

Promoting Growth with Stability: Challenges for the Current Monetary Policy Stance

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Highlights of Monetary Policy Statement (MPS) H1 FY10

- **Target growth of Broad Money (M2) of 15.5% deemed consistent with projected GDP growth (6.0%) and inflation (6.5%)**
- **Target growth of Reserve Money (RM) of 3.5%**
- **Growth projection for sources of RM**
- **Requirements under CRR and SLR unchanged and bias to have a lower interest rate regime**

Highlights of MPS (contd.)

- **Interest rate on repo and reverse repo remains at current levels**
- **Suspension of reverse repo operation continues**
- **Current exchange rate policy of maintaining export competitiveness and incentive for remittance inflow continues**
- **Non-sterilization of Taka liquidity from foreign exchange purchase continues**

Highlights of MPS (contd.)

- **Thrust on providing ample Taka liquidity, ensuring comfortable Dollar availability, and maintaining market environment conducive to adequate credit flow to productive sectors**
- **The overhang of Taka liquidity in the money market to be drawn down through growth of credit to public and private sectors**
- **Credit to public sector not to crowd out private investment**

Highlights of MPS (contd.)

- **Commitment to utilize foreign exchange inflow in growth supportive investment rather than in accretion of higher reserves**
- **Reiteration of the need to maintain ceilings on interest rate and service charges**
- **Renewed emphasis on directing credit to priority sectors typically underserved by market**

Highlights of MPS (contd.)

- **Commitment to instill competitive loan pricing practices in market**
- **Commitment to strengthen financial sector oversight**
- **Steps towards obtaining sovereign credit rating for Bangladesh to facilitate borrowing abroad by private sector**

General observations

- **BB practice of announcing half-yearly monetary policy stance: a tradition that brings transparency in policy decisions and its underlying process facilitating stakeholders to understand and anticipate policy**
- **A number of concerns need attention, otherwise MPS may remain a sterile document**
- **First, MPS needs to be backed by rigorous research and exchange of views with experts to ensure credibility and guide expectations of private agents in a consistent manner**

General observations (contd.)

- **Second, the MPS should make explicit the underlying framework used for target setting and adopting policy stance**
- **MPS does not provide any basis for projecting monetary aggregates except for equation of exchange linking growth of M2 with GDP growth, rate of inflation, and income velocity of money**
- **MPS sets growth of RM (operating target) deemed consistent with targeted inflation presuming RM growth leads to M2 growth (intermediate target) consistent with target inflation and adequate liquidity**

General observations (contd.)

- **Monetary program should consider (i) strength of relationship between M2 growth and inflation and (ii) weakening tendency in link between RM and M2 as financial sector develops with diverse array of financial assets**
- **Third, MPS should provide alternative and plausible scenarios of economic outlook and spell out appropriate policy responses**

General observations (contd.)

- **MPS should have outlined, for example, BB's response to potential escalation of inflation in FY10**
- **Finally, MPS should be more comprehensive in coverage bringing within its purview important components of financial sector such as micro-finance.**

Target Growth of RM and Sources

- **Net foreign assets (NFA) to grow by -4.1% in FY10 due to 'reserve drawdown for import of investment and consumption goods abating inflationary concerns by using up the liquidity overhang in Taka money market'.**
- **No projection of growth in exports and remittances but cautions that if 'the recession prolongs export growth may not be sustained and workers' remittance inflows may also weaken'. Also expresses optimism that current positive pace of global recovery will continue.**

Table 1: Growth Trends in NFA, Imports, Exports and Remittances

Year	NFA growth (%)	Import growth (%)	Export growth (%)	Remittance growth (%)
2001-02	47.6	-8.5	-7.4	33.0
2002-03	60.6	13.1	9.4	22.3
2003-04	14.5	12.9	16.1	10.2
2004-05	8.3	20.6	13.8	14.1
2005-06	26.5	12.2	21.6	24.8
2006-07	52.9	16.4	15.7	24.5
2007-08	14.8	26.1	15.9	32.4
2008-09	24.0	4.1	10.3	22.3

Target Growth of RM and Sources (contd.)

- **Since 2001-02, growth of NFA quite robust every year even with varying growth in imports, remittances, and exports**
- **In 2004-05, when remittances and export growth were at modest level of 14% but import growth was high at 20%, NFA grew at 8.3%**
- **Even with a substantial recovery in imports and some slowing down in exports and remittances, negative growth in NFA in FY10 is unlikely.**

Target Growth of RM and Sources (contd.)

- **In the event of a less than expected recovery in imports, projected growth of NFA will be more since MPS mentions continuation of policy of mopping up excess foreign exchange by BB to retain export competitiveness**
- **If growth of NFA in FY10 is significantly positive, growth of RM will be higher than target with continuation of current policy with regard to reverse repo and sterilization**

Sterilize or Not to Sterilize: Trade off between Inflation and Crowding Out

- **BB suspended reverse repo operation and left unsterilized Taka liquidity from its foreign exchange purchase in Q4 FY09 'to keep domestic borrowing conditions easy in the recessionary global environment'.**
- **With downward stickiness of lending rates, credit demand remained sluggish and non-sterilization and suspension of reverse repo contributed to glut of Taka liquidity and raised growth of RM to a staggering 31% in FY09.**

Sterilize or Not to Sterilize (contd.)

- **Ample liquidity should have raised competitive pressure on banks to reduce lending rates since last MPS. This has not happened**
- **With expected significant positive growth in NFA, RM and M2 will overshoot target in FY10 if policy of non-sterilization continues.**
- **As non-sterilization could not lower lending rates, reverse repo operation should be reactivated to ward off higher than target growth in M2 and consequent risk of higher inflation.**

Sterilize or Not to Sterilize (contd.)

- The emerging upward trend in non-food inflation is largely due to existing liquidity overhang.
- If private sector credit demand does not register expected increase, the risk of crowding out private investment due to envisaged rise in credit to public sector in FY10 will be low.
- If private sector credit demand rises as visualized in MPS, then reduced Taka liquidity due to sterilization will run the risk of crowding out private investment due to programmed credit to public sector

Sterilize or Not to Sterilize: (contd.)

- **MPS accommodates target private sector credit growth (16.7%) assuming significant decline in reserves, but if NFA rises at historical rates then M2 growth target (15.5%) would constrain private sector credit expansion with fiscal targets of FY10 budget.**
- **If import demand picks up significantly with BB purchasing little foreign exchange from market, then growth of NFA may not be too high. In that case, BB may consider lowering CRR and SLR to 2006 levels to avoid major crowding out effects due to projected lending to public sector**

Sterilize or Not to Sterilize: (contd.)

- **Credit policy needs to balance risks between current growth and inflation. Lead economy to high growth path while caring about potential buildup of inflationary pressure**
- **Inflation target of 6.5%. Not something unexpected in market. Market would more likely to shift focus to government borrowing program**

Foreign Exchange Reserves to Support Investment

- MPS indicates readiness of BB to use foreign exchange reserves to support investment
- It is not clear what will be the modality of such support measures, how large is its scope, and what are potential risks

Foreign Exchange Reserve to Support Investment (contd.)

- One possible mode could be for BB to sell foreign exchange in the inter-bank market to keep exchange rate stable in the face of increased import demand
- But this type of market intervention is nothing new for BB and in making the intervention BB has to make a judicious balance between the interests of importers and exporters

Foreign Exchange Reserve to Support Investment (contd.)

- **The other possible mode could be to use reserves for refinancing foreign currency credit operations of banks for investment financing**
- **Given that reserves of BB rarely exceed three months' import requirements, hardly much scope for using reserves for investments involving long gestation periods and risks**

Ceiling on Interest Rate

- **Despite huge overhang of Taka liquidity banks have consistently shown their tendency not to lower their lending rates**
- **BB imposed ceilings on lending rates in priority sectors**
- **This has not led to perceptible reduction in interest rate spread. Most banks have reduced deposit rates leaving the high interest rate spread unchanged. Challenge for BB is to bring down the spread**

Ceiling on Interest Rate (contd.)

- Evidence shows that imposition of ceiling has not led to any significant improvement in excess liquidity situation, rather the situation appears to have worsened.
- Past experience with administered interest rate shows that it usually leads to adverse selection depriving deserving sectors/individuals from access to credit

Ceiling on Interest Rate (contd.)

- **Since lack of competition in retail banking causes downward stickiness in lending rates, the policy stance of BB to instill competitive loan pricing practices and obtain sovereign credit rating for Bangladesh to facilitate borrowing abroad by private sector are steps in right direction. BB needs to spell out operational framework for implementation of these measures.**
- **Other factors for improving the situation with regard to lending rates include (i) reduction of interest rates on savings instruments of the government, (ii) raising efficiency of the SCBs, (iii) strengthening the equity market, and (iv) reducing the burden of bad loan.**

Conclusions

- **Despite uncertain macroeconomic scenario, fiscal/monetary stimulus measures expected to supplement domestic demand in FY10**
- **On balance, upturn in growth likely from mid FY10**
- **Risks to BB projections of GDP growth and inflation for FY10 are on the upside**
- **Price pressures from supply side may somewhat be mitigated by comfortable food grains stock, but BB should closely monitor level of liquidity to contain inflationary pressures if supply side pressure rises**

Thank you