

A prudent policy for growth

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Through monetary policy the central bank of a country controls supply, availability and cost of money so as to achieve optimum economic growth while maintaining price stability. Monetary policy is relatively flexible: immediate changes can be made in response to shocks, as opposed to fiscal policy, which takes longer time to manage and implement.

Monetary policy can be expansionary: increasing the total supply of money, as opposed to being contractionary, which decreases cumulative money supply. Expansionary policy is adopted usually when confronted with unemployment during recession by lowering interest rates. Conversely, contractionary policy is espoused to stabilise inflationary pressure through elevated interest rates. Lately, we have been hearing about "accommodative monetary policy" – warranting a balance between growth and inflation. In such policy, we see relatively quick shifts from expansionary to contractionary measures and vice versa to fine-tune growth in an economy prone to inflationary pressures.

Advanced economies formulate monetary policies based on a wide range of factors, including short and long term interest rates, velocity of money, exchange rates, bonds and equities, government versus private sector spending/savings, international capital flows and financial derivatives. Developed nations often use advanced tools like quantitative easing, an asset-repurchase programme employed by the Bank of England to combat recession.

Conversely, emerging economies' monetary policies are often constrained by underdeveloped financial markets, low per capita income and significant poverty. The scenario is complicated additionally by existing political and economic pressure. The central banks of the emerging world have to design prudent regulations and maintain exchange rates within a specific range while managing domestic activity and inflation.

Monetary policies in Bangladesh adopt similar tools and techniques as in other emerging economies maintaining restrictions in external capital account. Monetary aggregates based policies and programmes retain relevance in economies with restricted capital accounts; policy tools influencing growth of money

stock, namely monetary programme targeting broad money growth path, adjustments in cash reserve and statutory liquidity requirement (CRR, SLR) are used as appropriate, besides adjustments in key policy interest rates (repo, reverse repo interest rates in Bangladesh).

Since inception, monetary policy in Bangladesh was conducted with full direct control on interest rates and exchange rates, as also on the volumes and directions of credit flows. However, as of today, directed lending has been abolished and gradual liberalisation of interest rate has taken place. Thus, interest rates have become market driven. Exchange rate has become floating, with Bangladesh Bank (BB) buying or selling currencies to keep liquidity at a desired level, though we at times hear about "managed float" or "moral-suasion." BB has reverted over to open-market operations mainly through government treasury bills (T bills) auctions. As a result, cash reserve ratio (CRR) and statutory liquidity ratio (SLR) have become more stabilised.

Bangladesh's Monetary Policy Statement (MPS) for July-December 2010, released by the central bank recently, is focusing on continuous watch towards locating and neutralising the likely inflationary pressures from the growth supportive monetary and credit policies, which to the extent feasible, will be targeted to selected priority productive sectors.

Deepening of financial inclusion of agriculture, small and medium enterprises, renewable energy and ecological footprint will continue to remain as priority sectors, while at the same time, the BB continues to discourage expansion in lending for wasteful consumption and unproductive speculative investment. The discussion of the core strategies adopted by the central bank in the MPS July-December 2010 is categorised into the following facets:

Inflation outlook: Despite easing in domestic annual point-to-point CPI (consumer price index) inflation trend from March 2010, the 12-month average domestic inflation crept to 6.51 percent in April 2010, exceeding marginally the ceiling targeted for FY2010. BB thinks the average inflation will continue to creep up for some months before starting to decline in line with the trend in point-to-point CPI inflation.

Growth outlook: Output growth performance in agriculture sector was robust in FY2010. The agriculture ministry estimates FY2010 farm sector growth at 4.39 percent against last year's 4.60 percent. Industrial sector is expected to grow at 6.42 percent against last year's 6.46 percent.

The government's provisional estimate for overall FY2010 GDP (gross domestic product) growth is 6.09 percent against last year's 5.88 percent. For FY2011, BB thinks that GDP growth rate would be around 6.70 percent subject to a few conditions.

External sector outlook: BB thinks that both export and import in FY2011 are projected to grow at double-digit rates with workers' remittance inflows settling down around lower double-digit growth level. This will narrow down current account surpluses, with corresponding moderation in foreign exchange reserve growth. The need for US dollar purchases (with attendant infusion of equivalent taka liquidity) to limit taka appreciation will decrease, easing inflationary pressure.

Capacity utilisation: Domestic investment gets discouraged due to the prevailing high cost of funds. The central bank has, therefore, prescribed lending rate ceilings in priority economic sectors to accelerate growth and employment. As treasury yields and deposit rates have declined, BB has taken mandatory as opposed to advisory steps to diminish interest rates and service charges. BB programmes have placed greater directional emphasis on credit needs of agriculture and SMEs, which are underserved by the market.

However, BB is also aware of the potential diversion of this targeted lending to non-priority sectors and the possible inflationary pressure and has prepared to adopt adequate measures to stop wasteful credit growth.

Exchange rate management: The central bank has kept taka at an undervalued stable level with continuous foreign exchange purchases from the domestic market to protect export competitiveness and to maintain incentive for remittances. In the existing recessionary environment this is possibly a prudent move, as export sustainability has become an imperative issue. However, as discussed earlier with the growth of import this requirement will decrease.

Monetary policy statements in developed countries are generally short and precise, primarily focusing on the state of the economy and the stance (e.g. expansionary, contractionary) the monetary authorities might be taking to sustain growth and to keep inflation at a reasonable level. It is more of a framework or direction – rather than detailed discussion of the policy measures. Monetary policy in an emerging economy like Bangladesh should more be able to draw a balance between inflationary pressure and investment growth, thereby creating jobs in a labour surplus economy.

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