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Monetary Policy and its Coordination with Fiscal and Trade Policies

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1. Introduction

1.1 Why is money so powerful

Money is a powerful element in the economic sphere. Primarily because, money is a medium of exchange and an appropriate amount can even buy 'the tiger's eye'. At the same time, a fixity or paucity of the money income in a declining phase of purchasing power through inflation, the poor and the lower middle class may suffer miseries. Professor Friedman in a 2004 symposium held in celebration of the 40th anniversary of the publication intitled A Monetary History described the essence of that seminal work as "money does matter."

1.2 Quantity Theory of Money Revisited

In the meantime, Milton Friedman continued his vigorous opposition to the Keynesian position blaming the private sector for the Great Depression of 1929. He thus revived the Equation of Exchange MV = PT in his book called A Quantity Theory of Money- a Restatement published in 1956. This slightly modified version of the original Equation of Exchange replaced Q, the real output with T the number of sales (transaction). When sold out, Q and summation of T are the same. The new formulation of the quantity theory as interpreted by Friedman states that the amount of base money supply M in the economy multiplied by the velocity (speed) at which it circulates equals prices multiplied by the number of sales (or transactions).

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A careful look would also make it clear that the right-hand side of the equation MV = PT represents the money cost of the real or supply side of the aggregate output which must be matched, in an equilibrium by the aggregate demand expressed in terms of base money, M multiplied by V the velocity of money circulation. One of the interpretations of the Keynesianism is that the velocity of money circulation is very unstable; when it slows down, a liquidity trap is created; when it doubles up, inflation is inevitable.

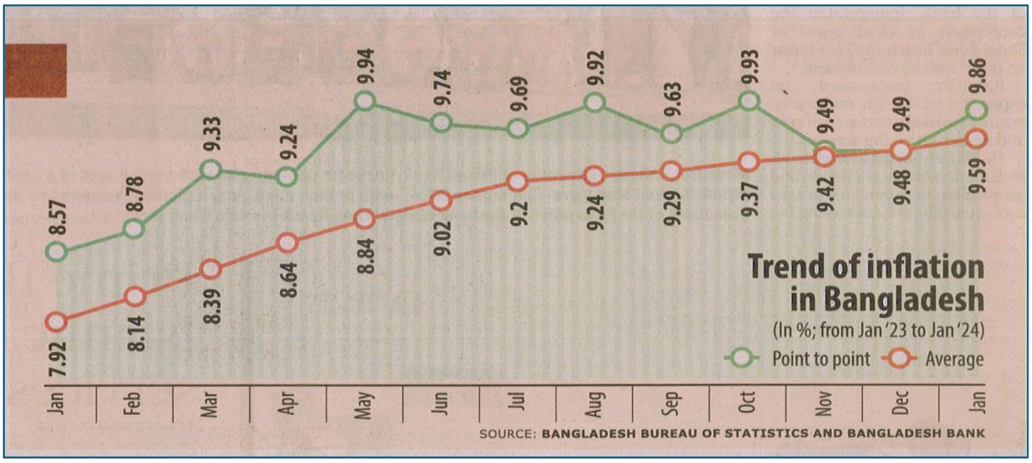
2. Importance of Monetary Policy in a Developing Country

2.1 In any country, developed or developing the central bank is tasked with the responsibility to protect the value of the local currency. Thus a low or no inflation, a stable exchange rate and a non-fluctuating interest rate together protect the value of the local currency and are viewed to be essential ingredients of a stable macroeconomic situation. In Bangladesh, inclusive growth over the years prior to the Covid Pandemic has been cited by the World Bank MD as inspiration to other developing countries. Even in 2020-21, the first year of the COVID, Bangladesh was amongst only a few counties that recorded a positive GDP growth rate of a 3.21%. However, a sudden 25%+ depreciation of Taka in 15 months starting middle of 2022 spiraled inflation rate nearing double digit over the last year; this has shaken the confidence of the efficacy of the monetary policy stance. Point to point inflation rate showed upward treat from 8.57 in January 2023 to 9.86 percent in January 2024. Naturally the annual average inflation rate during the same 12-month period also showed an upward trend from 7.92 percent in January 2023 to 9.59% in January 2024. But the annual budget 2023-24 still projected an average inflation rate of 6.5% ignoring the realities. Similarly, the insistence on a 6-9 policy meaning a 6% limit on deposit rate and not more than 9% lending rate has also been a policy that was neither copybook nor realistic. It discouraged savings because of a negative real interest rate and did not result in any obvious increase in private sector investment.

2.2 The 6-9 policy has harmed the bank deposit without bringing any positive to the new investment arena. Most economists and bankers agree that cheap credit may cause loans to flow to unworthy projects and ultimately add to the default loans. Some are of the view that when the lending rates are high, only responsible borrowers seek bank credits in the high productivity projects for them to be able to ensure high returns for repayment in time. Given that the bank borrowing may not be more than 50% of the total cost the higher cost in borrowing in a 3-5% higher lending rate may be not so significant if other costs like delayed approval, escalated cost due to appreciation of taka etc. could be reined in. Appreciation of taka without compensating fund assistance has become a major source of cost escalation of projects. Major problems created by the diversion of cheap bank credit and ultimate default through money laundering and conspicuous consumption. In a regime of repeated reschedulement at an abnormally low interest rate, a 2% down payment by defaulters seeking reschedulement compared to the 10% cash downpayment in advance by law abiding regular borrowers is a major flaw in the monetary policy.

3. Is the Monetary Policy Delivering in Bangladesh

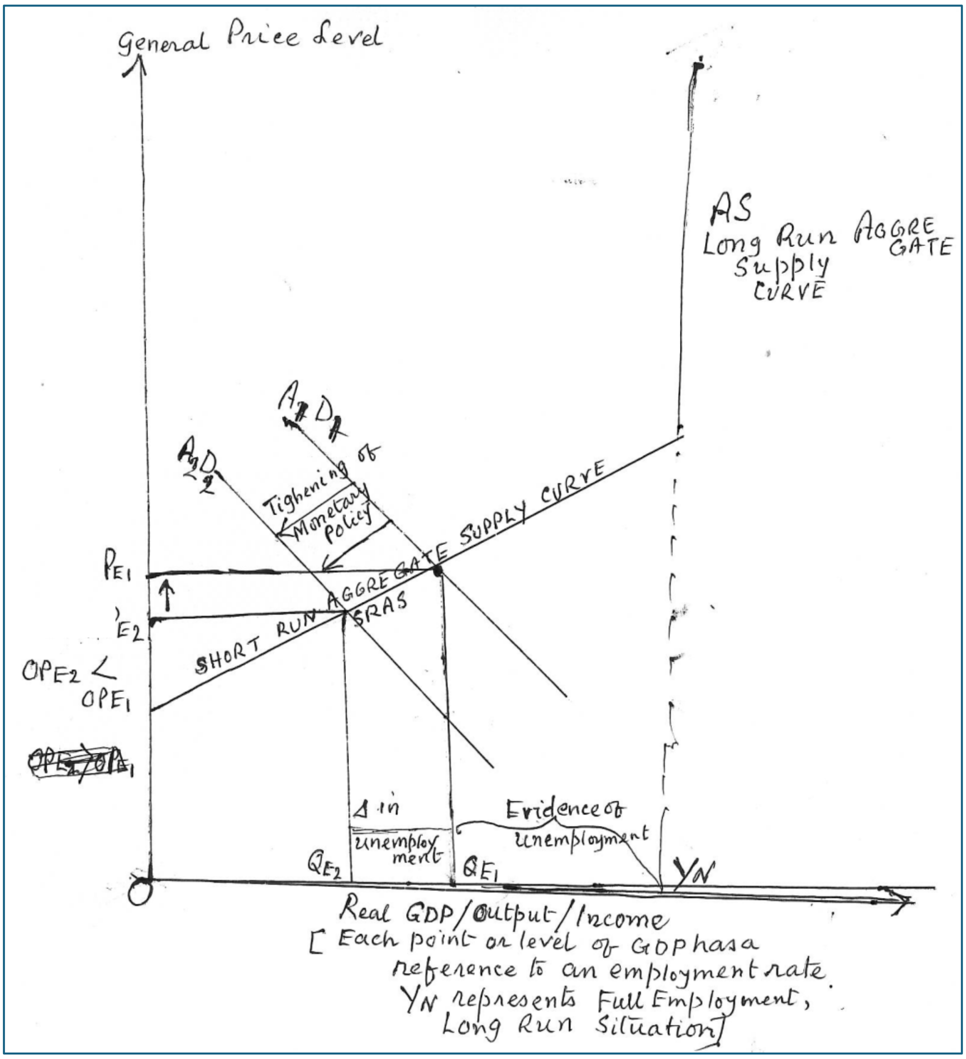
3.1 As observed in the diagram below, the inflation rate (point to point) reduced slightly to 9.49 in November and December 2023 but rose again to 9.86 in January 2024.



Source: *Inflation edges up despite monetary tightening. Why?* The Daily Star, 25 February, 2024

In January 2024 the central bank abandoned the 6-9 policy in favour of a tight monetary policy raising the policy rate by 25 basic points to 8%. Whether or not this rate hike has caused the desired effect of ultimately falling price levels will be known later. But the heat in the market has apparently even increased due to the advent of Shab-e-Barat and the Ramadan. Despite the rise in the interest rate on loans in the Six-Monthly Average Rate of Treasury (SMART) bills, the benchmark for the banks to fix lending rates. SMART advanced to 8.8% in January, a new high since its introduction in July 2023. Analysts do recognize only a mild impact on the price levels. The International Monetary Fund (IMF) has predicted that the global inflation would have fallen to 6.6% in 2023 compared to 8.8% in 2022; it may ease further to 4.3% in 2024. Bangladesh as a net importer should have benefited from this declining global price levels. Apparently, it has not so far.

3.2 The market observes in Bangladesh as well as BBS do not see any reason to expect a cooling down of the market in near future. Some economists and international observers also point out to ensuring reliable data from BBS for meaningful projections and objectively planning of future course of action. Given that the market in Bangladesh is under the influence of the syndicates, hoarders and other supply side hazards, the demand management through interest rate mechanism alone is unlikely to be effective. It also confirms the general perception that monetary policy alone is not capable of containing inflation. Moreover, in a situation of high underemployment as in Bangladesh which is at 38% or so (it would translate into a significant unemployment rate) perhaps applying the contractory monetary policy may exacerbate the unemployment situation as graphed below:



If the economy in the short run is in an equilibrium at QE, where the Short Run Aggregate Supply equals the Aggregate Demand Curve A.D, we see existence of unemployment underemployment equality Q_E-Y_N. A Contractionary monetary policy will reduce the general price level by PPE1 i.e from OPE1to OPE2 via a reduction in short run aggregate demand curve from A1D1 to A2D2. The Equation of Exchange or the simple Quantity Theory of Money will also yield the same result in price level reduction.

$$PQ = MV$$

$$P = \frac{MV}{Q}$$

reduction in aggregate money supply will cause

$$(M-\triangle M)V \Rightarrow (M-\triangle M)V < MV \Rightarrow \frac{(M-\Delta M)V}{Q} < \frac{MV}{Q}$$

i.e General Price level has decreased due to tight monetary policy.

if we accept the classical assumption Q & V are constant. However, if the Keynesian interpretation of the velocity of money circulation being unstable is applied, the conclusion of price reduction due to a lowering of the basic money supply may not necessarily hold. Keynes also asserted Q is not constant in the short run as there is unemployment in the economy.

3.3 The Coordination Council

The Coordination Council set up and activated a decade and half ago comprises of the following:

1. Hon'ble Minister of Finance: Chairman
2. Hon'ble Minister/ State Minister of Commerce: Vice Chairman
3. Governor, Bangladesh Bank: Member
4. Finance Secretary: Member
5. Chairman, National Board of Revenue: Member
6. Secretary, Economic Relations Division: Member
7. Member (GED) Planning Commission: Member

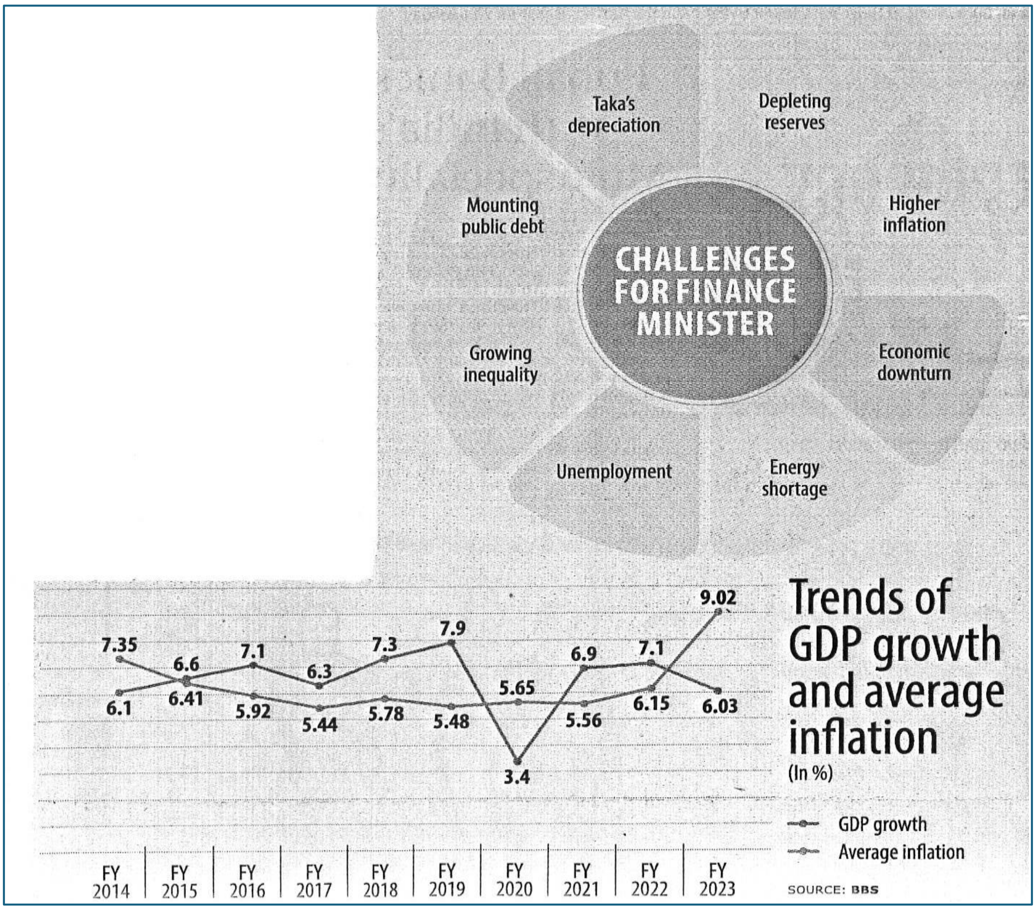
Bangladesh Bank provides the secretariat assistance to the council.

The composition of the council clearly indicates that GDP growth, revenue collection, external trade and monetary aggregates are all linked to each other in predicting the general price level. However, if the council would assert its authority under a general goodwill of the government, market would possibly see visible actions throughout the year and better outcomes thereof.

A Coordinating Monetary, Fiscal and Trade Policy

4.1 In the national Budget Document 2023-24 Towards Smart Bangladesh, Resource Mobilization and a rationalized aggregate expenditure, inter alia, were singled out for particular attention. Revenue: GDP ratio in Bangladesh is less than 10 percent. Out of the 7.8 million upper income persons, only 0.9 million pay taxes (CPD). Over the years, budget deficit kept on increasing as expenditure control remained only on papers. The two combined for bigger and bigger budget deficit as the political necessity to formulate larger budgets continued. Even on a rational basis the annual budget is still 15-18% of GDP and has to increase until it is 20%. Of the sources of resources for deficit financing: external borrowing, loaning from the banking system within and direct debt to the people, government has been preferring the bank borrowing option. Borrowing from the central bank is highly inflationary because $\triangle M$ has to be printed. $\underline{(M+\triangle M)V}$ is higher than MV. Happily, GOB appears to have stopped borrowing openly from the central bank as it heeded the advices and stopped forcing the central bank to print for that purpose. But borrowing from the scheduled banks elbows out the private sector whose investment level is at best stagnant. Thus, there is an impact on investment caused by fiscal budget deficit from the scheduled banks. The best option is to increase revenue collection by convincing the 6.9 million well to do citizens to pay taxes for the benefit of the country which is also directly or indirectly beneficial to them.

4.2 There are positive indications that policy initiatives, at least some of these have yielded results. Exports revenues are on the increase which may further kick up in the May-June reinvigoration of the global economy. RMG and knitwear exports are also going up albeit at a slower pace than we would like. However, the graph below rightfully reflects that the worries of the government that look over on 11 January 2024 are manifold.



Source: BBS

4.3 The taka for US Dollar swap between the central bank and the scheduled banks is apparently providing a breathing space. Two questions remain, however. Are the scheduled banks procuring the US Dollars from the middlemen who launder money by way of buying foreign currency from the remitters (because of the apparent `incentive') and bringing these back home through the unofficial channels. That may translate into a position to the Bangladesh Bank promoting money laundering. I do not wish to believe this is true but will need clarification about the source of the 'excess' foreign currency with the scheduled banks. The second question is about the sustainability of the mechanism when, of necessity, the authorities will have to put a brake on money laundering. There is also the issue about the source of the central bank's swap taka amounts. If the source is increasing money supply, $\triangle$M by printing notes, inflation may be fueled to hyper level as described in 4.1.

5. Recommendations

5.1 An action plan should be presented to the Coordination Council (perhaps with the inclusion of a non-government member as proposed by me) showing the causes, effects and remedies bearing in mind that (a) the GDP growth rate of 5.8% computed by the World Bank does not slip any further, (b) analyzing why interest rate mechanism which has worked in 08 of the 09 countries in taming inflation as shown in the table below has not worked in Bangladesh, (c) why more and more exports revenues are being held up (12% now) abroad over and beyond the Retention Quotas, (d) reasons for continuing with multiple exchange rates which has long been abandoned in the world is still in vogue in Bangladesh, (e) the reason for lack of progress is exports diversification and (f) how best can the monetary policy, fiscal and trade policies be coordinated.

Country	Inflation in Jan 2022	Inflation in Aug 2023	Interest Rate in Jan 2022	Interest Rate in Aug 2023
Canada	5.1%	4%	0.5%	5%
China	0.9%	0.1%	3.7%	3.45%
Euro area	5.1%	5.2%	0%	4.25%
Germany	4.9%	6.1%	0%	4.25%
India	6%	6.83%	4%	6.5%
Japan	0.5%	3.2%	-0.1%	-0.1%
UK	5.5%	6.7%	0.25%	5.25%
US	7.5%	3.7%	0.08%	5.38%
Bangladesh	5.86%	9.92%	5%	6.5%

Source: STATISTICA

5.2 We recommend adoption of an unified exchange rate computed on the basis of the Real Effective Exchange Rate (REER) factoring in to weighted average calculation of the exchange rate of the trade partners and the export competitors. During 1998-2001, REER was the basis for three devaluations often described by the Asian Development Bank as accurate. So there is no need to abandon 'Managed Float Yet.'

5.3 As these are prone to misuse by the middlemen in money laundering, the so-called “remittance incentives” should be merged with the united exchange rate which should be as close as possible to the Curb Market Rate (not more taka 3 difference). A cushion may be added to make the unified exchange rate attractive this may temporarily further fuel inflation though.

5.4 Using the Bangladesh Financial Intelligence Unit (BFIU) as the leader in an effectively combined Money Laundering Prevention Team comprising of the NBR, Ministry of Civil Aviation, Ministry of Home and the Intelligence Agencies, money laundering should be reduced significantly. There is perhaps a need for a through overhaul of the entire presence of officials and staff at the Shahjalal International Airport. Are not there too many Authorized Dealers in SIA and other airports. Newspapers very often publish sensational involvement of ‘insiders’ in the air ports in gold and drug smuggling and in money laundering.

5.5 National level efforts may be waged to convince the citizens who earn taxable income to pay their shares of the taxes. As per the findings of the Boston Consulting Group, 25 million people have per capita income of $5000 or above and therefore, subject to income taxation. Potential taxpayers very often ask embarrassing questions about the well-publicized corruption incidents of the heavyweights remaining unpunished. Thus a vigorous anti-corruption campaign is also a need of the hour.

5.6 Let the cost estimates of programmes and projects be carefully made during the pre-feasibility (it is a must for publicly funded project) and feasibility exercises. Any time overruns should actually be penalized as in most countries of the world. In Bangladesh, very often time and cost overrans go together; this cannot be acceptable.

5.7 Seriously examining a negotiated slow-down and reschedulement of some infrastructure project loans may be necessary in view of the interest rate payments on foreign loans doubling in the last six months. The situation is still under control and reference to Srilanka episode is uncalled for.

5.8 Consider a Compensation Mechanism for the project borrowers experiencing cost escalation for the budget component of the project in foreign exchange at the time of a taka depreciation.

5.9 We do not think it will be safe to go to a Free Float Exchange Rate until and unless there is a usable foreign exchange reserve (IMF definition) of five months. There can be a review of the matter when reserves rise to a level of $35 billion.

5.10 On the most immediately urgent problem of persistent high inflation, it is advisable to slow down on mere threats to the abnormal profit / economic rent seeking traders and to take some concrete actions described as under:

a) In 1972 creating TCB with 2000 or so employees, Bangabandhu Government built up a public sector buffer stock of essentials and issued these at very very low price through the newly set up Consumers Supplies Corporation (COSCOR), Statutory Rationing and Modified Rationing until the high inflation (global price levels were extremely high) started moderating. In 1998 after the long-standing devastating flood, Prime Minister Sheikh Hasina's statesman like guidelines were implemented by the Finance Minister SAMS Kibria assisted by the Agriculture Minister, Agriculture Secretary and the Governor Bangladesh Bank in feeding 15 million flood affected food starved through VGD+VGF programmes for 09 (nine) months from a 10 lakh ton foodgrains buffer stock that had been built up for the purpose. During 1998-2001, inflation averaged 2.8% and in 2000-01, it actually came down to 1.7%. GOB may build up a big buffer stock of rice + wheat, edible oil, sugar and onion and multiply the ongoing open market operations at least ten times for 3 / 4 months. This rather than rhetorics will force the hoarders to sell their illegal stock for the scare of price crash. The hoarders have to be dealt with under their nasty mechanism.

b) Number of licensees of these and other essential commodities may be enlarged at least 10 times so that no cartel is formed. This will also prevent the benefit of import duty reduction flowing to the hoarders themselves.

c) Formation of Grower cum Marketing cooperatives in Gram Bangla with access to easy concessional credit at 3% or so interest rate and to the GOB godowns (capacity may be increased to 3 million tons from the present 2.2 million tons). This will enable the growers to buy their own surplus during the harvesting seasons, storing these in GOB Godowns and selling the stocks throughout the year at stable and reasonable prices for the growers and the consumers to benefit simultaneously. In the medium term of two years, this cooperative system vigorously advocated by the Father of the Nation can be a permanent frillwork against the middlemen hoarders.

d) Much has been written and stated on the grave situation for the deterioration default loan and interest accumulation waivers. The government remains unconvinced. Net result amongst other things, is a liquidity crunch in the scheduled banks as the natural process of revolving credits is hindered by portions shunted out by repeated defaulters and interest waivers (often arbitrary and very little record or recovery). It is time that the government think about the grave consequences and act upon to firmly put an end to the default culture as was successfully done in the second half of the 1990s.

e) Long term credit giving unposed in the early 1990s on the scheduled banks (due to unwise advise of a multilateral development partner) should be eased out over time. Interest waivers are fraught with moral hazard and should better be discontinued.

f) A financial reforms commission may be set with appropriately high power to analyze the issues in the banking insurance revenue and expenditure sectors and the interrelationships therein. The recommendations to be received in a year or so should be considered seriously as long-term remedies ailing the vital sector.

g) Like in other South Asian countries a price commission must be set up to (i) collect contemporary global price range of all goods and services procured under public funds and (ii) enforce bids and auctions to be within these ranges.

h) It is high time, Bangladesh restores its financial year to January-December. There is absolutely no reason in support of the July-June year facilitating pilferage of 'REPAIRS' done in a hurry in April-June rains and river erosion.

i) In consultation with Wulama-e kerama, a 32 hour work week Monday-Friday (half day 8:00am-12.30pm) in conformity with international practice.

6. Bangladesh Bank Reforms

a. This is time to consider a gubernatorial appointment from within.

b. In the last one and a half decade, the size of the economy the bank deposits and bank advances has doubled without a numerical increase in the bank. Thus there is a need to increase the number of ADs and DDs and escalate their capacity.

c. Since the general manager have been renamed as Director, it may sound more reasonable to designate the Bangladesh Bank Board Directors as BB MEMBERS.

d. When would the government deem it fit to categorize the government position as a Statutory one. Until that time, should we not have a one term six years tenure or the Governor. Do we expect the government to once again allow a separate pay scale for Bangladesh Bank employees whose work is uniquely different than others. This will take only a small fraction of the annual project of the central bank.

e. Remembering that the foreign exchange reserves are the property of the people of Bangladesh, GOB and BB are only custodians/ manager, utmost care will have been taken in allowing project funding under the reserves resources if at all.