

Monetary policy is working

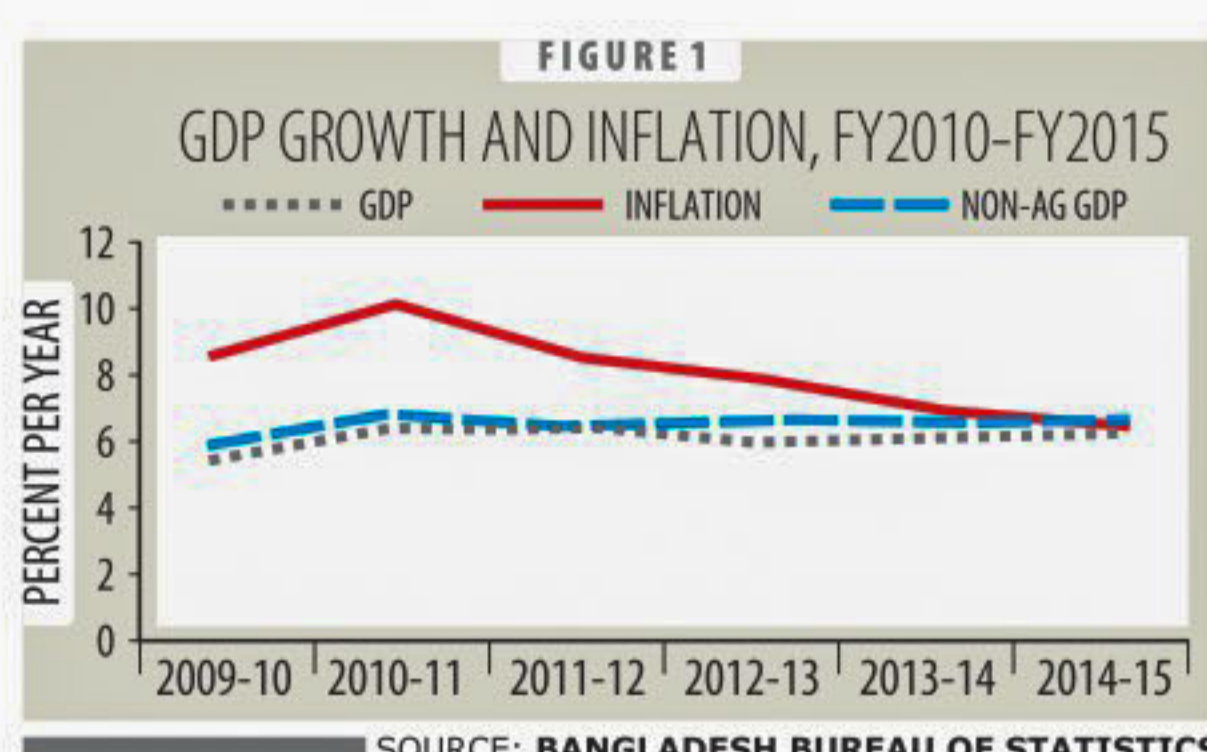
SADIQ AHMED

THE government deserves a solid round of applause for successfully implementing a sound monetary policy for three years in a row. Following a period of wayward monetary policy management from 2009-2011 that fuelled inflation, pushed unsustainable spikes in land and stock prices and exerted pressure on the exchange rate, the Bangladesh Bank took corrective actions in 2012 that restored monetary discipline. This prudent monetary policy stance has been preserved since then. The results have been very positive and supportive of the overall development goals of Bangladesh. Inflation has come down, the exchange rate has stabilised and asset price correction has happened.

While this achievement should be celebrated, there is no room for complacency. The BB is in the process of formulating its next six-monthly monetary policy. During the consultation process several dissenting voices were aired arguing that the fight against inflation is over and the time is ripe for easing the monetary policy stance in order to push the GDP growth rate. This is a familiar argument aired every year with little or no supportive evidence provided for this prescription.

Since a wrong monetary policy stance can be very disruptive and costly to the economy, as witnessed during 2009-2011, it is imperative that the government must not be pushed into this type of populist prescription unless it is backed by concrete and convincing evidence.

Let me examine the merit of the argument in support of the so-called "easy monetary policy". By this I presume the proponents are asking for increasing the rate of growth of money supply. The idea is to reduce the interest rate by increasing the supply of money, which then creates an incentive for investors to invest



more and that in turn will support a higher rate of GDP growth. This prescription is founded on the following empirical assumptions. First, a correction of monetary policy stance since 2012 has adversely affected growth. As such there is a trade-off between growth and inflation. Second, monetary correction has increased the interest rate. Third, the rate of investment is constrained by the interest cost of credit. So, a lowering of interest rate will boost the rate of investment.

All these assumptions are empirically testable. While I have not undertaken rigorous econometric testing of these hypotheses (and neither have the proponents), I can provide some commonsense arguments why these assumptions are unfounded based on the recent Bangladesh experience.

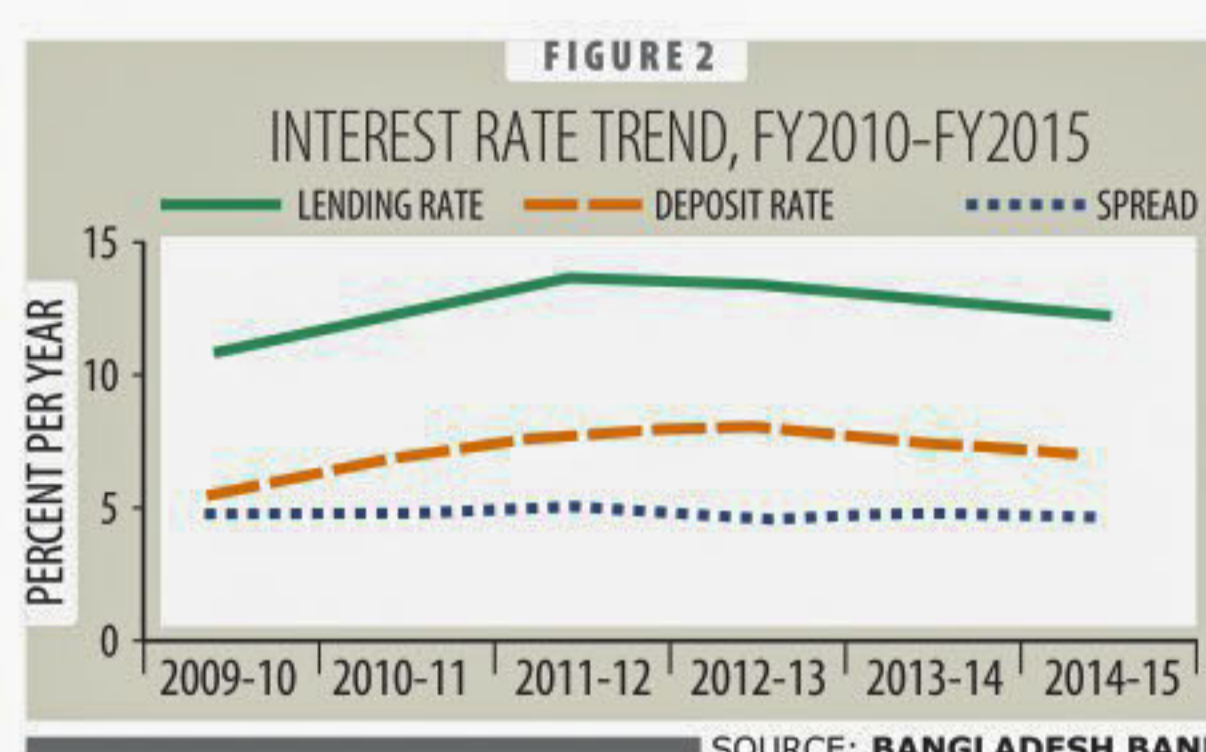
Let me first examine the growth-inflation trade-off argument. Figure 1 shows the trend in inflation and GDP growth from FY2010 to FY2015. This captures the most recent experience in Bangladesh and nicely contrasts the two monetary policy stances pursued in Bangladesh: the expansionary phase -- FY2010-FY2011; and the prudent phase -- FY2012-FY2015. The average growth of money supply (M2) was 22 percent per year in the first phase and 16 percent per year in the second phase. The trend in inflation (solid line) shows a substantial upward spike between FY2010 and FY2011,

responding to excess monetary growth, and since then a continued decline in response to the correction in the growth of money supply.

The trend of GDP growth is represented by the dotted line, which shows an increase in GDP growth in FY2011 (from 5.6 to 6.5 percent) and then a flattening out at around 6.0-6.5 percent. The dashed line shows the trend in the growth of non-agricultural GDP. Since agricultural GDP growth has very little to do with monetary policy, the trend in non-agricultural GDP captures better the impact of monetary policy. It shows a similar pattern, but interestingly there is a gentle upward trend between FY2013 and FY2015.

The main conclusion is that Bangladesh has been experiencing a healthy rate of GDP growth in the range of 6.0-6.5 percent of GDP during the Sixth Plan period and at the same time it has successfully achieved a significant decline in the rate of inflation. For this period, there is no evidence of a trade-off between inflation and GDP growth.

Regarding the relationship between monetary policy correction and interest rate, the results are shown in Figure 2. Despite sharp increases in the rate of growth of money, the average nominal lending and deposit rates were on an increasing trend during FY2010 and FY2012. Nominal average lending and deposit rates have been coming down since FY2013 even though



monetary growth is sharply lower than in the expansionary phase. So, there is no evidence that nominal interest rates have gone up due to monetary correction; on the contrary interest rates have come down.

Economists will recognise that the reasons why nominal interest rates are coming down is first because inflation rates are coming down; what matters for saving and investment rates is real interest rate (adjusted for inflation) and not the nominal interest rate. The second reason is that the demand for credit is sluggish owing to political uncertainties and other constraints to investment -- factors that have very little to do with monetary policy stance.

This brings me to the third contention that the private investment rate is sluggish because of high interest rates. We saw above that domestic interest rates are coming down in nominal terms. So the argument must be cast in terms of real lending rates. While inflation rate has decelerated substantially, the nominal lending rates have not fallen commensurately. Consequently, there is an upward pressure on the real lending rates.

However, the idea that monetary policy easing will lower real interest rate is not convincing. Lowering real interest rates through inflation is not a sustainable proposition as evidenced from the FY2010-FY2012 episode when nominal interest rates

climbed with higher inflation. This is because depositors require a minimum real interest rate to keep deposits; otherwise they will shift to other assets. So, when inflation increases, banks are forced to raise the nominal deposit rate to maintain the deposit base.

A further reduction in real interest rate can be brought about sustainably by reducing the spread between the average deposit rate and average lending rate. As shown in Figure 2, the spread is very high and a steady 5 percent, irrespective of monetary policy stance. The spread is high because of a number of inefficiencies in the banking sector including a high and growing ratio of non-performing loans. Banks tend to jack up their lending rates in order to cover these losses. All other factors that contribute to banking sector inefficiencies and/or lower their operating income (such as reserve requirements or supporting treasury functions), tend to increase the spread. The central bank should work closely with commercial banks and develop policies that can lower the spread.

Most importantly, the ability to achieve higher rate of GDP growth (accelerate from 6 percent to 8 percent) is constrained primarily by the rate of investment, the quality of labour force, technology and institutions. The rate of investment in turn is constrained by inadequate tax resources to finance public investment and for the private investment there are at least three binding constraints: energy, land and transport. On top of all of these factors, the ongoing political turmoil is a big deterrent to private investment. Unless these fundamental constraints are addressed, it will be difficult to increase the rate of investment.

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China unveils fresh support measures as economy shows renewed weakness

REUTERS, Beijing

China announced fresh support measures on Friday for its slowing economy after data showed a worrying drop in bank lending and foreign investment growth falling to a two-year low.

The central bank said it would lend 50 billion yuan (\$8.1 billion) to banks at discounted rates to allow them to re-lend the money to farmers and small businesses - areas of the economy that are usually short of cash.

The latest attempt to ease policy in a "targeted" manner to help the most vulnerable sectors came as data showed that foreign direct investment (FDI) in China rose just 1.7 percent in 2014, the slowest pace since 2012.

The world's second-largest economy drew a record \$119.6 billion worth of FDI last year, slowing markedly from growth of 5.3 percent in 2013, the Ministry of Commerce said.

Investment flows into China are an important gauge of the health of the world economy, and are also a good indicator of where capital is flowing within the Chinese economy.

"The priorities of macro policy this year is to let the economy shift its gears without it losing its growth speed," said Zhu Zhixin, a vice director at China's powerful economic planner, the National Development and Reform Commission (NDRC).

Hurt by a housing slump and waning investment and manufacturing growth, China's economy likely expanded 7.2 percent in the Oct-Dec quarter from a year earlier, its weakest rate since the depths of the global financial crisis, according to a Reuters poll of economists.



Xiaomi Vice President Hugo Barra speaks at the WSJ Live conference in Laguna Beach, California on October 28, 2014.

Xiaomi to invest in Indian start-ups, overseas content

REUTERS, Beijing

CHINA'S Xiaomi Inc plans to invest in Indian tech start-ups and overseas media content, as the world's No.3 smartphone maker looks to dominate homes with its own TVs and appliances.

Just three years after selling its first handset, a \$1.1 billion round of fundraising announced in December valued the privately held company at \$45 billion, making it the world's most valuable tech start-up.

With Samsung Electronics Co Ltd and Apple Inc in its sights in the handset market, Xiaomi is now expanding into home appliances and television. The Beijing-based company has already reserved \$1 billion for Internet TV content.

"Where we really want to make significant investments is in content, particularly in the Chinese market to start with but beyond that in other markets as well," Hugo Barra, vice president of Xiaomi's global division, said in an interview on Friday.

Taking a leaf from Samsung's book, Xiaomi's recent investments include a Chinese electronics maker as part of a strategy to build an Internet-of-things environment, where devices can be controlled by smartphones.

"One area that we are also looking to make some investments in is start-ups in India. India is already the largest market for us outside of mainland China," Barra said, without elaborating on the types of start-ups.

Xiaomi has had mixed success in India. Sales of its handsets were suspended there after telecoms equipment maker Ericsson filed a complaint alleging infringement of intellectual property rights. Partial sales were permitted from December though the case is yet to be settled.

Barra dismissed concern that overseas expansion could be stalled by allegations of IP violation, and said Ericsson's lawsuit doesn't affect day-to-day operations.

"We have licensed a lot of intellectual property already," he said. Xiaomi licenses others' intellectual property, but some claims made against the company are illegitimate and Xiaomi will fight those, Barra said.

Critics say Xiaomi is unwilling to expand into Western markets because it still has too few patents to compete.

"It doesn't have anything to do with intellectual property," said Barra. "It has to do with the fact that we have much more significant opportunities in developing markets, where our model of selling very high specification devices at really aggressive prices is much more powerful."

"These are larger populations when you add them together than the Western world."

On Monday, Reuters exclusively reported that Chief Executive Lei Jun and Facebook Inc counterpart Mark Zuckerberg discussed a potential investment by Facebook in China's top smartphone maker ahead of last month's fundraising, but a deal never materialised.

Goldman Sachs earnings hit by weak trading

AFP, New York

Goldman Sachs on Friday reported a dip in quarterly profits as a weak performance in bond trading and some other segments offset lower expenses.

Quarterly earnings at the US investment bank were \$2.17 billion, down 7.1 percent from the year-ago period.

Revenues dropped 12.5 percent to \$7.69 billion.

Like other big Wall Street banks, Goldman suffered from a fall in trading activity in fixed income, currency and commodities.

Revenues in this segment declined 29 percent as the bank pointed to an "environment generally characterized by difficult market-making conditions and continued low levels of activity."

India Reliance Q3 profits fall

AFP, Mumbai

India's Reliance Industries reported a 4.5 percent decline in quarterly net profits Friday as the massive fall in global crude prices hit margins in firm's petrochemicals and refining businesses.

Reliance, controlled by the country's wealthiest man Mukesh Ambani, said in statement that group net profit for the three months to December decreased to 52.56 billion rupees (\$849.11 million) from 55.02 billion rupees a year ago.

The sharp fall in benchmark crude oil prices during the October-December period was the "key factor" in the 20.4 percent drop in revenues to 963.3 billion rupees (\$15.56 billion) as well as in margins, Reliance said in a statement.

StanChart eyes bank stake sales as it tries to slim down

REUTERS, Hong Kong

STANDARD Chartered's abrupt move to shut its global equities business last week could be a prelude to the lender selling off stakes in a number of Asian banks as it looks to boost capital, people familiar with the lender's thinking said.

The most likely potential sale is Standard Chartered's \$621 million holding in Agricultural Bank of China Ltd (AgBank), a person with direct knowledge of the situation said.

The bank's 45 percent stake in Indonesia's PT Bank Permata, valued at around \$638 million, could also be sold, though that deal would probably come after an AgBank stake sale, people close to the bank said.

Early this month Standard Chartered moved aggressively to reverse its flagging fortunes by closing the bulk of its global equities business and axing 4,000 jobs in retail banking.

But Chief Executive Peter Sands is under pressure to cut costs and bolster capital levels further, as the bank grapples with potential losses from commodities loans that could mean it needs \$4.4 billion in extra provisions.

"It was an easy decision to get rid of the equities business but there are other things the bank could be doing," said a former Standard Chartered executive.

The change in the banks fortunes reflects the fact its focus on emerging markets and commodities has flipped



Passersby walk in front of the main branch of Standard Chartered in Hong Kong.

from being a strength to a weakness in the current economic climate.

"The tailwinds that benefited Standard Chartered from 2008-2013 became headwinds in 2014," Jefferies analysts said in a note this week.

Having minority stakes in other banks has become less attractive to lenders like Standard Chartered as new rules mean they now have to hold more capital against those holdings.

Bankers cautioned though that there is no active sale process for any of these assets.

A spokeswoman for Standard Chartered declined to comment. Sources were not authorised to speak publicly about the matter due to client confidentiality.

The stake in Indonesia's Bank

Permata could attract interest from Asian banks, especially Japanese lenders, bankers who have worked on similar deals told Reuters.

Japanese banks have been aggressively expanding into Indonesia amid sluggish growth at home.

Standard Chartered teamed up with Indonesian trading firm Astra International to buy a controlling stake in Permata in 2004. Any sale could be complicated though by the agreement that binds Standard Chartered with Astra.

Standard Chartered also owns a 15.4 percent stake in Vietnam's Asia Commercial Joint Stock Bank valued at about \$105 million, while in China it holds a 20 percent stake in unlisted China Bohai Bank for which it paid \$123 million in 2005.

EU charges Amazon tax deal with Luxembourg was illegal

AFP, Brussels

EU regulators charged Luxembourg Friday with giving illegal tax breaks to Internet shopping giant Amazon, putting European Commission chief Jean-Claude Juncker back in the spotlight over deals made when he was the duchy's premier.

The European Commission's preliminary findings into Amazon's deals with the tiny country were the latest in a widening probe by Brussels into sweetheart tax arrange-

ments between major companies and several countries.

They follow last year's "Luxleaks" scandal which revealed details of tax breaks given to dozens of major firms during Juncker's 19 years as Luxembourg premier.

The Commission, the EU's powerful executive arm responsible for policing its competition rules, said its "preliminary view is that the tax ruling... by Luxembourg in favour of Amazon constitutes state aid."

"The Commission has doubts at this stage as to that ruling's compati-

bility with" European Union internal market rules, which are meant to ensure a level playing field for companies and to protect consumers, it said.

Accordingly, the arrangement may have given the company an unfair advantage over competitors and would therefore be illegal.

Luxembourg said it "is confident that the allegations of state-aid are without merit... and it will be able to show that its tax arrangements were legitimate and afforded no unfair advantage."