

July-Dec MPS and inflation gini

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For all its faults, few can question the latest Monetary Policy Statement (MPS) of the Bangladesh Bank (BB) for lack of consultations. BB must be credited with establishing at least two fine traditions worth upholding. First, these bi-annual MPS have been announced on time with unfailing regularity since its inception some three years ago. It clearly adds to the atmosphere of policy certainty, a plus for businesses and investors. Let's face it, the MPS has become, perhaps as a complement to the budget, one more statement of economic policy that should be taken note of. Second, BB spared no pains to get expert and stakeholder consultations during the formulation of the MPS. The consequence of this openness is evident in the text of the MPS – elegant, coherent, and professional. Anyone attending these consultations must have been impressed with the quality and professional level of the discourse. The process did not end there. BB has followed up the announcement with more open discussions to get review and feedback. The result will be better and more effective monetary policy in the future.

This time the Bangladesh Bank has presented us with a well-crafted programme of monetary management that seeks to balance the economy's competing demands of growth and price stability. Of late, both of these macroeconomic indicators suffered; one from external factors of a global slowdown; another, from a rate of monetary expansion that ran ahead of output of goods and services. The key thrust of this MPS is clearly on inflation. The objective is to cap it at 6.5% for the forthcoming fiscal year, a goal actually set by the fiscal year (FY) 2011 Budget. In light of the creeping point-to-point inflation, BB's target is to moderate the rising trend rather than put the inflation gini in the bottle. But growth, claims the MPS, will be facilitated with supportive monetary and financial policies that will create and diversify access to financing for diverse output activities. How does BB plan to achieve the twin objectives of growth and inflation control with the ammunition it has

under its control – money supply. BB would have to accomplish a remarkable balancing act to reach its goal this time.

The dilemma? How to fuel growth while tightening money supply to curb inflation? To be sure, inflation, already at 6.5%, has been creeping up

lately and, if left unattended, could reach unacceptable levels. Economic growth has also suffered, what with the global economic slowdown which took the wind out of our export sails. To push it up to 6.7% from the

5.5% rate attained in FY2010 will be no mean feat under the present energy constraints.

But here is how BB plans its monetary management for the coming year to fuel growth with price stability. Primarily, BB plans to slow down the growth of Broad Money – a key indicator of the economy's money supply – from the estimated rate of 18.8% in June FY10 to 15.2% for FY11. Note that the average growth rate of M2 for the past three years has been 18.5%, a rate that could be described as more than accommodating in view of the growth of nominal GDP (real GDP growth plus inflation) of no more than 12% during the period. That is a clear prescription for fueling inflation, which eventually catches up. In view of the low global inflation, the current inflationary trend in Bangladesh can only be attributed to the history of money supply growth which went ahead of output of goods and services. Realizing this obvious arithmetic, BB has finally decided to put the brakes on money supply growth.

Question is what component of Broad Money is BB targeting to get this job done and will it succeed? Cutting M2 growth by 3.6% in one go seems a bit of a stretch given recent history. First, the assumption of a modest growth of 4.2% in net foreign assets might not hold with a significant pick up in exports (and imports) with current account surplus projected at no less than 2.5% in FY11. If BB's plans materialize, the major brunt will be borne by the private sector whose credit growth is expected to be restrained at 16% from 21% in FY10. If the potential driver of high growth is restrained, will it not make it harder for the economy to clock 6.7% GDP growth? How reasonable is it to put a damper on the impetus for private expenditure now is a fair question to ask. Again, hoping that the public sector will pick up the slack with a whopping 25% growth seems rather optimistic. Projections by Policy Research Institute present a more likely scenario in light of balance of payments trends and the robust pick up in exports and private sector activity while remittance flows are holding.

Finally, a closer look at the inflation targeting by BB surely raises certain questions on equity. One might argue that there was nothing sacrosanct about a 6.5% inflation target except that it was conceived as some comfort zone for the price level in FY11 Budget that sought 6.7% GDP growth. It is high by global standards though not so by developing country standard where a modest rate of inflation is thought to grease the wheels of the economy. But equity buffs contend that "it might bring some gain to the affluent, but will surely cause pain for the poor". Inflation's impact is known to be inequitable. Higher inflation makes things worse. In that light, a fair question is to ask why BB should simply validate the budgetary postulate of inflation rather than doing what most central banks are meant to do – that is, curb inflation. Certainly, in the Bangladesh context, a lower rate of inflation is better than a higher one. Given past history of money supply growth, I suppose BB could only manage a modest control of the inflation situation without hurting private sector's growing proclivity for investment.

The same inclination is evident from the MPS statement about a slight undervaluation bias in the exchange rate management, to help exports. That bias has kept Taka nominal exchange rate at par for nearly three years running (around Taka 69 per US Dollar), preventing its appreciation which would have translated into lower inflation but also lower returns on exports. To be fair, in this event, BB is placed between the rock and a hard place. To maintain the bias would help exporters but not the poor, in the short term. However, over the long run, if such undervaluation bias helps to keep and expand our export markets, more jobs will be beneficial to the poor.

In the policy space, more often than not, there are trade-offs to be weighed and the policy choice is not what is prescribed in textbooks as the first best option. Real life is about making do with the second best.

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