



## Monetary Policy Statement: An Appraisal

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Bangladesh Bank (BB) has recently issued its latest Monetary Policy Statement (MPS) for the period July-December 2015. This MPS has been described as a continuation of policies embodied in previous MPS'. BB has moved to a restrained monetary policy since FY12 in the aftermath of an impending Balance of Payment (BOP) crisis and a significantly higher inflationary environment.

We all know that the easy monetary policy stance, adopted by the BB since FY10, which at that time it termed as an “accommodative monetary policy” also led to double digit inflation, stock market bubble formation and its bursting in the FY11, and sharp increases in land and property prices. The shift in monetary policy stance since FY13 has helped restore price stability as inflation has been brought down to less than 6.5% and led to corrections in asset prices in general, both in nominal and real terms.

Against this backdrop, the continuation of prevailing policy stance is certainly commendable. The quantitative targets such as expansions of broad money (15.6%) and credit to the private sector (15.0%) for FY16 appear consistent with the GDP growth target of 7.0% and inflation target of 6.2%. The analysis presented in the MPS regarding non-food (core) and food inflation is appropriate given that non-food inflation is trending upwards and has

reached 6.74% in June 2015. The BB's position that this jump in the core inflation at present warrants "a cautious stance" is admirable.

In the MPS, BB also underscored the importance of supporting and boosting private sector investment consistent with targeted growth rate of 7.0% growth rate. Certainly, BB's effort to support export growth through an expanded Export Development Fund (EDF) amounting \$2.0 billion, and establishing a sizable fund for foreign currency financing of investment in environmentally sustainable projects in the textile and leather processing sectors are steps in the right direction to promote investment.

These efforts notwithstanding, it is widely known that engendering private sector investment requires much more than what could be supported through the monetary policy. In particular, it is generally accepted that private investment in Bangladesh is constrained by infrastructure deficiencies and general political and governance issues. While monetary policy in general cannot influence these major issues which lie beyond its domain, it certainly does have an important role in promoting investment by lowering the borrowing rates.

Lowering lending rates to single digit levels, as demanded by private sector investors and business community in general, is not unreasonable but certainly cannot be delivered over the short term. Reduction of lending interest rates to single-digit level will require bringing down the inflation rate further to perhaps 3.0-4.0% level and reduction of the spread between the deposit and lending rates to 3.5-4.0% from the current level of about 5.0%. The average lending interest rate in China, at 5.6% in FY14, was substantially lower than that of Bangladesh, at 12%-13.0%. The lower Chinese borrowing rate can be attributed to the low inflation (about 2.0%) and low interest rate spread (less than 3.0%) in the Chinese economy.

The argument that higher growth requires higher inflation (the old "Phillips Curve" argument) should not be used to justify higher inflation in Bangladesh which is well above its trading partners. Higher inflation in Bangladesh results in a case of perverse taxation that harms the poor and thus contributes to social inequality, leads to real exchange rate appreciation eroding the country's competitiveness, and contributes to rapid asset price increases making the poor poorer (as they do not have much asset holding). Bangladesh needs to move out of the mindset that 6.0-7.0% inflation is necessary for growth rate of 7.0% or higher. It needs to be more aggressive on the inflation objective like the Reserve Bank of India (no more than

4.0% inflation in two years time) under the leadership of Dr. Raghuram Rajan.

BB's view that inflation need not be lowered and may even have to be upped (as implied in the MPS) is contrary to the Chinese experience. The Chinese experience certainly does not indicate that an "inflation of 7.0 or 8.0% is necessary to absorb speeding up of employment, output and wages growth", as stated in the MPS. If such is the monetary policy stance, then Bangladesh's quest for single lending rate will be futile. Double digit lending rates in such a situation is a natural outcome and Bangladesh has long been successful in achieving this feat despite the bad governance and inefficient management in the financial sector.

While we agree with the analysis of the developments in inflation presented in the MPS and the caution expressed therein, we fail to agree with the forward expectation on inflation as stated in the MPS (quoted above) and believe that this tolerance for high inflation is unsuitable for an "inclusive" growth augmenting policy.



With regard to forecasting of key monetary aggregates, which underpins the monetary programme, BB needs to be more realistic and accept the ground reality. As can be seen in the Chart 1, for May 2015, the public sector credit growth was originally projected to be 25.3% while the actual growth was negative 2.7%. Similar discrepancies are also observed in the forecasts for the Net Foreign Assets (NFA), with previous projected growth rates for NFA being much lower than the actual outcomes. These observation points to the fact that BB's forecasting was substantially off in certain key areas and it should revisit its quantitative framework and take better cognizance of the policies that are in place at the time of preparing the quantitative exercise.



These very large discrepancies between the actual and projected outcomes in key monetary aggregates raise questions about the quality of financial programming exercises underpinning the monetary policy. Based on past experience, we are apprehensive that the actual and projected outcomes in this MPS-particularly with respect to NFA and government borrowing-will also continue to be very different. For example, even as outsiders we can

convincingly argue that given the relatively higher interest rates offered by National Savings Schemes (NSS), the level of non-bank financing will continue to be very high as it was in FY15, and net borrowing by the government from the banking system may very well be negative once again if the government policy with regard to national savings instruments continues as it is now. Similarly, the increase in the NFA will be much higher than the growth rate programmed in the MPS, in part because of continued strong inflow of foreign assets induced by the significantly high interest rates offered on taka assets. Overall, we would like to see a better exercise that reflects outcomes closer to reality.

The MPS should have also warned that the widening interest rate differential between the banking system deposits and NSS instruments will also pose a serious challenge for monetary management and to the health of the banking sector. In FY15, due to high rate of purchase of NSS instruments, deposit growth in the banking system was limited to only 12%. Despite the reduction in NSS interest rates by 2.0 percentage points in May 2015, the spread between the NSS instrument and bank deposit rates is still very wide and non-bank financing through NSS is continuing at the rate of Tk. 25 billion per month which is considerably in excess of the budgeted monthly inflow.

If the NSS interest rate structure remains as it is, the deposit growth in the banking system will be very low, constraining credit expansion by commercial banks. The Treasury bill market will also dry up, undermining bond market development. Based on these considerations, BB should have made a louder plea for further reduction in NSS rates in the MPS by linking it to T-bill rates of similar maturities. While that was not done, BB and the Ministry of Finance should still work together to bring about the required reduction in the NSS interest rates by overcoming the associated political challenges.

In conclusion, we believe that, despite some deficiencies in the quantitative framework, the latest MPS contains valuable insight into monetary policy stance of the BB for the coming months. BB's cautious monetary policy aimed at supporting 7.0% growth and 6.2% inflation target is appreciable. However, the cavalier attitude towards high inflation in Bangladesh in future is unwarranted and counterproductive. BB should also take steps to boost deposit growth of the banking system and thereby create the base for private sector credit expansion in a sustainable manner by working closely with the Ministry of Finance. The observations made above are in line with BB's core objective of a supportive monetary policy which

promotes investment, price stability, and inclusive and sustainable growth at much higher rates.