Monetary Policy Statement: A Review

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The latest Monetary Policy announced on 19 July, 2009 is the first policy statement by the new Bangladesh Bank Governor Dr. Atiur Rahman. The announcement of the policy is timely and well coordinated with the FY10 budget. We welcome the continuation of the relatively new Bangladesh Bank (BB) practice of announcing the monetary policy stance at half-yearly intervals. The announcement of monetary policy has become an established tradition of the industrial country central banks, and it is good to see BB belonging to this distinguished camp. This provides us the opportunity to objectively analyze BB's view of the evolving economic outlook and the appropriateness of its policy response.

The new monetary policy covered most the important macro and monetary topics. The main objectives of the new monetary policy, particularly with regard to economic growth and inflation, have been closely coordinated with the objectives set out in the FY10 budget. The growth rate of broad money (M2) has been set at 15.5%, which appears to be broadly consistent with the real gross domestic product (GDP) growth objective of 6.0 per cent and inflation target of 6.5 per cent after allowing for further monetization of the economy. While endorsing the overall monetary target set in the Statement, a careful review of monetary policy statement however raises a number of important issues which are discussed below.

Inflation: Inflation is traditionally the central focus of any central bank monetary policy statement. The manner in which the important issue of inflation has been covered in the BB statement however gives the appearance of a sense of complacency with the regard to inflation. The Statement rightly notes that inflation in Bangladesh has been on an upward trajectory, compared with the IMF's World Economic Outlook (WEO) forecast of one per cent decline in consumer prices in emerging and developing economies. It however does not even attempt to provide any explanation for the recent upward trend in inflation in Bangladesh and does not provide assurance to the observers like us how Bangladesh Bank intends to tackle the emerging inflationary pressures in the economy and the factors behind such pressures.

Inflationary pressures in an economy do not emerge in one day. It builds up slowly and there are signs of that if we want to look for those. Food price is always volatile and Bangladesh is no exception; we have seen that in the past. That is the reason most central banks rely on an alternative measure called “core inflation”, which in most cases is the inflation excluding price developments in food and energy which are volatile, prone to supply shocks and beyond the control of monetary policy. The closest approximation of core inflation in Bangladesh is “non-food inflation.” This non-food inflation, as shown in Table 1 of the Statement, reached its bottom in December 2008 at 4.76% and since then has been increasing steadily to reach 6.49% by May 2009. With commodity prices once again on an upward trend, external environment may not be much favourable in the coming months and BB may have to take a much more proactive role in this regard in the coming months.

The inflationary pressure that we are observing is not unexpected given the liquidity expansion that has already taken place in the economy. The main cause of the rise in core inflation, in our view, is excess liquidity in the system due to exorbitant growth (i.e. 31 per cent in FY09) of reserve money (also called high-powered money). This is largely the result of the rapid buildup of net foreign assets (NFA) due to continued large remittance inflows and the decline in import payments in recent months. We do not think that Bangladesh Bank has made any strong attempt to sterilize the liquidity impact of the reserve buildup and the consequent liquidity expansion is certainly creating pressures somewhere; the building up of inflationary pressures in asset markets (stock market and real estate) and in nonfood prices is probably the manifestation of such pressures. Because of these considerations, the issue of inflation and BB’s policy response should have deserved much more attention in the Statement in the form of careful analysis and providing clear indications about its plan in this regard.

Monetary Programme Targets/Aggregates: The key monetary aggregates shown in Table 2 need better rationalization. We fail to understand why net foreign assets (NFA) of the banking system will become negative in FY10, while it has been growing at high double-digit rates in recent years and estimated to have grown by almost 24 per cent in FY09. This envisaged reduction in the NFA is predicated upon a projected decline in foreign reserves by about half a billion US dollars in FY10 compared with the level recorded for FY09.

Such an assumption is however inconsistent with the current declining trend in import payments and the outlook for workers' remittances and export receipts. Import growth has been negative during the last few months and is expected to remain negative in the first half of FY10 based on the import LC opening data. Despite some slowdown due to the impact of global economic meltdown, exports and remittances are expected to grow at moderate rates, as we have seen in recent months. Projections made by Policy Research Institute point to a further significant increase in foreign reserves in FY10 due to continued sizable external current account surplus and positive overall balance of the balance of payments. Foreign reserves have increased by more than $1.5 billion in the last quarter and we would expect a similar outcome in the next six months, exceeding the $8.0 billion level by end-2009. Under these circumstances, it would be a major challenge for BB to contain M2 (broad money) growth at 15.5% as envisaged in the Statement. Bangladesh Bank authorities certainly are aware that excessive M2 expansion would put further pressure on the inflation rate, thereby undermining the inflation objective of the Government.

Crowding-Out of Private Sector Credit: The issue of crowding out of private sector credit did not get much attention in the Statement despite the deep concern expressed by the business community in the aftermath of the budget announcement. Because BB monetary projection assumes a significant decline in foreign reserves, it can accommodate a respectable growth in private sector credit (16.7%). In the event of the likely scenario that the NFA (which is a part of M2) increases by about 20% as happened in FY09, the limit on M2 growth of 15.5% would constrain the scope for credit expansion to the private sector. Assuming that the fiscal targets (i.e. revenue and expenditure) of the budget are attained, the above scenario of monetary aggregates would certainly crowd out the private sector if BB intends to adhere to its M2 target (as shown under the PRI scenario in Table 3). It is somewhat interesting to note that, in tune with the critiques of the high ADP spending target in the budget, BB in the monetary policy statement suggests that "because every year the initial budgetary public expenditure programmes underwent subsequent substantial downsizing, requiring lower actual bank borrowing than the initial projections, government bank borrowing projected in the budget will not crowd out private sector borrowing needs”. However, such a suggestion directly goes against the much needed expansionary fiscal policy stance adopted in the FY10 budget. Would it rather not be appropriate for BB to urge the government to implement its development plan expeditiously and also intensify government efforts to mobilize larger amounts of foreign assistance in the form of budget support to help reduce government borrowing and release more resources for private sector credit expansion?

Establishing Ceilings for Lending Rates: We all agree with BB assessment that the prevailing high lending rates in Bangladesh are discouraging domestic investment. Lending rates thus need to come down to accelerate growth and employment through higher investment. However, in order to reach its goal of lowering the lending rate structure by overcoming the “downward stickiness of lending interest rates”, BB has prescribed “ceilings on lending interest rates… for borrowers in priority economic sectors”. This measure is generally believed to be counterproductive and hopefully does not signal a permanent shift away from market-based financial intermediation. Administered interest rate is a thing of the past and no modern central bank adopts this approach as a vehicle to achieve its objectives under normal economic conditions. The superiority and efficiency of market-based interest rate structure are well established in economic literature do not warrant any further elaboration. We hope the practice of administered ceiling is temporary and will not be expanded or extended further. If this ceiling continues for a long time, the “priority economic sectors” (the target group) will soon be starved off credit as banks will divert credit to so called non-priority sectors to earn higher interest income. Since this “cat and mouse game” between BB and commercial banks would be never ending, it is best that this practice is stopped.

BB needs to take a comprehensive strategy to bring about a gradual reduction of the interest rate structure. Lending rates structure is directly related to costs of fund, savings behaviour of the economy, linkages with the international capital market and the rates of return on investment in the domestic economy. How will the banks mobilize savings for longer term lending at 11 per cent to the priority sectors without creating a mismatch between assets and liabilities (in terms of maturity structure) when national savings schemes are offering 12.5% interest for three and five year deposits? Should not BB be talking about that? BB should also look into the issue of allowing banks and large private corporations to borrow from abroad at cheaper rates, which has become one of the cheap sources of fund for large Indian companies. If there are monopolistic/collusive practices by banks, identify and introduce sanctions against such practices. There are many other things that can be done to improve financial intermediation. There is no silver bullet and no single step can do the job instantaneously. The authorities would need to deepen the financial market over time and improve market efficiency to achieve the ultimate objective. Any short-cut will reverse the gains already made in Bangladesh and would inflict more damage to the financial system. In this regard, we welcome the new initiative for obtaining a sovereign credit rating for Bangladesh, which will facilitate borrowing abroad by the private sector on more favorable terms. (The writer is Executive Director, Policy Research Institute of Bangladesh)