

# THE BUSINESS STANDARD

## Growth recovery and higher inflation: Intended and unintended outcomes of pandemic era expansionary monetary policies

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Illustration: TBS

Since the onset of the covid-19 pandemic at the beginning of 2020, the world economy has faced a massive shock due to the shutdowns and restrictions on movements imposed to curb the infection rate. This has led to an unprecedented contraction in the world economy with jobs being lost and consumption coming to a halt. The situation in Bangladesh was no different. Due to the rampant infection of various covid-19 variants, the country had to go for measures such as "general holiday", lockdown etc. This meant that the whole economy was severely impacted. As 87% of Bangladesh's labour force is employed in the informal sector, they were hit the hardest by the lockdowns. Furthermore, the Cottage, Micro, Small and Medium Enterprises (CMSME) sector also faced a grave crisis as they usually do not have access to capital and savings to survive in situations such as this. According to a survey by the Centre for Policy Dialogue, 41.4% of the

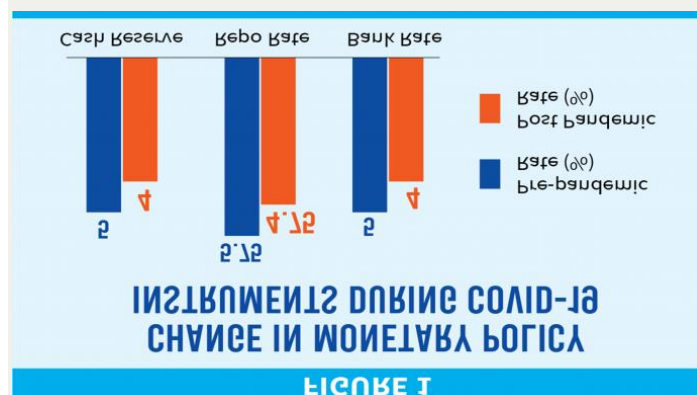
women-led MSMEs had to completely shut down, 7.1% had to reduce office space, 2.9% had to relocate to a cheaper place. As a result of all these adverse pandemic impacts, World Bank estimated that Bangladesh's real GDP growth rate fell from 8.2% in the fiscal year 2018-19 to 2.4% in the fiscal year 2019-20.

### The adoption of expansionary monetary policies to curb pandemic impacts

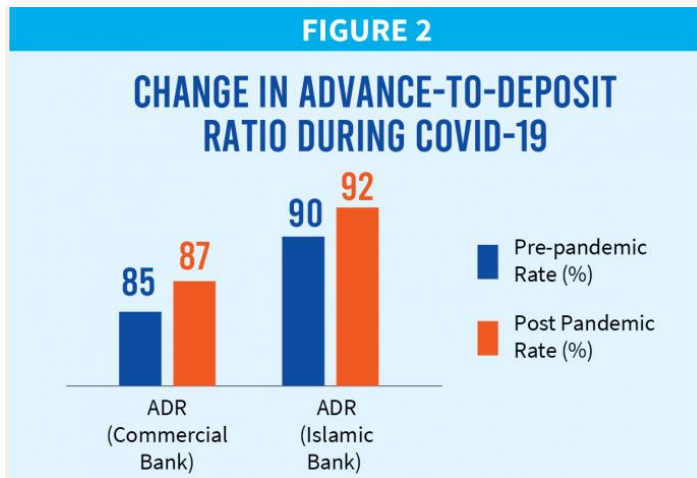
In such a scenario, it was crucial to adopt expansionary macroeconomic policies. Hence, the Government of Bangladesh (GOB) has adopted an expansionary fiscal policy by announcing stimulus package of over more than BDT 1 Trillion(3.7% of GDP). At the same time, Bangladesh Bank has opted for an expansionary monetary policy to ensure adequate liquidity and fund flows into the financial system to facilitate the faster recovery process of the real economy. The monetary policy mechanisms adopted by the central bank include reducing the Cash Reserve Ratio(CRR), Repo rate and Bank Rate, enhancing the advance-to-deposit ratio (ADR), introducing the credit refinancing scheme, lowering interest rates etc.

The Cash Reserve Ratio(CRR) determines the portion of customer deposits that commercial banks must keep as a reserve with the central bank. The Repo Rate refers to the rate at which commercial banks borrow money by selling their securities to the central bank. The Bank Rate is the interest rate a nation's central bank charges to its domestic banks to borrow money. The advance-to-deposit ratio (ADR) measures loans (advances) as a percentage of deposits.

**Figure 1: Change in Monetary Policy Instruments during Covid-19**



Source: Bangladesh Bank



*Source: Bangladesh Bank*

The BB has adopted these expansionary monetary policies so that the commercial banks have ample cash reserve to execute the fiscal stimulus package announced by the government. Since about 80% of the stimulus package is in the form of liquidity support, it was essential for BB to adopt an expansionary monetary policy to accommodate the demand for liquidity. Thus, BB has taken the steps to change the rates in Figure 1 and Figure 2 during various stages after the pandemic struck.

### **Policy support to curb pandemic impacts**

Bangladesh Bank has announced four types of policy support mechanisms in the Monetary Policy Statement for FY 2021-22. They are:

Continuation of the ongoing refinancing scheme with more focus on labour-intensive SME sector for the eradication of urban poor

BB created a Credit Guarantee Scheme for CMSMEs with a budget of BDT 20 Billion. The central bank aims to fully operationalize this scheme to expedite CMSMEs financing, particularly towards the light engineering, cluster and value chain, and women entrepreneurs' development

Permitting banks and financial institutions for opening technology-driven sub-branch in the rural remote areas by engaging their own-recruited minimal workforce for creating quality jobs and enhancing financial inclusion

Bringing the severely covid-19 impacted education sector to the refinance scheme so that both the needy teachers and the students can get their minimum required amounts of loans for purchasing necessary electronic equipment, smart devices

The central bank has undertaken these policy initiatives to ensure that fragile sectors such as CMSMEs can recover from the pandemic. These are also aimed at expanding

financial inclusion and creating jobs in the rural areas of the country. One of the most praiseworthy initiatives is focusing on the education sector. The sector is in a troubled spot because Bangladesh holds the record of longest closure of educational institutions during the pandemic. In this scenario, this initiative is a welcome support mechanism for the sector.

### **The impact of the monetary policies during Covid-19**

The central bank has adopted expansionary monetary policies and provided policy support to mitigate the impacts of covid-19. However, the impact of these initiatives has been mixed. In the following section, the impact of monetary policies on GDP, private sector, inflation etc. is discussed in detail.

### **Bangladesh's growth trajectory back on track**

Amidst a pandemic, it is expected for the central bank to undertake expansionary monetary policy in the hope that the higher level of money supply in the economy will reduce interest rates, which in turn will encourage higher investment which will then lead to employment creation. Bangladesh Bank is hopeful that its expansionary monetary policy will yield the expected best case scenario results as it has forecasted a 7.2% economic growth rate target for 2021-22. However, this seems to be overly optimistic as World Bank has stated that the rate should be 6.4%. Even though the central bank's optimism may not be realized, the expansionary monetary policy can be deemed partially successful given the World Bank's projection of 6.4% growth is a revised projection whereas the previous projection was 5.1%. This means that there has been substantial economic recovery as the worse brunt of the pandemic has subsided.

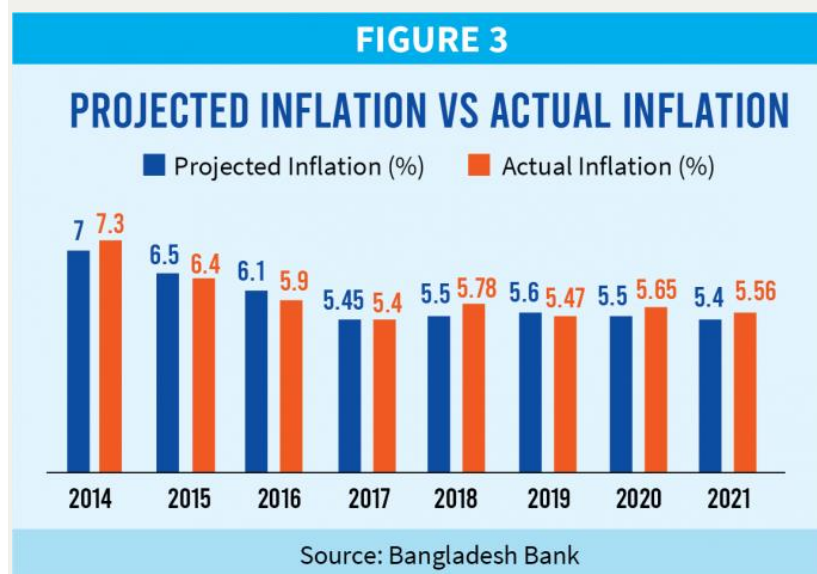
### **Private sector credit growth: Central bank's optimistic targets unlikely to be achieved**

Bangladesh Bank has also shown misplaced optimism while providing estimates for the private sector credit growth rate. The bank has projected that the growth rate will be 14.8% in 2022. The growth rate decreased from 8.6% in the fiscal year 2020 to 8.4% in the fiscal year 2021. Hence, the expansionary monetary policies and the resultant lower interest rates have not resulted in higher investment due to the pandemic. There is still scepticism about the future due to the pandemic. Businesses have suffered and are still trying to recover. Moreover, a survey by the South Asian Network on Economic Modelling (SANEM) and Asia Foundation found that 69% of the businesses received no stimulus funds. The inaccessibility of the stimulus packages has hindered the recovery process in the private sector. Hence, it is unlikely that the central bank's optimistic targets will be achieved in the next fiscal year because the impact of the pandemic is still felt throughout the economy.

### **Higher inflation on the horizon: Result of excess liquidity**

When expansionary monetary policy is taken to stimulate investment and create employment, it is expected that there may be a rise in inflation in an economy. The same happened in Bangladesh during the pandemic as the actual inflation percentages were higher than the projected figures. However, the inflation targets were achieved in most of the fiscal years prior to the pandemic. This means that higher inflations have occurred as a result of the pandemic.

Figure 3: Projected Inflation vs Actual Inflation



Source: Bangladesh Bank

The expansionary monetary policy has resulted in an increase of excess liquidity in the banking sector from BDT 103,000 crore in January 2020 to BDT 231,462 crore in June 2021 (Source: Bangladesh Bank). All liquidity available in the banking system that exceeds the needs of banks is called excess liquidity. This unprecedented increase in excess liquidity means that the demand for loans is low due to the aftermath of Covid-19. As private sector credit growth is not satisfactory, it can be incurred that the portions of the excess liquidity are being channelled to the unproductive sector. According to CPD, the presence of excess liquidity in unproductive sectors will induce higher inflation in the economy, raising the prices of essential commodities creating hardship for the poor and vulnerable non-poor population. Hence, the economy is not able to sustain the extent of expansionary monetary policy undertaken by the central bank. Thus, the central bank should consider reducing some of the expansionary mechanisms such as CRR to reduce the excess liquidity pressure and in turn the possibility of higher inflations.

### **Inefficacy persistent in policy support implementation**

The central bank has announced steps to provide refinancing and credit guarantee schemes for the CMSME sector. However, the implementation of the stimulus packages has been inefficient thus far. The SANEM survey mentioned before found that large firms

had greater access to the stimulus package as 46% received funds from the stimulus package in contrast to 30% medium firms and 9% small firms. A BRAC Institute of Governance and Development (BIGD) study on the SME sector found that three months after the declaration of government stimulus, only 63% of the surveyed workers knew about the stimulus package. 81% of those who knew about this package reported that it was quite or very difficult to get support and 17% reported that they knew how to get the support. Interestingly, 31% of those who know, noted that they have already applied for the package. Unfortunately, only one owner received it. Hence, the ambitious stimulus package has not been successful in catering to the needs of the SME sector. It is imperative that fragile SMEs receive the necessary support. It is worth noting that fragile firms are the ones that do not have sufficient capital to qualify for loans in the first place. Hence, providing liquidity support for such firms is not an efficient way to ensure their recovery. They need cash support in the form of grants. Therefore, the central bank's well-intentioned efforts may not help the SME sector to get back to its pre-pandemic state. Both the government and the central bank should figure out a better mechanism to support the SME sector. Furthermore, the central bank must ensure that the information regarding provisions for smart devices for teachers and students reach the rural areas so that the most affected ones receive the benefits. Otherwise, like the stimulus packages, many will not even know about the entitled assistance.

The central bank has been vigilant throughout the pandemic to mitigate the economic shock. However, it is necessary for the central authority to review some of its existing policies. For example, the expansionary monetary policies are currently signalling the possibility of higher inflation as the excess liquidity has reached an all-time high. Hence, it is necessary to tone down the expansionary policies and reduce the CRR. Furthermore, it is necessary to review the policy support mechanisms to make sure that they are actually effective in helping the CMSME sector. That being the case, the central bank still has a crucial role to play in the economic recovery process of the country.



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