

Govt borrowing and money market developments: The real situation

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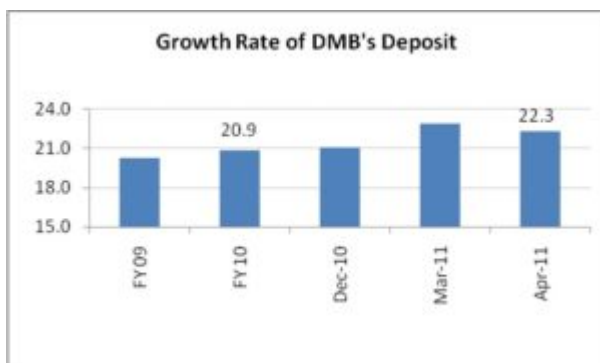
In the recently ended fiscal year government has borrowed TK 204 billion from the banking sector

which was negative TK 38 billion, implying a repayment by the government to the banking system in the preceding fiscal year (FY). Based on these numbers there have been arguments from different quarters that government's fiscal policy is crowding out private sector credit and investment and contributing to the ongoing money market tensions. The analysis presented bellow attempts to identify the real situation, based on data published by Bangladesh Bank (BB) and recent press reports.

To finance fiscal deficits, Government of Bangladesh domestically borrows from two sources—the banking system and non-bank sources. The latter takes place primarily in the form of sales of Shonchoy Patra or national savings scheme (NSS) instruments of different maturities/types. We need to understand that the money borrowed through NSS or from commercial banks essentially comes from the same source—deposits of the households with the bank and non-bank institutions. Depending on their respective rates of return, measured by interest rates offered under different instruments, households decide where to invest their financial savings in banking or non-bank instruments.

In years when returns on NSS instruments were higher relative to deposit rates of bank, as it was in FY10, households deposited more money in NSS instruments. Consequently, government's non-bank borrowing exceeded its planned borrowing target by a big margin. The Government ended up borrowing TK 124.2 billion in FY10 compared to only TK 38 billion

in its budgetary plan for the fiscal year. In contrast, in FY 11 when the deposit rates of commercial banks had increased relative to that of NSS instruments, people switched their deposits from NSS to banks. As a result, compared to the non-bank borrowing target of TK 80 billion in FY 11, net borrowing was only TK 24.4 billion during the first 11 month of the fiscal. In essence the money which could have been deposited with NSS ended up in banks due to higher interest rates offered by them (banks).



What we see from the above analysis is that the borrowing from bank and non-bank sources is dependent on relative interest rate policy and the amount not received from non-bank has essentially fueled deposit growth of commercial banks. As a result growth of deposit of DMBs has increased at a higher rate than previous fiscal.

The developments described above indicate that since NSS and banking system are part of same financial system, what is important is to looking at domestic borrowing of the government, which includes banks and non-banks and not to focus exclusively on only the component of government borrowing from the banking system. On this basis, we now look at whether the government sector really borrowed what it had planned from the domestic sectors.

	Budget FY 11		Actual FY 11		Budget FY 10		Actual FY 10	
Bank Borrowing	156.8	203.9	167.6	-37.9				
Bangladesh Bank		96.4		-66.3				
DMBs		107.5		28.4				
Non-Bank Borrowing	80.0	32.0*	38.0	124.2				
Total Domestic Borrowing	236.8	235.9	205.6	86.3				

* Non-bank borrowing is an estimate based on developments up to April 2011

According to the government plan in FY 10, domestic borrowing was supposed to be TK 205.6

billion but actual borrowing was only TK 86 billion. In FY 11 budget, government announced to borrow TK 236.6 billion from domestic sources and in the event actual borrowing was about TK 236 billion. Thus despite the surge in domestic borrowing over the preceding year, actual borrowing was very much in line with what was planned for at the time the budget was announced.

In FY 11 what really changed is the distribution of borrowing between bank and non-bank sources of financing. The amount that the government could not borrow from the non-bank source as per its original plan was largely compensated by borrowing from the banking system. At the same time, due to lesser government borrowing in the form of NSS instruments, bank deposits also increased markedly. Bank deposits increased by TK 645 billion in last twelve month up to April in FY11, compared with an increase of TK 582 billion in FY10. Thus one can argue that the increase in banking sector deposits essentially covered the additional borrowing requirement of the government without exerting any additional pressure on the banking system.

The point I wanted to make above is that, fiscal management in FY11 despite its deficiencies in some areas, cannot be blamed for current money market situation and for crowding out private sector investment. The prevailing tightness in liquidity in the money market is primarily attributable to excess lending to the private sector and to a limited extent due to increased borrowing by the public sector enterprises.

While I do not see any major problem emerging from the overall level of government borrowing in FY11 from the banking sector, I find a major problem in the reported composition of government borrowing. Based on press reports, out of TK 204 billion borrowed from the banking sector TK 96.4 billion came from Bangladesh Bank (BB), which in my view is a major concern. As we all know, borrowing from BB is not same as borrowing from deposit money banks (DMBs). BB's lending to the government sector essentially means printing of money which is called high powered money and with money multiplier being around 4, one unit increase in high powered money will result in a four-fold increase in broad money or liquidity expansion over the course of the year.

It would have been highly desirable on the part of BB to refrain from injection of such a large quantity of high powered money into the economy in the final months of the fiscal year. BB

should have forced the government to borrow from the DMBs. It would have forced commercial banks to contain their levellending to the private sector and would have also entailed higher interest rates on treasury bills.

Instead of allowing money market operate properly, BB injected the liquidity which essentially monetized large part of the government borrowing instantaneously. The effect of such a large scale monetization of the fiscal deficit, if not sterilized, will be seen in the form of higher inflation and a further depreciation of the exchange rate in coming months. The second bubble currently forming in the capital market may also be partly attributable to the liquidity injection by BB. This injection of high powered money has largely happened in May and June, the last two months of the fiscal year. BB should mop up the recent injection of liquidity without any delay and we look forward to seeing definite steps to this end in its forthcoming Monetary Policy Statement. (The writer is executive director, Policy Research Institute of Bangladesh. He can be reached at e-mail: ahsanmansur@gmail.com)