

Bangladesh Bank's MPS: What should be the stance?

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Bangladesh Bank (BB) is likely to announce the Monetary Policy Statement (MPS) today (Tuesday) for the period July-December 2016. Prior to finalisation of the MPS, it held consultations with the stakeholders concerned. I had the opportunity to attend one of the stakeholders' consultations and also observe some of the commentaries recently came out in our national press about which way the next MPS should focus. In this presentation, I would like to share my thoughts with the broader public and fellow economists, which I have already conveyed to BB.

If we take a look at the performance against the objective set in the last MPS, we can notice that Bangladesh's inflation performance was better than targeted. To a large extent, this outcome was supported by lower international commodity prices and favourable domestic supply situation. In addition, we also observe that interest rates have started coming down because of lower inflation rate and access of domestic private sector to international capital market. Housing loan can now be obtained at less than 10% and prime borrowers can access the market even at rates of 5%-6%. In response to lower interest rates, private sector credit has also picked up significantly, and currently stands at more than 16%. These are all positive developments.

Now, what should be the objective of the next monetary policy against this background? What would BB like to achieve through the upcoming MPS?

I strongly feel that the objective should be to sustain the gains achieved in the previous year in terms of lowering the inflation and interest rates in a sustained manner. Point to point inflation has come down to 5.45 percent in May 2016, but it is still not low by any standard. Inflation expectation is still quite strong and wage pressures are very much there. At the

same time the borrowing rates are still significantly above the corresponding rates of our trading partners and comparator countries.



BB's policy of keeping the exchange rate virtually pegged against the US dollar, despite a significantly wide inflation differential above our trading partners, is contributing to rapid appreciation of Taka. While BB is rightly buying dollar from the interbank market to keep the exchange rate stable against dollar at the current level at 78 per US dollar, the real effective exchange rate (REER) of Bangladesh Taka has already appreciated significantly (by more than 50% over the last 5 years through March 2016). This clearly is not very supportive of our export objective. If our inflation rate remains significantly above our trading partners throughout the medium term and BB maintains a virtual peg against the dollar, then the resulting large loss of competitiveness is bound to hurt our exporters.

There are two ways of addressing this issue:

First, bring down the inflation rate over time so that the degree of appreciation of Taka in real effective term is limited. Second, engineer a nominal depreciation of the currency in line with the inflation differential vis-a-vis the trading partners. Between the two, BB should certainly opt for the first one and thereby aim at bringing down the inflation rate steadily towards the average of BD's trading partners and maintain exchange rate stability.

The lower inflation will also help sustain the recent reduction in interest rates. Lending rates have come down significantly in recent months, but it needs to come down much more to be similar to the levels enjoyed by the exporters of our competitor countries. Lower inflation would help BB to lower the whole interest rate structure while ensuring reasonable real returns to the depositors. Maintaining the balance between the deposit and lending rates is also very important if we want to reduce the whole interest rate structure in a sustainable manner. However, it is also true that the scope for significantly reducing the lending rate is being seriously undermined by the wide spread between the lending and deposit rates that Bangladeshi banks still maintain. While the average spread has marginally come down to 4.90 (as of May 2016) more than half of the commercial banks are still charging spreads above 5%.

The key to the deduction of spread in BD lies in significantly reducing the loan loss provisioning requirement. Bangladesh's very high level of classified loans (about 9-10% of assets of the banking system) is a major cause of the still very high lending rate, although deposit rates are quite low. Actual non-performing assets are believed to be much higher than that. In a well-managed banking system, non-performing loans should remain within 1-2% of total assets.



This is a major governance problem facing the Bangladesh banking system and it needs to be addressed forcefully. Although this is not directly related with the core objectives of monetary policy, if health of the banking system continues to deteriorate and contributes to higher lending rates, certainly our investment and growth objectives will be undermined.

Arguments are often made by certain quarters that since the interbank overnight rates are well below the BB intervention rates (repo and reverse repo rates), the intervention rates have lost their relevance and should be cut down in the context of the new MPS. This is not a compelling argument. Real intervention rates in Bangladesh are the lowest among all comparator countries and currently in the negative territory because of relatively higher inflation in Bangladesh. The intervention rates have lost their relevance because of excess liquidity in the banking system and inadequate level of sterilization by BB. Moreover, with the strong recovery in private sector credit currently underway which is also likely to accelerate in the coming months and the sluggish growth in deposits of the banking system (currently at 13.3%), the excess liquidity is likely to disappear very soon.



It is certainly the responsibility of BB to make credit available for the private sector to sustain growth in investment and trade. We welcome the recent acceleration of credit demand by the private sector, but at the same time Bangladesh Bank would need to be careful about diversion of credit to speculative activities, as it happened during FY10-12. It is the responsibility of a central bank to take the punch bowl away when the party is on and gets wild.



Some commentators argue that rapid private credit expansion helps acceleration of growth and employment generation and thus Bangladesh Bank should ease the stance of monetary policy. My response to these commentators would be that this argument is valid only up to a point. Private credit expansion beyond reasonable limits generally fuels speculative activity and may lead to formation of asset market bubbles, eventually leading further accumulation of nonperforming assets. As we have seen in the FY10-12 episode, the surge in private credit ranging up to 25%-29%, did not contribute to higher investment with private investment to GDP ratio remaining virtually unchanged.



In conclusion, I would like to reiterate that Bangladesh has made some gains in its fight against inflation and BB deserves credit for bringing down the interest rate structure to some extent. Bangladesh economy is growing nicely at a record 7% pace, supported by continued macroeconomic stability. This is not the time to artificially stimulate the economy by easing the monetary policy stance. Private sector investment in Bangladesh is constrained by serious infrastructure deficiency, lack of serviced land, and serious governance problems at various levels. Monetary policy cannot do much to alleviate these constraints. BB should thus remain focused on what it can do and, in my view, that should be limited to bringing down the inflation rate further and improving governance of the banking system through strengthened banking supervision.