Challenges for BB to manage

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Bangladesh's financial system has, in recent years, experienced rapid expansion in terms of financial deepening and inclusiveness. Like most other countries, developing and developed, it has also faced a number of challenges. Challenges are many for any central bank of a developing country like Bangladesh. Three of such challenges are somewhat pressing and also interrelated.

Of them, the first issue relates to the long standing complaint of the private sector about high interest rates adversely impacting private investment and domestic economic activity. This is a legitimate concern. But the issue is complicated by high level of non-performing loans (NPLs) for public and private commercial banks. This signifies a huge loan loss burden for the banking system which has also reduced banking profitability. Furthermore, merchant banks incurred huge losses due to the bursting of the stock price bubble. Then again the underdeveloped nature of the bond market of Bangladesh is also hindering access to this source of financing for the investors. While development of the bond market is a medium-term challenge, a sustained reduction of domestic interest rate structure remains a major near-term challenge for Bangladesh Bank (BB).

The second related issue is the exchange rate dilemma of BB. While BB has successfully maintained exchange rate stability, given the underlying appreciation of the exchange rate in real effective terms, can the virtual peg against the US dollar be sustainable over the medium term?

Third and final issue is also related to the interest rate issue. To address the interest rate issue through enhanced competition and also as part of the process of gradual opening up of the capital accounts in terms of access to foreign funds, BB has recently liberalized borrowing in foreign currency by domestic enterprises. While this policy has some intended impact on the interest rate structure by forcing domestic lenders to compete with borrowing from abroad at lower interest rates, it has created some tensions in the money market due to higher liquidity and some resistance from some banks and analysts about the appropriateness of going for this liberalization.

It is worth mentioning that depositors getting a negative real rate of return on average, is not good for savers. Borrowers are getting funds in real term that is less than the spread charged by banks, which means the lowering of lending rates is coming at the expense of savers. Thus the high real interest rate needs to be explained in terms of developments in the spread in interest rate between lending and deposit rates.

There are three key parties/players engaged in the operations of the banking system: depositors; banks as the financial intermediaries; and borrowers using the intermediated savings for investment and trading activities. For healthy growth in domestic savings and the deposit base, banks need to offer at least marginally positive real interest rates to the depositors. This means that for any significant reduction in the nominal deposit rate the domestic inflation rate needs to be brought down further.

At the same time, Bangladesh's very high gross non-performing loan (GNPL) — at more than 12% compared with only 1.0%-3.0% for countries like China, Malaysia, Indonesia, Thailand and India– points to the fact that inefficiencies in its financial intermediation will continue to adversely impact the spread and the borrowing rate. Banking sector governance, supervision and competition must be strengthened significantly if BB and the Government are serious about reducing the lending rate significantly without creating market distortions. Furthermore, BB needs to work on reducing the inflation rate further to 5.0% or less if it really wants to support a reduction of the nominal interest rate structure in a sustainable manner. The best example in this respect is China, where low and stable inflation rate (2.0-3.0 per cent) with low loan losses have helped maintain lending rates at low levels.

The reduction of interest rates should be on the basis of a medium term market-based process that involves reducing inflation, reducing the cost of doing banking operations, and lowering of loan losses through better lending practices. Any lowering of interest rates on an ad hoc basis and administratively will not work to reduce the interest rate structure in a sustainable manner. Systematic efforts to reduce the loan losses and required provisioning, continued lowering of domestic inflation, and related adoption of prudent monetary policy and enforcement of strengthened supervision would need to be taken by BB under a market-based strategy in order to reduce interest rates.