Lift interest rate cap, let monetary policy work

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By *Dr. Sadiq Ahmed*

Deft macroeconomic management over the past three decades has served Bangladesh well. Total export earnings, buoyed by a heady pace of growth in earnings from readymade garments, and foreign remittances, climbed to $ 81.4 billion in FY2022, rising from a mere $5.2 billion in FY1990. Imports boomed that supported rapid growth in GDP, investments, and exports. All this was possible without any pressure on the balance of payments (BoP).

The current account was either in surplus or in a small deficit that allowed external debt to grow only moderately while reserves expanded rapidly from $1.1 billion (3 months of imports) to a peak of $48 billion in August 2021 (8 months of FY2021 imports).

This comfortable BoP situation has come under pressure since September 2021, which has been accentuated since March 2022 following the Ukraine War and the associated heightening of global inflation. Despite record foreign exchange earnings, the value of imports surged due to global inflation, resulting in a record current account deficit in FY2022 ($18.7 billion).

Reserves fell rapidly and short-term debt accumulated. Reserves continued to decline in the first three months of FY2023, notwithstanding import controls. By the end of September 2022, reserves had fallen to $36.5 billion (4.7 months of projected FY2023 imports), an astounding loss of $11.5 billion in a 13-month period. Despite import controls that are threatening to hurt manufacturing growth and exports, there are no signs that the BoP pressure is easing.

With a short-term debt growing to $20.7 billion in June 2022 and continued BoP pressure, it is little comfort to see reserves dwindle at such a rapid pace. While the Ukraine war and global inflation are beyond the control of the Bangladesh policy-makers, Bangladesh can’t afford to see the BoP situation get out of control. There are no signs that the war or global inflation is going to end very soon.

On top, Europe has already entered into a recessionary phase and the US risks falling into one. An extended period of global stagflation could seriously hurt Bangladesh’s exports that would be a very unfortunate outcome.

Bangladesh does have a good track record of getting out of tight BoP situations as it did in FY2012 by using a judicious mix of foreign exchange, monetary and fiscal policies to reduce aggregate demand, lower the pressure on the exchange rate and stabilise the macroeconomy. So, there is hope this time also policy-makers will rise to the occasion. Unfortunately, however, the macroeconomic management over the past 12 months or so has failed to arrest the deteriorating situation. So far, policy-making has been either ineffective or gone in the wrong direction.

The government started well by announcing its intention to free up the exchange rate and protect the reserves. Unfortunately, the policy has remained more on paper. There was an initial correction of the over-valued Bangladesh currency, but its correction course was arrested as the Bangladesh Bank has continued to inject reserves into the exchange market to prevent further depreciation of the taka.

Additionally, the BB has adopted three exchange rates: one for exports, one for remittances and one for imports. These multiple currency practices are undermining the earlier BB announcement that it will implement market-based foreign exchange management. The heavy loss of reserves is the price paid by the BB to protect the over-valued exchange rate. This must stop to put the macroeconomy on a sustainable path.

Furthermore, the adoption of the 6/9 interest rate policy has severely handicapped the government's ability to reduce the demand pressure on the BoP and domestic inflation. The absurdity of this policy is indicated by the fact that domestic inflation now exceeds 9 per cent, whereas the maximum lending rate has been capped at 9 per cent, indicating that the real lending rate has now become negative.

It is obvious that at negative real borrowing rates, there will be excess demand for credit. Indeed, the private sector credit growth has surged in recent months approaching a 14 per cent annualised growth rate in September 2022 as compared with 8.4 per cent in FY 2021. So, instead of cutting credit growth to reduce demand, inflationary pressures have been magnified by credit acceleration, adding to the BoP pressure.

The required policy corrections are obvious. The exchange rate must be freed up truly with one uniform rate and no further injection of reserves that are already at a low level.

In order to moderate the depreciation of the exchange rate, the BB can intervene through a tightening of domestic credit by letting go of the 6/9 policy. It can monitor the progress of the required correction by using its normal monetary policy instruments such as the bank rate and open market operations. The opening up of the T-bills to the general public is a positive step that will strengthen the monetary policy. The BB must now move to eliminate the 6/9 policy and let monetary policy work.

The author is vice-chairman of Policy Research Institute of Bangladesh.

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