Monetary policy's prime target: growth or inflation?

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WHILE monetary policy is regarded as the most important economic guideline in developed countries, it is treated as a complementary promise to fiscal policy in most developing countries. In Bangladesh, the scenario is even worse. Here the finance minister, as a fiscal-policy leader, dictates explicitly what Bangladesh's monetary policy should be -- exhibiting the total absence of monetary-policy independence.

Bangladesh Bank, as the central bank of the country, announced its monetary policy in July this year as it does every year. Interestingly, the central bank's restrained stance on monetary policy this July was no surprise, because the finance minister had clearly signalled the stance of the upcoming monetary-policy in his budget speech that was made public in June. The finance minister explicitly declared that the upcoming monetary policy will be 'restrained,' making the monetary-policy statement simply a 'compliance report' by the central bank. While the influence of the government on the central bank is well known, particularly in developing countries, this type of predetermination lacks respect to the monetary authority, and is never seen in neighbouring countries such as India and Pakistan.

Given the coverage of its operation, the central bank is the most powerful economic institution even in a developing country like Bangladesh. For example, the amount of banking-sector loans is almost 52 percent of total national output, whereas the fiscal budget covers only 18 percent of national income. Of course, that 18 percent is very crucial to mobilising outstanding loans of 62 billion dollars, but it must not be ignored that the central bank plays a gigantic role in growth by involving the largest segment of national workforce of the economy. As the monetary-policy statement of 2012-2013 asserts, the two main objectives of the central bank include controlling inflation and fostering economic growth. This dual mandate of Bangladesh Bank becomes hard to

accomplish when the finance ministry targets high growth but low inflation. High growth is often inflationary and high inflation is always detrimental to growth. In the last fiscal year, Bangladesh had achieved economic growth of 6.4 percent, while inflation was slightly above 10 percent. For the fiscal 2012-2013, the government aims at achieving growth of 7.2 percent but targets inflation at 7.5 percent, making the task of the central bank tougher than before. Since moderate inflation is the prime goal of any monetary policy, Bangladesh Bank is left with no option but to adopt a restrained monetary policy that limits broad-money growth to 16 percent and reserves money growth to 14.5 percent for fiscal 2013.

The government's excessive influence on the central bank is a sign of authoritarian economic management that contradicts public policy on deregulation and the market economy. We have a bad tradition of seeing the central bank as an accommodating institution to fiscal desperation that usually originates from short-term political priorities. That is why money supply grows so fast in Bangladesh and hence inflation hovers over the double-digits. This tradition must be changed. The central bank must be empowered with greater monetary policy independence to bridle inflation and ensure macro-stability to eventually stimulate growth.

If money-velocity growth is assumed to be constant and economic growth turns out to be 7 percent, money growth of 16 percent will bring inflation down to around 9 percent, which is still above the targeted inflation of 7.5 percent. Hence, money supply must be more conservative than it is now, but that stance may reduce the growth of private credit, which again will lower economic growth. Thus, Bangladesh Bank is forced to operate in a difficult zone when inflation is already of double digits.

The scenario becomes even worse when the government spells out a long-term inflation rate of 5 percent in the budget speech of 2012-2013. We are not sure where this magic number of 5 percent comes from, but we are sure that the government wants moderately low inflation for the long run to make economic growth sustainable. If that is the case, Bangladesh Bank must continue its conservative stance on money growth until inflation drops down to 5 percent. Neither reserve-money growth of 14.5 percent nor broad-money growth of 16 percent looks conducive to long-term inflation of 5 percent. Money growth should fall below 15 percent in a gradual fashion, and that might temporarily lower output growth.

We have to accept this tradeoff to make Bangladesh Bank function as per long run goals of macro-stability and sustainable growth. Then monetary policy surely requires independence. Various studies show that a higher degree of monetary-policy independence is associated with a lower inflation across the globe. The government's expectations on Bangladesh Bank are too high to accomplish. It wants that the central bank will kill two birds with one stone every time. If low inflation is a priority, as it should be the case for the sake of sustainable growth, the government has to compromise on ambitious growth targets at least in the short run.

Inflation tormented the global economy over the 1970s. Paul Volcker, the Federal Reserve chair, realised that controlling inflation must be the first priority for a central banker. He tightened money supply to an extreme point even knowing that it will lower output growth. America experienced its first manmade recession in history in the early 1980s, but the scenario eventually took a positive turn. Not only did inflation come under control, but the US economy also entered the long boom for 17 years until the end of the 1990s.

Volcker was able to accomplish his goals in a sequential fashion because he could work independently. He shot one bird at a time without any concession to inflation. Time has come for our central bank to act first on inflation in the similar fashion. Are we ready to make our governor accountable directly to people and parliament, rather than compliant to the fiscal desperation? The central bank, the main anchor of the economy, must work independently to ensure macro-stability and respectable growth in an emerging economy.

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Switzerland most competitive economy: WEF

REUTERS, *Geneva*

SWITZERLAND ranked as the world's most competitive economy for the fourth year running, while the United States continued a four-year slide down the table, the World Economic Forum (WEF) said in its annual survey on Wednesday.

The study by the WEF, best known for running the annual meeting of world business leaders at the ski resort of Davos, ranks 144 countries by examining 113 indicators culled from official data sources and a poll of 15,000 executives who opine on the country where they do business.

Switzerland pipped Singapore to the top spot thanks to strong scores in areas such as innovation, labour market efficiency and effective public institutions.

The United States fell from fifth spot to seventh because of political and economic problems that detracted from its status as a global powerhouse of innovation, the study said.

"We see this development as a result of the growing macroeconomic imbalances in the country but also due to the political deadlock that has been augmenting the problem of macroeconomic imbalances," said Margareta Drzeniek, a senior economist at the Geneva-based organisation.

"There does seem to be an inability to take decisions on the political side."

Rather than a big shake-up in the rankings, the 2012 survey found deepening divides, she said.

"One of the reasons those persistent divides are not being closed -- and the prime example here is Europe, or the United States as well -- is because of the political deadlock that we've observed, that has prevented those countries from taking a longer term approach to improving competitiveness with a view to stabilising growth in the future."

"This political deadlock is jeopardising the future prosperity of those countries because it may lead to a reduction of productivity and a loss of competitiveness and reduced growth in the future."

The lowest ranked EU country was Greece, at 96th. But it was rock bottom - 144th out of 144 - for its macroeconomic environment.

Qatar moved up three places to 11th but may need to reduce its vulnerability to commodity price fluctuations if it is going to break into a top 10 dominated by northern European countries, the report said.

Four of the five BRICS nations fell in the rankings, with only Brazil climbing, up five places from last year to 48th.

China still led the group. Its 29th place ranking was down from 26th in 2011 but still 30 places ahead of India, which has lost 10 places since peaking at 49 in 2009.

THE US ELECTION

Living in the economic past

CHRYSTIA FREELAND

THIS US election campaign is being billed as a battle of big ideas. That is a good thing. But it is a shame that the fight is not being waged in the 21st century.

In choosing Representative Paul D Ryan as his running mate, Mitt Romney swapped his Massachusetts pragmatism for a proudly ideological commitment to limited government. The Democrats, by contrast, believe in the essential role government plays, and are willing to raise taxes, at least on the rich, to pay for it.

This a clear and important battle line in the United States. But the argument over the size of the state comes with little regard for the very particular economic realities of this era. Like generals fighting the last war, US politicians are solving the economic challenges of the past century.

That is a problem because we are living at a time of deep and fast economic change. The intuitive sense that the economy is becoming less predictable and less secure is right. Thanks to globalisation and the technology revolution, the nature of work, the distribution of the rewards from that work and maybe even the economic cycle itself are being transformed.

But one would not know it from the US political debate, whose familiar melodies of small state versus large state, higher taxes versus lower taxes and the importance, or not, of reducing the budget could have been played in any decade since World War Two.

Most people in the United States are comfortable with these old songs -- everyone knows the words -- but they are an inadequate response to the new economic demands of the 21st century.

The economic reality is that, thanks to smart machines and global trade, the well-paying, middle-class jobs that were the backbone of Western democracies are vanishing. Neither Mitt Romney's smaller state nor Barack Obama's larger one will bring them back. That is because the paradoxical driver of this middle-class squeeze is not some villainous force -- it is, rather, the success of the world's best companies, many of them American.

The record profit at Caterpillar, for example, is a tribute to the company's skill at operating in a global marketplace and adopting cutting-edge technologies. But, for some Caterpillar workers, that good news recently translated into a six-year wage freeze, which union employees accepted after a strike in Joliet, Illinois, failed to secure a better deal.

This is the knottiest economic problem of our time: figuring out how to manage an economy whose engines of growth are enriching the few but squeezing the many.

Instinctively, Americans understand this is happening. That is why the Democratic ticket, despite the complaints of some of its wealthy backers, has stuck with its critique of Romney's former company, Bain Capital, as an outsourcer of jobs. The point that middle-class workers sometimes suffer from the same decisions that increase shareholder value is one that many Americans know from their own life experiences.

But what neither party likes to talk about much is that this socially malignant outcome is being driven at least in part by the forces of free-market capitalism that most people welcome. The attacks on outsourcing do not convince everyone, because they know that Obama has no intention of outlawing it -- and that if he did, the economic impact would be devastating.

The tempting answer, which I heard most recently in an interview with Glenn Hubbard, an economic adviser to Romney, is to optimistically assume that, just as the early traumas of the Industrial Revolution gave way to widespread prosperity in much of the world, the economic transformations of today will eventually work out.

"If you were to go back to 1940 and have this debate, we might worry, well, what if people are going to lose their farm jobs?" Hubbard said. "Then the debate was over manufacturing, then over service. And if an economist is honest with you, the best he or she can say is, what we need to do is allow those opportunities to happen, and they will."

There are a few problems with this happy prediction. The first is that, while the Industrial Revolution did, indeed, eventually make ordinary people richer than at any other time in human history, it took two world wars and Communist revolutions in Russia and China for the world to iron out the kinks. The second is that, to make industrialization work, the West created an elaborate set of new political, social and economic institutions, including universal public education, trade unions, and the social safety net.

It took more than the spinning jenny or the steam engine to transform local, agrarian, family-based communities into national, urban, individualistic ones. New political and social institutions will be needed to midwife the latest shift into global and virtual communities. Inventing those institutions is hard, and talking about them can be frightening, but that is the political conversation the Western world should be having today.

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