



Inflation and not so SMART interest rates

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SMART refers to the Six-Month Moving Average Rate of Treasury Bill, the instrument Bangladesh Bank (BB) uses to make interest rates flexible within bounds. Unfortunately, it is not working as it has reduced neither inflation nor foreign exchange shortages.

But let us start with some good news on the economy. In January, [remittance inflow was \\$2.1 billion](#), a marked increase, while [export earnings amounted to \\$5.7 billion](#). Robust inflow of medium- and long-term loans (including from the IMF) led to an infusion of over \$2.5 billion to gross reserves over the past two months. The current account deficit was drastically reduced to a small surplus, though with steep costs, while revenue collection increased by 14.74 percent in January.

That said, the economy's immediate challenges remain concerning. Moreover, a key element of the government's response, its monetary policy, has not been able to stabilise the balance of payments and foreign exchange markets. Plus, the failure to tame inflation not only imposes a steep tax on the poor and the middle class, it also erodes economic competitiveness.

The challenges come from three directions. First, the balance of payments pressures and the dollar shortage continue due to the unanticipated emergence of financial account deficits. While Bangladesh has traditionally maintained a healthy surplus (inflow of funds) for its financial account—\$15.5 billion in FY2022—it [saw a deficit of \\$2.1 billion in FY2023](#). In the first six months of the current fiscal year, this deficit [widened to nearly \\$5.4 billion](#), that is, about \$7.5 billion less than the \$2.1 billion surplus the IMF's programme projects for June 2024. This has happened mainly because foreign short-term lending and trade credit have dried up. The widening of the deficit also signals foreign banks' lack of confidence in Bangladesh's economy.

Second, although the trade deficit has declined sharply, this has resulted from cutting imports of intermediate goods, capital goods, and raw materials down by 20-25 percent in the first half of the current fiscal year. The reduction in imports has not been made to happen through exchange rate adjustment, but through the rationing of foreign exchange. Banks, not prices, have determined in an ad hoc manner who will receive credit and foreign currency.

Third, inflation rates have increased from six percent two years ago to [9.86 percent by the end of January 2024](#). Inflation has spiked in Bangladesh since 2022 for two reasons. First, international energy prices roughly doubled and edible oil prices markedly increased in 2022. Second, the 30 percent depreciation of the exchange rate for the US dollar over the past two years meant that taka import prices continued to rise even when dollar prices fell.

In recent months, international prices of LNG and oil have fallen between 40-70 percent. Also, according to Bangladesh Bank's Monetary Policy Statement (January-June 2024), depreciation tapered off to only 1.49 percent in July-December 2023. As such, external factors could not be driving the ongoing inflation.

So, what is causing inflation to worsen? Much is said about the role of syndicates and

intermediaries in this regard. There is, however, little evidence about the active role of syndicates in fixing prices. Economics suggests that this is difficult to do unless a small, tightly knit group has highly centralised control over the supply of specific items such as edible oil. Still, the government should be vigilant indeed. However, blaming minor traders and stockkeepers for higher prices would be a travesty, not to mention economically risky. These small players play a vital role in the supply chain by bringing the harvest and supplies from the farms or factories to consumers. If their activities and supplies are disrupted through “police action” or vigilantism, we may see higher inflation.

The main culprit behind rising inflation is a tepid and conflicted monetary policy that has kept demand for goods and services high on one side and their supply low on the other. It has kept supply low by rationing artificially low-priced foreign currency which has suppressed imports of vital raw materials, intermediate, and capital goods.

It has kept demand high because despite increasing the main policy interest rate (that is, the repo rate at which banks borrow from BB) six times, the increases have been too little, too late. Thus, although inflation rose sharply in 2022, the central bank waited until June 2023 to remove the market cap on interest rates, which was also somewhat deceptive. Commercial banks’ lending rates are still capped by its so-called SMART instrument which ties market interest rates to the past six-month average rate of treasury bills: the rate at which the government borrows, which has been kept artificially low by stopping bidding when the interest rate became high.

For these reasons, the main policy interest rate has been negative in real terms—less than inflation rates—since 2021, encouraging commercial banks to borrow and finance higher demand, discouraging savings, and raising the advance-deposit ratios. Thus, credit to commercial banks increased by nearly four times over FY2023, and even last November was nearly three times what it was a year ago.

The second problem is with money supply. On one hand, money supply growth, especially credit growth in the private sector, has been limited—likely negative in real terms—over the past year. On the other hand, the central bank has been indulging in the most inflationary of activities: financing government deficits. Since this lending requires new money—referred to as “printing money”—it is inherently inflationary. Bangladesh Bank nearly tripled its lending

to the government to [nearly Tk 98,000 crore](#) in the 2022-23 fiscal year. While the government has repaid some of this money over the previous six months, the stock of lending to the government as of last December was over twice what it was in June 2022.

Overall, the sharp rise in borrowing by commercial banks and by the government has meant that the velocity of money—how fast money changes hands—has markedly increased alongside a decrease in output or GDP growth. That is the only way to understand why inflation is creeping up despite low money supply growth.

So, what now? There are good reasons to be cautious and well prepared in the face of a floating exchange rate. One does not want to cause exchange rate overshooting and an inflation-depreciation spiral. But the exchange rate has to be floated, even if as a crawling peg at first. And caution should not turn into paralysis that increases uncertainty and erodes confidence.

Firstly, to dampen demand, the repo rate—the central bank’s policy interest rate—has to be increased to make it positive in real terms. Also, commercial banks’ lending rates have to be made market-based. If Bangladesh Bank insists on keeping rates in a corridor anchored to the SMART, it must stop interfering with the bidding and let treasury bill rates increase where demand meets supply. BB must signal its determination to fight inflation. Otherwise, inflationary expectations could run away, making the problem vastly more acute.

Second, to reduce the monetary overhang, Bangladesh Bank needs to continue to recover its government loan; let the government borrow from the market to repay this loan and finance its deficits. This will also help to set interest rates appropriately. It may be that the fiscal deficit and government spending must be squeezed more, but in a prioritised manner. Not, for example, by pressing down the woefully under-budgeted expenditures on repairs and maintenance, which already saw only four percent of its budget being spent in the first three months. These measures will cause pain, much as vaccine shots cause pain.

Third, along with implementing the measures above, the government needs to implement its plans to introduce a crawling exchange rate system that allows the exchange rate to float, albeit in a managed manner initially. There is no other option to stabilise the external account. However, and this is critical, the only way to make a crawling peg effective will be to

liberalise interest rates.

Finally, when the banking sector is already under stress in this time of uncertainty, it is essential to make a strong start on reforming the financial sector. As the central bank's recent Financial Stability Assessment Report stated, non-performing loans (NPLs) **comprised nearly half the assets of five banks**. Overall, NPLs amounted to Tk 156,000 crore in June last year, or over three percent of GDP. When loans are correctly classified, the situation will reveal itself to be far worse.

It will be difficult to finance Bangladesh's long-term growth without cleaning out the balance sheet of our financial sector. Left ignored, systemic risks may cause significant adverse shocks to the economy in the near term. On the other hand, thinking positively, banking reforms, as in the 1980s and 1990s, can pave the way to sustained future growth.

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