Monetary policy dilemma of Bangladesh Bank

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The Bangladesh Bank head office is seen in the capital's Motijheel area. The policy dilemma is likely to intensify in the coming months, complicating the central bank's monetary policy

management. Star/file

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As the covid-19 pandemic unfolded, central banks across the globe responded with a dramatic easing of monetary policy to provide liquidity support for the faltering economic activities.

Bangladesh Bank's (BBs) policy response was also similar, but measured in terms of scope and extent in line with the unfolding domestic economic conditions. The injection of liquidity, as part of the government's bank-led economic stimulus package, has been sizable and considered absolutely essential to avoid any liquidity crunch in the economy.

In the event, due to the ongoing surge in the officially measured inflow of workers' remittances and the decline in import payments associated with economic slowdown, the external current account of the balance of payments (BOP) recorded large surpluses and foreign exchange reserves of BB increased by more than $11 billion to more than $43 billion by end-December.

The strengthening of the BOP through the reserve buildup is a welcome development, although it is to a large extent an outcome of weak domestic demand and economic activity.

The implementation of the stimulus package led to injection of high-powered money into the economy in the form of BB's liquidity support (potentially up to Tk 60,000 crore). The inflows forced BB to intervene in the foreign exchange market to keep the exchange rate of the dollar against taka stable by preventing a significant appreciation of the taka in the interbank foreign exchange market.

The interventions in the interbank foreign exchange market and the counterparts of the large pandemic-induced foreign assistance to the government (about $2 billion) injected huge amounts of liquidity into the banking system.

The amount of high-powered money injected into the banking system through the reserve buildup has been in the range of Tk 80,000-90,000 crore. The combined liquidity injection

into the banking system from these two sources alone already amounted to about Tk 1.4-1.5 lakh crore.

This rapid liquidity injections have been happening at a time when the growth in private sector credit demand has decelerated to 8.2 per cent, the lowest level in the last one decade or more. Large corporates with strong financial standings are also borrowing from abroad at much cheaper rates and restructuring their liabilities by substituting domestic debt with foreign currency denominated debt at much cheaper interest rates.

Combined with the massive slowdown in credit to the private sector, the liquidity injection has contributed to a significant liquidity overhang. For most banks the advances to deposits ratios have come down well below the regulatory limit of BB.

The result is a collapse in the interest rate structure with deposit rates coming significantly below the inflation rate. The lending rates have also come down to levels not seen in several decades.

For good corporates, the current domestic borrowing rates are ranging between 5 per cent-7 per cent, well below the 9 per cent lending cap imposed by the government.

Against this background, BB's monetary policy committee will soon be reviewing the stance of monetary policy and make necessary adjustments for the coming months.

In this context, BB needs to understand: (i) what are "real sources" of the ongoing surge in workers' remittances; (ii) the state of the real economy preferably based on surveys of key economic sectors; (iii) possible implications of the excess liquidity for domestic consumer price index (CPI) and its spillover effects on the asset price inflation; and (iv) the outlook for the remittance inflows and domestic private sector credit demand in the coming months and their implications on the excess liquidity in the money market. The remainder of this paper focuses on these issues in order to draw some policy implications for the consideration of BB authorities.

UNDERSTANDING 'REAL SOURCES' OF REMITTANCE INFLOWS

Officially recorded inflows classified under workers remittances have increased by more than 40 per cent in the first half of FY21. This has happened at a time when the number of workers going abroad has declined by almost 75 per cent.

New workers going out of Bangladesh for work abroad has stopped after February 2020 and has not reopened as of now.

At the same time, because of the collapse in petroleum prices and the pandemic induced recession, most oil exporting gulf countries and some others have sent back 300,000-400,000 workers from those countries.

Income levels of workers in the gulf countries and in other parts of the world also might have declined, and there is no reason to expect that their income have gone up enabling them to send significantly more money to their families. There are other reasons like expatriates sending more money to their relatives adversely impacted by the pandemic (such as loss of jobs or illness) and to mitigate the impact of the flood and long rainy season on farm and nonfarm rural income.

Another factor which might have contributed to the surge was that hundreds of thousands of repatriating workers were sending their hard-earned savings prior to their return. Each of these factors might have played some role but none can explain the continued increase in inflows well after the return of workers and the end of the floods. Thus we need to look for other plausible factors such as: (i) expatriates are sending their financial savings to Bangladesh due to virtually zero returns on financial assets in many host countries; and (ii) people switching to more formal channel due to technological interventions like instant cash transfers through mobile financial service networks and attracted by the 2 per cent cash incentive provided by the government.

Both of these factors are sustainable over the next few years contributing to continued strong inflows, given the expected continuation of easy monetary policy in the industrial world.

STATE OF THE REAL ECONOMY AND OUTLOOK

All available economic indicators are pointing to continued weakness in the domestic

economic activity. In addition to subdued credit demand, demand for imports have declined and remains significantly below the 2019 level.

Tax collection remains very weak with the projected revenue shortfall of about Tk 80,000 crore in FY21. In particular, the growth in domestic VAT, which is directly linked with domestic economic activity increased by only 2 per cent in the first half of FY21, pointing to a decline in real terms.

Exports, which recovered somewhat during July and August, have once again declined due to the fall in orders from the EU and the USA as a result of the second coronavirus pandemic wave in the Western hemisphere. Overall, the growth outlook for FY21 is likely to be worse than in FY20.

POSSIBLE IMPLICATIONS OF EXCESS LIQUIDITY

Excess liquidity in the money market is generally manifested in commodity price and asset price inflation. Global liquidity expansion has already contributed to global commodity price inflation in the midst of economic recession.

Prices of food grains like rice (reaching 7-year high), wheat, corn and soybean are much higher than last year; same with construction materials and hydrocarbon products; industrial inputs like cotton increased significantly (28 per cent); and prices of construction materials like steel (32 per cent) have also increased sharply due to supply bottlenecks or shocks.

Commodity prices and industrial and construction raw materials in Bangladesh (such as edible oil, wheat, cotton, yarn, steel, etc.) are also rising significantly with rice prices at record high levels. Thus food inflation will remain high, although due to subdued wages and diminished capacity to spend for a large part of the population resulting from increased poverty and joblessness, non-food inflation will continue to remain moderate.

In this setting, the excess liquidity is likely to end up in asset price inflation, as recorded in most industrial countries and in India. In the USA and India stock prices are at already record high levels. In Bangladesh, the stock price index already increased by more than 50 per cent in the midst of the pandemic and further upward moves leading to another price bubble

cannot be ruled out if the excess liquidity remains high.

OUTLOOK FOR REMITTANCE INFLOWS AND DOMESTIC CREDIT DEMAND

The outlook for remittance inflows are likely to remain buoyant supported by the last two factors mentioned above. Given the continued weak import demand, foreign exchange reserves may approach $50 billion by the middle of 2021.

In order to prevent a significant appreciation of the taka, BB would most likely continue to buy dollars and in the process excess liquidity in the money market will increase further significantly.

What is the policy dilemma for BB?

Continued inflows in the form of remittances—be it portfolio investment or shift to the official channel—are not without negative implications.

While reserve buildup is desirable, the resulting liquidity expansion may create asset and commodity price inflations. Despite subdued private sector credit demand, broad money by end-December increased by 14.2 per cent and the corresponding reserve money growth was 21.2 per cent.

The situation is likely to get worse in the coming months, forcing BB to consider ways to contain reserve money growth. But the task may be complicated because any sterilisation operation will be financially costly with negative impact on BB's profitability which is already under pressure through virtually zero rate of return on foreign assets of BB.

Any sizable sterilisation operation may also trigger more capital inflows as returns on taka denominated financial assets are likely to increase.

Doing nothing may not also be an option, given the likely pressures on commodity and asset price inflation. It will also appear paradoxical that on the one hand the government will be giving cash incentive to promote foreign exchange inflows, on the other hand BB will be mopping up the resulting liquidity by issuing BB bonds and incurring significant costs in the

process. BB also cannot afford not to purchase foreign exchange because without such a sustained intervention the exchange rate of taka will appreciate against foreign currencies eroding further Bangladesh's export competitiveness.

This policy dilemma is likely to intensify in the coming months complicating BB's monetary policy management.

Getting out of this dilemma will require a strong rebound in investment and other components of domestic demand contributing to strong rebounds in private sector credit demand and import payments.

However, such rebounds may take time (particularly for investment and term loan disbursement) and, in the meantime, the best thing that the government can do is to stop paying the 2 per cent cash incentive to put a damper on inflows resulting from the interest rate differential in favour of taka assets.

Already there is enough interest rate spread between taka and dollar or yen assets for the carry trade to take place in an environment of stable exchange rate. There is no point in further encouraging currency carry trade by using public funds and thereby increasing future risks of sudden surge in outflows whenever the exchange risk will reemerge.

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