**Scholars Journal of Economics, Business and Management (SJEBM)** **e-ISSN 2348-5302**
***Abbreviated Key Title: Sch. J. Econ. Bus. Manag.*** **p-ISSN 2348-8875**

A Unit of Scholars Academic and Scientific Society, India
An International Publisher for Academic and Scientific Resources) **DOI:** 10.36347/sjebm.2018.v05i02.002

# Does Bahrain Control Inflation Rate? Descriptive Approach

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**Article History**
*Received: 07.02.2018*
*Accepted: 10.02.2018*
*Published: 15.02.2018*

**Abstract:** The study aims at determining the monetary policy effectiveness on reducing the inflation rate in Bahrain during the period (2001-2016). The methodology of the study depends on the descriptive analysis in order to review the policy instruments pursued by Central Bank of Bahrain (CBB) to control inflation rates during the study period. The main findings that monetary policy that employed by CBB has been able to curb inflation and keep it stable and at an acceptable level despite of rising the world prices, particularly the prices of imported commodities in recent years, which means that relative success of adopted monetary policy tools.
**Keywords:** Inflation, Monetary policy, Central Bank of Bahrain (CBB), Macroeconomics, Bahrain.

## INTRODUCTION

Both developed and developing nations seek to fight inflation-which either refers to money supply increasing or sustain increase in price level for long period of time. The first called monetary inflation while the second one called price inflation-because inflation is an evil that should avoided where high inflation and particular hyperinflation destroys the economy and causes economic and political crisis [1].

Several theories tried to explain the inflation phenomena and its causes, these theories can be divided into three groups; the Monetarist theory, the Keynesian theory and the Structuralist theory [2].

The early Monetarist adopts the quantity theory of money and argues that "holding other things equal, the general price level changes due to change in quantity of money in circulation"; this indicates that when quantity of money raised it would lead to an exactly direct and proportionate increase in the level of price , and vice versa [3]. Modern quantity theories developed by Friedman holds that "inflation is always and everywhere a monetary phenomenon that arises from rapid expansion in the quantity of money than total output" [4], where the quantity of money changes it will affect only the price level or the economy's monetary side [5].

The Keynesian theory adopts a short run analysis and assumes that prices determined by non-monetary forces. It integrates the monetary theory and the theory of output and employment via interest rate, where interest rate used as a medium factor to show the relation between nominal money income and price level [1]. When the quantity of money increases, it leads to a fall in the interest rat**e** that might enhance investment and rise the aggregate demand (AD) as well both output and price level [6].

Structuralist theory argues, "Inflation is a manifestation of structural rigidities in the system" [7]. Inflation caused by structural imbalances such as the imbalance between demand and supply of industrial inputs, food scarcity, foreign exchange bottlenecks, infrastructure bottlenecks and social and political constraints [2].

There are many instruments or polices could be employed to reduce and control inflation, such as monetary policy which represents "the art of money management that deals with the relationship between interest rates and the aggregate money supply in an economy" [8]. Keynes, Rational Economists and Latin America structural economists state that "monetary policy is a main policy employed by Central Bank to combat inflation when it occurs and reduces its cots" [9]. Despite of there is a wide agreement that monetary policy is an instrument to promote economic growth and stabilize inflation, but there is less agreement about how this policy exactly exerts its influence [10].

The impact of monetary policy tools on inflation discussed by several empirical studies. Some studies such as: [11, 12] focus on interest rate (or Taylor rule) as a main instrument to control inflation. Other studies such as: [13-16] focus on the instrument of Monterey base (or Mccallum rule) to fight the inflation, while some studies such as: [17-20] stress on the importance of exchange rate to bring down inflation to a target level especially during the transition period.

Bahrain represents one of the Gulf countries that started implementing economic and financial reforms in successive phases since 2001 in order to raise the economic growth rate reduce the unemployment rate and stabilize the forging exchange market. The reform program had received significant support from citizens and international organizations. It includes a set of monetary policy tools to eliminate the inflationary pressures in the national economy and stabilize the domestic price levels that consistent with the target set by Bahrain's economic vision 2030 [21].

The current study aims at assessing the monetary policy effectiveness on reducing the rate of inflation in Bahrain over the period (2001-2016). The period of study witnessed several events. The September 11, 2001 events that causing global markets to drop sharply, the global financial crisis in 2008, and dropping the oil prices from $112 to $48 in January 2015. These events led to negative impacts on Bahrain's economy. The study adopts a descriptive analysis in order to review the inflation rate and monetary policy in Bahrain during the study period. The study depends on secondary annual data on inflation and money supply obtained from annual reports of Central Bank of Bahrain.

The rest of the current study organized as follows: Section two is an overview of inflation and monetary policy in Bahrain during the study period. Section three illustrates how the tools of monetary policy could deal with inflation rate. Section four is a conclusion and recommendations.

**Inflation rate and monetary policy in Bahrain: An overview**

Inflation rate in Bahrain- measured by the percentage change in consumers price index (CPI)- fluctuated between rise and fall during the period under study, where Bahrain economy influenced significantly by the global inflation due to the high degree of Bahrain's dependence on imports of consumer goods and capital alike. The rate of Inflation was almost 1% in year 1990 and increased to 2.7% in 1995. It was negative in the year 2001 and it started to increase relatively from 1.6% in 2003 to 3.53% in 2010 and reached to its maximum rate in 2016 (3.6%) as shown in figure (1).

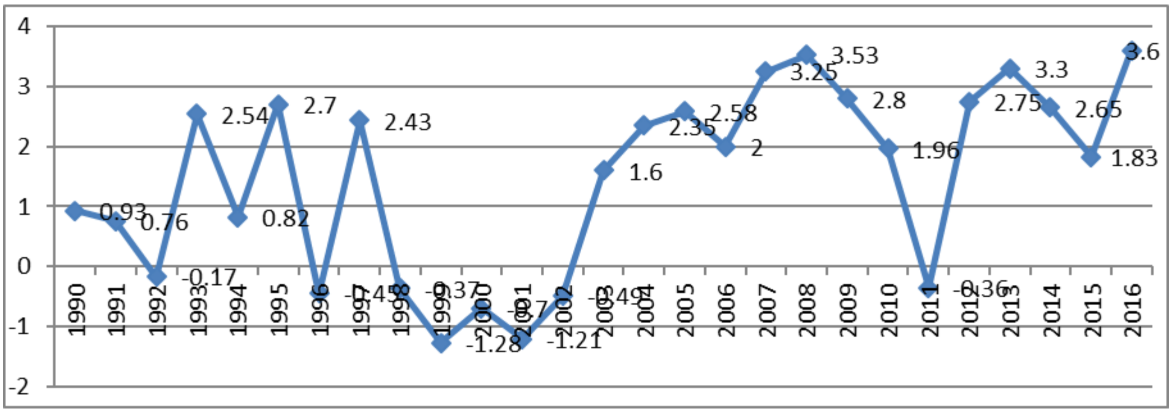


**Fig-1: Inflation rate in Bahrain during the period (1991-2016)**

Stable currency exchange rate and low inflation are important long run features of the Bahrain economy that support business environment stability as well as high levels of investment. World Bank database show that the inflation rate in Bahrain over the last decades was less than the inflation rates in other similar countries (World Bank Database).

Central Bank of Bahrain (CBB) represents a monetary institution in charge to set and implement monetary policy to achieve the inflation target. Bahrain monetary policy centered on the exchange rate; this because of Bahrain is a small and open economy that mainly depends on foreign trade where exports and imports represent more than 140% of GDP; therefore Bahraini dinar (BD) is pegging to the US dollar since 1980. Pegging the US dollar serves to enhance credibility and transparency of monetary policy to maintain financial stability.

CBB employs three different instruments for managing monetary policy. The first instrument is offering foreign exchange facilities for buying and selling BD against US dollar at rates very close to the official exchange rate. The second instrument is supplying set of deposit and lending standing facilities in Bahraini dinars to all retail banks. This policy guides the short run interest rates in the money market and ultimately influences the deposit and lending rates that the offered by banks to customers. The third instrument is guiding the retail banks to hold unremunerated reserves with the CBB. which contributes to adjust the CBB's structural liquidity situation, on one hand , and serve as an active monetary policy instrument for day-to-day liquidity management, on the other hand.

The annual report of CBB argue that “CBB does not maintain any administrative controls over market interest rates, where there are no interest rate caps or floors and it does not seek to influence directly the cost of credit or the distribution of credit in the economy; accordingly, private sector is free to allocate credit as it sees fit” [21].

**Monterey policy effectiveness to control the inflation rate in Bahrain**

In this section, we try to assess the role of monetary policy tools that employed during the study period in Bahrain to control the inflation rate, that could happened due to many factors such as: imbalances of domestic liquidity, imbalances of domestic credit structure among economic activities, and increasing the aggregate final consumption.

**The role of monetary policy to treat the imbalances in the domestic liquidity**

The imbalances in the structure of domestic liquidity due to increasing the amount of money in circulating outside the banking system contributed to feed inflationary pressures in Bahrain economy during nineties, where aggregate demand for goods and services increased, while aggregate supply was very limited which created shortage in supply and led to raise the domestic price levels. During the period (1990-2000), the percentage rate of currency in circulation to total narrow definition of money supply (M1) raised from 23% in 1990 to 27.1% in 2000, where the average during this period was 28.6%.

CBB adopts certain tools to curb the inflationary pressures such as adjusting the proportion of the legal reserve ratio up to 5%, raising the interest rates on deposits in commercial banks from 0.025 % to 0.5% , in addition to issuing Treasury bills; these adjustments led to the following [21]:

- The average of currency in circulation to total domestic liquidity dropped from 28.6% during the period (1990-2000) to 17.6% during the period (2001-2016), where it declined from 20% in 2001 to 15.5% in 2016.
- The quasi money as a ratio of aggregate domestic liquidity rose from 63.3 % during the period (1990-2000) to 74.6% during the period (2001-2016) due to increasing the time and saving deposits from 57% in year 2001 to 65% in year 2016, in addition to increasing the deposits of foreign currencies from 2.5% to 8.7% in years 2001 and 2016 respectively.

According to the above outcomes, we can argue that the monetary policy tools of CBB could reduce the proportion of cash in circulation to total liquidity and raised the ratio of quasi-money to gross domestic liquidity, which has contributed to control the inflation rate and made it at acceptable standard where its average was 2% during the period (2001-2016).

**The role of monetary policy to fix the imbalance distribution of credits among economic activities**

CBB annual reports illustrate that the average annual growth rate of domestic credit was 15.5%, which was higher than the real GDP average growth rate, which was 5.8% during the study period. Moreover, the share of personal and services sectors of available credits were very big comparing to the share of manufacturing sector. As shown in figure (2), the available credits to individuals as a percentage of the commercial banks annual credits went up from 28.7% in 1990 to 35.1% in 2000 and to 42.1% in 2016, while the share of industrial sector declined from 17.5% in 1990 to 14% in 2000 and to 7.7% only in 2016. The share of the construction sector fell from 15.6% in 1990 to 12% in 2000, but its share back to rise again in the beginning of 2006, and it reaches 30.6% in 2016. The transportation and communications sector share declined from 10.02% in 1990 to 2.11% in 2000 and to 1.8% only in 2016.

The misallocation of credits among economic activities led to insufficient funds for medium and long run industrial projects that need funds to utilize the unemployed production capacities and increase real supply of commodities, which might lead to eliminate the demand gap and stabilize prices [22].

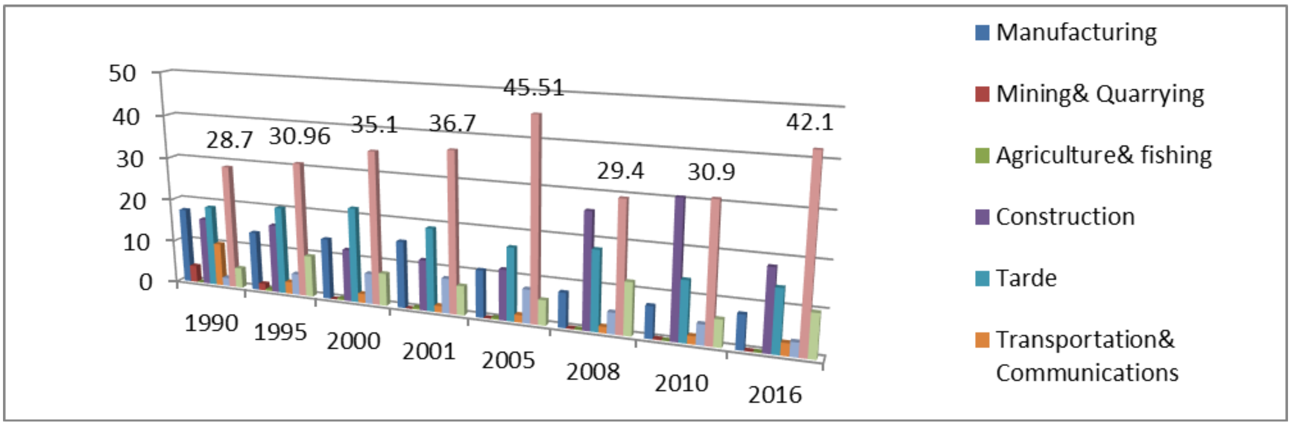


**Fig-2: Commercial Banks credits distribution among economic activates (1990-2016)**

From the above the we conclude that there is limits of monetary policy in fixing the imbalance of credit distribution; which affects negatively on the performance of production that could not to meet the domestic demand while aggregate demand by individuals is high; this led to Bahrain's dependency on the outside world and increasing its imports.

**The role of monetary policy to tight the increasing in the total final consumption**

The average ratio of final consumption to GDP at constant price (2010=100) was 68 % during the period (1990-2000), which contributed to decrease the domestic savings ratio, and decline the necessary funds to economic and social development projects. The CBB sought to encourage individuals to save, by raising interest rates on deposits and issuing Treasury Bills, in addition to some measures taken by the government such as liberalization of some commodities and services and removing subsidies partially on some commodities such as gas and meat. These procedures helped to reduce the final consumption growth and partially eliminate the excess aggregate demand for goods and services and achieve relative stability in price levels.

The annual reports of CBB show that the total final consumption as a ratio of real GDP declined from 53.4% in 2000 to 52.4%, 47% in 2005 and 2010 respectively, and 43% in year 2016. The average growth rate of final consumption of public and private decreased from 13.5% during the period (1990-2000) to about 8% during the period (2001-2016). These indicators reflect significant role of monetary policy tools to reduce both the growth rate of final consumption and its share of GDP, this helped partially to eliminate the inflationary pressures that might arising from increasing the aggregate final consumption in the economy of Bahrain.[23]

## CONCLUSION

The monetary policy of Bahrain based on pegging the Bahraini dinar to the US dollar since 1980. This approach helped to stabilize prices in Bahrain compared to other similar countries. The study found that CBB monetary policy had the ability to restraining inflation rate, and keep it at permanently low average levels while the world price levels increased sharply.

The study recommends the following: Diversify the national income sources in order to give Bahrain chance to control its currency exchange rate, in addition to diversification the reserve portfolio to increase the share of other currencies such as the Yuan and Euro currencies especially after raising the interest rate in USA. Redistribute banks' credits for the benefit of industrial sector –especially food &beverage and steel industries- because these are the main sectors that will help to reduce imports and increase exports and will significantly impact on Bahrain's balance of trade. Reduce the personal credit share that used for increasing the aggregate spending on goods and services while there is no increase in domestic production. And finally, increase the deposits' interest rate to competitive rate in order to encourage Bahraini to save more that reflects positively on decreasing the aggregate demand and price levels.

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