDIN

Mohammed Farashuddin

Bangladesh Bank is going to announce the July-December monetary policy statement next week. This is the first policy stance under Governor Fazle Kabir. During the stakeholders' consultation organised on July 11, inklings have been provided for a refreshing departure from the growth slowing contractionary monetary policy to a moderately expansionary one. This is expected to further encourage private sector investment for growth and employment generation. Among the recent positive developments, a healthy increase in the private sector bank credit is quite remarkable.

In discussing the monetary policy with reference to Bangladesh, additionally special care will be needed to minimise the effect of escalating terrorist activities. The law enforcers are doing an excellent job of tracking and apprehending the sponsors of the terrorists, sealing the terror dens and busting the training camps of the killers. Bangladesh's growth performance and social transformation have received increasingly louder applaud of the global community, culminating in the invitation of Prime Minister Sheikh Hasina to the latest G-7 Summit. The escalation of terror should not be allowed to slow the growth momentum. The issues that need attention for the monetary policy are money supply, inflation, interest rate, exchange rate, reserves, bank loan defaults and the regulatory framework.

Bangladesh Bank has to, by definition and mandate, ensure price stability towards preservation of the value of the taka. The Equation of Exchange, MV=PQ i.e. P=MV/Q where P is general price level, M is the base money supply, V is the velocity of money circulation and Q is the real GDP, is very often misunderstood in the sense that a contractionary monetary policy is regarded by many as the end all and be all for ensuring price stability.

READ MORE ON B2

GDP growth, monetary policy and inflation: reality check

FROM PAGE B1

It must be remembered that the annual money supply growth must ensure monetary matching of the intended GDP growth, covering the inflationary trend and have a precautionary cushion. The monetary policy for the current year should thus provide money supply growth of at least 16.5 percent (7.5 percent of GDP growth + 6.5 percent inflation rate and safety cushion 2.5 percent). Given the healthy growth of almost 16 percent in private sector bank credit, all concerned, the Bangladesh Bank in particular, should more carefully proceed not to discourage private sector investment from the increasing private sector credit.

It is thus disappointing to hear Bangladesh Bank inviting the government to borrow more from the banking sector. Since the credit growth is limited by the money supply reality, higher level of government borrowing from the banking sector will certainly elbow out private sector. The government would thus do well to reduce budget deficit (Tk 97,853 crore) by enhancing NBR revenue collection including the taxation of the e-commerce, effective alternative dispute resolution reforms and regulating the mobile phone fund transfer to proper mobile banking. There is no reason on earth why the government should not collect at least half of the operating surplus of Bangladesh Petroleum Corporation.

An effective implementation of higher taxation on the low-cost tobacco (the tax level is the lowest in the world) would either reduce smoking if the demand is elastic or lead to higher revenue collection or to both bringing a win-win situation. If the budget deficit can be reduced to Tk 70,000 crore and $4.51 billion of the $23 billion pipe line of the foreign loan can be utilised in 2016-17 ($3.3 billion utilised in 2016-16 and a momentum can be created), then the government will be left with a net deficit of not more than Tk 35,000 -- Tk 15,000 crore from bank borrowing and Tk 20,000 crore by selling savings certificates. It may thus be possible to fully implement the budget ensuring a 100 percent implementation of the annual development programme marking a bold departure from the past.

The interest rate in a free enterprise or even a mixed economy is to be determined by the market forces which do not seem to operate yet in the Bangladesh economy. Bangladesh Bank findings in March, April and May 2016 have consistently shown that 25 to 27 scheduled banks maintain a spread between 5.5 percent and 9.5 percent, which is morally unfair and financially harmful for investment for growth. Private sector banks with low default rates have cost of fund at 3.5 percent to 4 percent and these banks must not charge above 7.5 percent to 8 percent lending rate. Banks with high defaulted loans including the NCBs have cost of fund escalating up to 7.5 percent or so. It is possible and desirable to evolve and implement innovative policies to significantly reduce bank loan defaults (a) without denting the investor (defaulters included) incentive, (b) minimising the loss of the banks and (c) maximising the national interest of higher GDP growth. Formulas do exist to ensure such a win-win situation which the government and Bangladesh Bank should look for.

Of all the elements of the monetary policy, the exchange rate regime of the Bangladesh Bank is the most perplexing. Floating market based rate exists on paper, but the practice is less than an optimal REER (real effective exchange rate) based fixed exchange rate regime. The trade i.e. exports competitors, India, Vietnam and Indonesia have depreciated their currency by 10 percent to 15 percent in the last 15 months and the taka has been allowed to maintain its value thereby appreciating it relative to the three competitor currencies. Consequently the Bangladesh exports growth in 2015-16, impressive as it is, could not be as much as it could have been. Economists are afraid that a free float will reduce the exchange rate to Tk 72 or so per US dollar although they do not visualise the demand pressure if all the underground dealings come to the fore as these would in a free exchange rate regime. But a political government may not have the stomach to risk this 'instability' in the third of its five-year tenure. Hence this option has to wait.

Bangladesh Bank knows that a properly calculated REER could mean Tk 100 or so to a US dollar exchange rate. Thus the authorities may think to appropriately administer an exchange rate around Tk 83-Tk 85 boosting the exports via reduction in the foreign exchange price of Bangladesh exports. This will also not only halt the slide in the remittances but will also provide a fillip to higher remittances. The cost in terms of higher amount of local currency matching the exports and the remittances net of the imports expenditure should not add any extraordinary pressure on price levels.

It may be noted that the inflationary trend is determined by the relative movement of the aggregate demand or total purchasing power (MV) and the real GDP, Q as the equation cited earlier. Investment will push up MV and Q will increase in response to the investment but with a time lag. Thus inflation may set in. But the past investment may start yielding results now to increase Q as well somewhat moderating the inflationary trend. Imports also augment Q. Investing producers and the traders always welcome moderate inflation 6-8 percent in order to have the profit incentive. The major price reduction in petroleum products and all the other commodities that Bangladesh imports will continue to pull down the prices in Bangladesh. The country's inflation rate at 5.8 percent, although very low, is still higher than India (5.2 percent), China (less than 2 percent), all the other Asian countries and Europe and North America. Now is the time to come out of the fear of inflation and craft a monetary policy that will build up on the momentum and the tremendous pace at which the infrastructure in being built and nurture the private sector credit increase for growth and poverty reduction through employment generation.

As far as the $30-billion reserve is concerned, it is useful for confidence building and gives a good feeling. But a reserve that is equivalent to nine months' imports cost is a luxury that Bangladesh can ill afford. Just as we suggested in December 2011 using reserves for domestic financing of the Padma bridge, we again feel the government should seek low interest (1 percent or so as the reserves kept in other central banks earn) or no interest loan from the reserves to finance mega infrastructure projects. One such project can be modernisation of the railways- broad gauging, double tracking and electrification for enhancing the productivity of the economy tending to push down the ICOR (incremental capital output ratio).

The coordination council scrutinises for consistency and coordinates the monetary policy, the interest rate regime, the foreign exchange rate and the overall fiscal policy. It is highly recommended that the half-yearly monetary policy may be placed before the coordination council for final check.

The writer is a former governor of Bangladesh Bank.