Strategies for Bangladesh Bank - I

Strengthening monetary framework

Sharjil M Haque in the first of a two-part article on 'Strategies for Bangladesh Bank'

With political turmoil strangling Bangladesh, economic activity is once again going downhill. The government is already speculating that the budget deficit may rise to around 7.0 per cent of GDP (gross domestic product) this fiscal year - well beyond the generally acceptable limit of 5.0 per cent. Revenue mobilisation and poverty-reducing expenditure remain woefully low and we have already seen a cut in the Annual Development Programme (ADP) allocation. The quality of fiscal spending has often been questioned on justified grounds.

In such a scenario, the role of the Bangladesh Bank (BB) is vital as the country struggles to achieve long-run goals like graduation from the LDC status and becoming a middle-income nation. Over the years, the BB has generally been praised for ensuring price and exchange rate stability as well as for commendable initiatives in financial sector supervision and inclusive growth.

But gaps still remain in further optimising central banking practices and bringing monetary management in line with global standards.

This paper presents key strategies and policy considerations for the central bank from macro, monetary, macro-financial and banking sector perspectives.

BALANCING RULES WITH DISCRETION: The monetary policy in Bangladesh is fully discretionary. The BB targets broad money based on economic conditions but without a structured framework which links policy rates to inflation, output or exchange rates. A quick review of the literature will show the reader that there is overwhelming empirical evidence that rules-based monetary policy is far more effective in meeting inflation objectives than one governed solely by discretion.

Additional arguments for utilising a rule-guided framework include promotion of transparency and accountability and avoiding pressures from special interest groups who may want to influence price levels.

Most developing countries do not utilise rule-based approach to monetary policy since the central banks have multiple objectives. For Bangladesh, another reason is lack of data to compute potential output - a hypothetical construct which states how much output would be if the economy were producing at full capacity. Yet international development organisations like the International Monetary Fund (IMF) argue that a modified version of the widely-cited Taylor rule can be used by developing countries to bring much-needed discipline to monetary policy.

To incorporate this concept, the BB needs a framework where policy rate is a function of real interest rate, the gap between current inflation and inflation target, output gap and exchange rate. Such a formulation would encompass the central bank's monetary policy objectives. By assigning weights to each of these parameters, (inflation logically getting the highest priority), the BB can use macroeconomic developments in a structured framework to guide decisions on setting policy rates. To deal with the challenge of output gap computations, collaborating with the IMF or leading think-tanks in Bangladesh can help build a generally acceptable methodology.

It should be noted that policy-makers should only use rules as guides. Discretion will still take precedence, but the idea is to balance it with a structured framework linking all of our macro objectives.

MANAGING EXPECTATIONS: The BB needs to communicate its objectives more frequently to the public to properly manage expectations. Since the BB's monetary policy briefings are spaced six months apart, it has generally under-utilised the communication channel which advanced economies have tapped quite successfully. Also, given that Bangladesh is frequently subjected to political turmoil which induces speculation on future price levels, this strategy can help moderate inflation expectation.
A suggested strategy may involve holding quarterly press conferences where policy intentions and methods to achieve the targets are expressed clearly to the public. Only then will the central bank be viewed as credible and be able to better manage expectations.

GLOBAL MACRO VARIABLES: Monetary policy in Bangladesh is based on a commendable framework which considers the interplay between economic growth, exchange rate, inflation, interest rate and money growth. But Bangladesh is not a closed-economy. International trade constitutes more than half of the GDP. It may be prudent to incorporate global macro variables into the framework for more informed decisions. For instance, India and China are two of the country’s largest importing partners. Sudden changes in local demand-supply conditions or monetary policy stance in these countries might affect Bangladesh’s imports from these destinations. Therefore, identifying possible causality between global macro variables and Bangladesh’s inflation becomes imperative. We present an example with commodity prices; the oil price crash improved terms of trade (and by extension the current account) while the opposite took place when cotton prices escalated off the roof in 2011.

Both figures 1 and 2 show that for much of the last four and a half years, inflation in Bangladesh moved in tandem with cotton and oil prices - at least to a certain degree. Going beyond graphic analysis, a simple correlation test will show the reader that cotton price and inflation had a correlation of 0.51 from July 2010 to December 2014. The figure stood at 0.38 for oil price and inflation. To finalise the argument that there is a possible causality, the scatter plot with a logarithmic trend line (Figure 3) shows significant positive relationship between cotton prices and inflation in Bangladesh. These numbers are definitely not small enough to be taken lightly and need further analysis to identify the impact on inflation in Bangladesh.

Commodity prices are just an example. How should monetary policy be adjusted if similar global macro variables like monetary policy in Europe, China, India and the USA or values of reserve currencies change drastically? With further capital account liberalisation also on the cards, it, therefore, follows logically that the BB’s monetary policy should place greater emphasis on external economic activities.

The central bank can consider creating a weighted average measure, composed of relevant external variables. Weighting can be assigned based on a factor’s significance to Bangladesh’s current account and macroeconomic developments. Incorporating such a variable in the existing decision-making process ensures that monetary policy formulation in Bangladesh will adjust to possible external volatility.

NO GUARANTEE: The central bank has been quite successful for the last couple of years in pegging the exchange rate to around BDT 78 per USD by proper management of foreign currency supply in the market. Over the years, there has also been ongoing debate on whether to allow small depreciations of the exchange rate to improve trade balance. With Bangladesh back to a widening current account deficit, the idea of a currency devaluation could be explored again by the central bank. However, there is one major question regarding this strategy. Will the increase in export receipts be greater than the increase in cost of imports?

The Figure 4 shows that trade deficit has not improved during either of the two major devaluation episodes of Bangladesh’s exchange rate - 2005 and 2011. Rather, the deficit worsened, especially during 2011. A look at real effective exchange rates (Source: Bangladesh Bank) shows large depreciation in 2011, which coincided with worsening trade balance from 2010 to 2011. These figures indicate that depreciation does not improve trade balance in Bangladesh. This tension between higher exports and an offsetting rise in imports needs to be resolved through careful analysis of the Marshall-Lerner (M-L) condition.

Finally, given that the M-L analysis depends on long-run elasticity of exports and imports, the central bank will need to carefully monitor composition of major commodities in imports on a regular basis (exports of course are dominated by RMG for the time being. So the composition is somewhat constant). The rationale behind this is that if product composition in imports changes, driven perhaps by changes in real income, import income elasticity will change as well. It means, even if the M-L condition holds today, there is no guarantee that it will hold a few years down the road. So the analysis will need to be repeated before any major devaluation policies are implemented.

COORDINATION OR DEPENDENCE ON FISCAL POLICY: The final point in this section addresses the issue of central bank independence. Again, before going to the economy of Bangladesh, one must point out that there is a plethora of empirical evidence that proves, without doubt, that an independent central bank is more successful in curbing inflation than one which is at least partially influenced by fiscal authority.

The latest monetary policy statement in Bangladesh mentioned that there will be continued fiscal-monetary coordination among senior policy-makers to ensure that macro-adversities such as ‘crowding out’ does not take place. But what are the implications of the statement which states that the government of Bangladesh announced an inflation target of 5.0 per cent by 2017? Furthermore, the national budget states ‘an investment-friendly monetary policy will be maintained ensuring uninterrupted credit flows to the productive sectors’ (Source: Budget Speech 2014-15, the Ministry of Finance, Bangladesh). The speech, as all readers are aware, goes on to say that the Ministry of Finance has been quite successful in containing inflation; but this is the core objective of the central bank!

Do these statements suggest that the central bank is independent from the government? The BB governor and other senior officials at the central bank need to devise a strategy to significantly reduce the influence of the government in its macro-economic policy decisions. Otherwise, reducing inflation to 5.0 per cent may take much longer than the envisaged 2017 target.

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