

Emerging macroeconomic imbalances and roles of BB

Sunday, Feb 18, 2018

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Bangladesh Bank issued its new six-monthly monetary policy statement at a time when the economy is at a crossroad due to the emergence of serious imbalances in both the money market and the balance of payments.

The external trade account deficit widened to more than \$7.5 billion in first five months of fiscal 2017-18, contributing to a current account deficit of \$4.4 billion over the same period, compared with less than \$0.7 billion recorded in the same period a year earlier.

Exacerbating the situation, a wide gap is also emerging in credit and the deposit growth rates in the banking system, contributing to an acute liquidity crisis in the banking system.

This note tries to analyse the adequacy and the relevance of the new MPS in addressing the emerging twin imbalances in the economy, both in terms of its explicitly stated actions and messages conveyed to the policymakers and markets.

At the outset, we need to understand why did the liquidity crunch emerge and why it was not felt until recently?

The ingredients for the liquidity problem was in the making for the last several years as the banking system was experiencing a declining growth in its deposit rate, primarily due to the diversion of household financial savings to National Savings Directorate instruments/bonds offering interest rates well-above the market rates.

Although this diversion of deposits away from the banking system has been going on for the last several years, its impact on liquidity was not felt until recently, as the banking system

was flushed with excess liquidity.

Since the growth in bank deposits continued to plunge and eventually declined to only 11 percent in fiscal 2016-17 and growth in private sector lending accelerated to 18-19 percent, the excess liquidity evaporated rapidly. And the tightening of the liquidity situation intensified.

The liquidity problem was also accentuated by the increasing burden of non-performing loans.

In order to sustain profit growth, many banks have started to violate macro-prudential conditions like the loans-deposit ratio. The violations have pushed the ratio of many banks to the 90-92 percent range, well above the prudential norm of less than 85 percent.

Due to this excess lending, some banks are on the verge of becoming illiquid and scrambling for deposits, thereby pushing up the deposit rates.

Deposit rates of banks have already increased by 4-5 percentage points — more than 75 percent above the levels prevailing only a few months back.

The outcome of the process is already visible in the permanent loss of “single-digit lending rate” that Bangladeshi entrepreneurs and other borrowers used to enjoy in recent months.

Can we blame the BB for the liquidity crisis and the surge in the interest rate structure against this background? Could Bangladesh Bank prevent this situation on its own?

Since the policy with regard to savings certificate interest rates is dictated by the government and in recent times against the advice and plea by the BB, we should not blame the central bank.

The central bank has to minimise the damage by focusing rightly on the macro-prudential condition with respect to loan-deposit ratio and has instructed all commercial banks to reduce their ratios to 83.5 percent and to 89 percent for Islamic banks.

It has also given the banks five months to improve their liquidity by lowering their ratios as appropriate.

Question may arise whether the BB can and should prevent the rise in the interest rate structure.

The interest rates offered for savings instruments are currently serving as the anchor for the deposit rates in the banking system.

As long as they remain well above the deposit rates in the banking system, the deposit growth will remain subdued and there will be pressure to mobilise deposits and the deposit rates would continue to rise.

As a matter of fact, much of this adjustment has already happened with the deposit/FDR rates increasing by 4-5 percentage points in recent weeks.

Historical data indicate that once bank deposit/FDR rates come up to within 1 to 1.5 percentage points of the savings certificate rates of same maturities, the deposit rates will stabilise and deposits will start flowing back in to the banking system.

The adjustments brought about by market forces will surely help accelerate deposit growth from its recent historic lows, and at the same time help decelerate credit growth due to the combined pressures of lower loan-deposit ratio and higher interest rates.

This convergence of the lending and deposit growth rates will be critical for easing the liquidity crisis in the banking system, although at a substantial cost to the economy.

I essentially view this development as the punishment enforced by the market forces — an outcome that is undesirable, unfortunate and could have been avoided had the government brought down the savings certificate interest rate structure when the market interest rate structure was at its lowest points.

It is well established in economic theory that there cannot be two prices or rates of return for the same/similar financial instruments in a unified financial system.

Since administered savings certificate interest rates were not allowed to come down to the levels of market determined rates, the market rates had to move up towards the savings certificate rates to ensure market equilibrium.

The second major problem that the BB is facing is in managing the exchange rate in the face of mounting balance of payments imbalance.

The monetary policy states the issue but does not go into deeper and convincing discussion of the BB's exchange rate policy in the coming months.

The external current account deficit has surged to \$4.76 billion in the first half of fiscal 2017-18, compared with a deficit of \$0.54 billion a year earlier.

The corresponding trade account deficit was \$8.6 billion, almost double the level of deficit from a year earlier. This situation is creating imbalances in the foreign exchange market, forcing the BB to sell dollars in the interbank foreign exchange market to stabilise the exchange rate.

The BB has already injected dollar liquidity by selling about \$1.5 billion in the interbank market, but there is no end in sight.

In this respect, my advice to the BB will be to stop injecting dollars into the interbank market to prevent further depreciation of taka against the dollar because such interventions would lead to further withdrawal of liquidity from the banking system.

Moreover, such interventions should not be used and cannot be successful in changing the market dynamics when the fundamentals indicate continued large imbalances in the balance of payments and in the interbank foreign exchange market.

Interbank exchange rate has depreciated to almost Tk 83 per dollar, and this is happening despite the BB's use of moral situations and arm-twisting of banks while at the same time pumping of foreign exchange in the interbank market, which, in turn, is draining down its own reserves.

This cannot continue for long. The country cannot afford to run down its reserves significantly without addressing the fundamental factors contributing to the growing imbalances.

The pipeline for import is very strong. The value of new import letters of credit opened during the July-November period stands at \$20.6 billion, and the outstanding stock of import LCs opened as of November was \$36.4 billion.

As this large stock of LCs gets settled, there will be further pressures on the BB's foreign reserves.

Unless these imports are backed by foreign financing associated with mega projects, there will be a large drop in reserves, which may not be good for the economy.

It is therefore important that the government contains the domestic demand pressure by pruning the self-funded projects that do not have counterpart foreign financing.

Some form of belt tightening will be absolutely essential for the next 6 months to 1 year.

Higher interest rates and a further depreciation of the currency to discourage imports and encourage exports are important elements to address the imbalances.

Tightening the belt in an election year when political economy calls for stimulating economic activity will certainly not be an easily agreeable step politically.

Given the unpleasant scenarios that are unfolding, we believe that the BB is right in enforcing the macroprudential condition related to loan-deposit ratio.

The tightening of monetary policy stance is already underway through market forces as the interest rates are increasing rapidly.

Allowing the interest rates to go up is not a choice for the BB; it is fait accompli.

The higher interest rates, although costly for the economy in many ways, will, however, enhance the attractiveness for holding taka assets, contain domestic demand and thereby

also help stabilise the exchange rate over time.

Some degree of depreciation of taka is unavoidable — a part of the required adjustment has already happened and more will probably be needed.

It is important that the process is managed through appropriate policy adjustments before being overwhelmed by the brutal force of the market, which will be disorderly and much more costly for the economy.