



Bangladesh Bank's Monetary Policy Statement : Some Observations

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I. Introduction

Observations on Monetary Policy Statement (MPS) Will Focus on the Following Areas:

- ❑ The macroeconomic setting against which the MPS has been issued by this Bangladesh Bank (BB);
- ❑ Monetary policy complications arising from this macroeconomic environment.
- ❑ Can Bangladesh Bank (BB) set a monetary target if it is targeting the exchange rate?
- ❑ Some other important specific issues regarding the MPS.



II. The Macroeconomic Setting and Monetary Challenges

- ❑ Slower domestic activity, particularly in the first half of FY10.
- ❑ Larger current account surplus due to slower imports and buoyant remittance inflows.
- ❑ Excess liquidity in the banking system, due to slower private sector credit demand and also reflecting the sharp increase in net foreign assets (NFA) of the banking system.
- ❑ Inflationary situation is benign, but may not stay that way if reserve money expansion remains unchecked.

The Balance of Payments Outlook Remains Very Strong

Table 1. Balance of Payments

Balance Of Payments(US\$ million)				
Items	Balance of Payments for FY08	Balance of Payments for FY 09(Jul-May)	Balance of Payments for FY 09(est.)	Balance of Payments for FY10*
Trade balance	-5541	-4698	-4906	-5552
Merchandise export	13945	14190	15542	16940
(Growth (%))	15.8	11.7	11.5	9
Merchandise import	-19486	-18888	-20448	-22492
(Growth (%))	26.1	7.7	4.9	10
Current Account Balance	672	1809	2275	2203
(% of GDP)	0.8	2.0	2.5	2.2
Capital Account (net)	576	409	460	450
Financial Account	-431	-691	-490	-245
Errors and omissions	-213	-134	-270	-350
Overall Balance	604	1393	1975	2058

*Projected

□ It poses a new type of challenge for monetary management in Bangladesh, not experienced before.



Excess liquidity in the Banking System has made the Interbank Market Dysfunctional

- ❑ Overnight rates have collapsed and now ranging between 0.1%-.0.3% over a prolong period.
- ❑ BB interventions to mop up the excess liquidity have been delayed and the efforts of recent days have been very limited.
- ❑ There is real risk that much of the liquidity will spill into the stock market and real estate and encourage financial institutions to engage in other speculative off balance sheet activities.
- ❑ Such developments may potentially creating other major problems for the economy and for the viability of those institutions down the line.
- ❑ The recent bailing out of banks in the FSU countries and Nigeria are some such examples.

III. Adequacy of Policy Response Through the MPS

- ❑ The MPS rightly takes note of some of these developments in section 2 on macroeconomic outcome and outlook.

- ❑ However, the MPS makes a strange argument that since both the overnight and treasury bill rates plummeted and “banks displayed no enthusiasm for corresponding decline in their lending rates, Bangladesh Bank addressed this downward stickiness of lending rates by prescribing ceilings on lending interest rates....”

- ❑ While the MPS mentions about numerous refinance schemes, it fails to recognize how much further liquidity BB has been injecting through its various refinance/discount facilities and the associated quasi-fiscal costs.

Does the MP Framework Pass the Reality Check?

- ❑ Based on the BOP projections, the NFA of the banking system is expected to increase by \$2 billion or 30.9 percent in FY10.
- ❑ Already foreign exchange reserves have increased by \$0.75 billion since end-June; and compared with January 2009, the increase in foreign exchange reserves of BB was about \$2.6 billion.
- ❑ In contrast, the monetary program underpinning the MPS, envisages a reduction of the NFA by \$0.5 billion in FY10.
- ❑ Past history of NFA growth in Bangladesh also cannot be reconciled with this envisaged reduction in the NFA in the MPS.

What is the Likely Scenario?

- ❑ As shown in the BOP projection earlier, the overall BOP surplus will be about \$2 billion in FY10.
- ❑ The corresponding increase in the NFA would be about the same, assuming no major shift in the asset and liability positions of BB.
- ❑ In that situation, the Monetary Program with the targeted 15.5% M2 expansion would be like:

Table 2. Bangladesh: Monetary Survey, 2008-10 (Growth Rates)

Components	Jun-08	May-09	June 2009, BB MPS	4- Year Average	FY10 BB MPS	FY10 PRI Projection	FY10 Scenario with 16.7% growth in private sector credit
1. NET FOREIGN ASSETS	14.5	27.1	23.9	20.2	-4.1	30.9	30.9
(a) BANGLADESH BANK	13.3	31.7		22.1			
(b) DEPOSIT MONEY BANKS	24.9	-3.1		8.1			
2. NET DOMESTIC ASSETS	18.2	17.2	16.0	18.2	19.3	12.6	19.7
A. DOMESTIC CREDIT (a+b+c)	21.2	17.2	17.1	19.1	18.7	12.9	18.9
Claims on Public Sector (a+b)	10.0	17.7	24.5	20.3	25.3	25.4	25.4
a.Claims on Govt.(net)	30.4	24.7	26.2	24.2	29.6	29.6	29.6
b.Claims on Other Public	-32.2	-5.3	15.4	11.7	0.0	9.8	9.8
c.Claims on Private Sector	25.2	17.1	15.0	18.9	16.7	8.6	16.7
B. NET OTHER ASSETS	42.7	17.6	24.7	27.3	15.4	14.4	14.4
3. BROAD MONEY(1+2)	17.6	18.6	17.2	18.2	15.5	15.5	21.5

Implications and Policy Trade-offs Underpinning the Likely Monetary Outlook

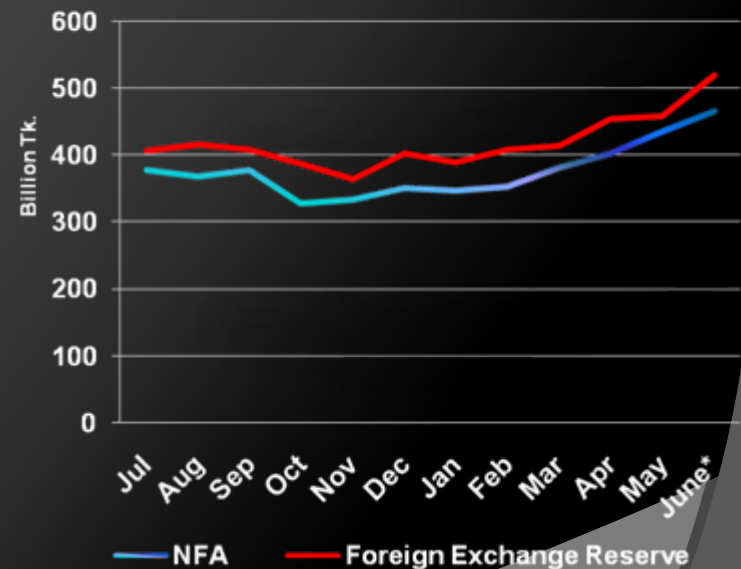
- ❑ Certainly private sector credit cannot be limited to 8.6 percent, it has never happened and it should not happen in that way.
- ❑ Government's current policy with respect to loss making public enterprises does not go well with assumption of no net borrowing by the public entities from the banking system. We do not know how big the amount of borrowing will be, but certainly it will not be zero as envisaged in the MPS.
- ❑ If the credit target for the private sector is to be realized, as it should be, the expansion of broad money would probably increase to 21.5% compared with 15.5% targeted under the program.

We May also Pose the Question Whether BB Can and Does Have a Monetary Target At All?

□ We all know BB is targeting the exchange rate stability, which probably it should do since the exchange rate would otherwise appreciate significantly hurting the exporters.

□ As BB buys foreign exchange from the interbank market in support of this policy, foreign assets of BB go up (Figure 1) and so does the reserve money expansion, unless mopped up by BB.

Figure 1: NFA and Foreign Exchange Reserve in FY09





We May also Pose the Question Whether BB Can and Does Have a Monetary Target At All? ...Cont'd

- ❑ It is therefore no surprise that with the rapid buildup in foreign reserves in recent months, reserve money expanded by more than 30% in FY09, a pace certainly not consistent with the inflation objective.
- ❑ Since targeting money supply would entail limiting growth of reserve money or the Net Domestic Assets (NDA) of BB, the task will be challenging (if not impossible) and will require mopping up of excess liquidity as part of very active monetary management through open market operations.

What does the MPS say about these issues?

- ❑ The MPS essentially tries to bypass these issues.
- ❑ On crowding out, It simply brushes off the issue of potential crowding out of private sector credit by the public sector, which the Chambers and Federations are so concerned about in the aftermath of the budget announcement.
- ❑ The MPS simply states that because every year public expenditure program underwent substantial downsizing, requiring lower actual bank borrowing, government bank borrowing will not crowd out private sector borrowing needs.
- ❑ Certainly, such a suggestion goes against the much needed expansionary fiscal policy stance adopted in the FY10 budget.
- ❑ Would it not be inappropriate for BB to urge the government to implement its development plan expeditiously and intensify its efforts to mobilize larger amounts of external budget support to help release resources for private sector credit?

What does the MPS say about these issues?...Cont'd

- ❑ On liquidity management, the MPS is almost mute.
- ❑ Certainly the task is urgent with the growing risk of excess liquidity flowing into undesirable activities.
- ❑ Although belatedly, BB has recently announced the intention to engage in mopping up of excess liquidity. But so far, based on press reports, only Tk. 7 billion has been withdrawn from the money market.
- ❑ The overnight rates are still 0.1%-0.3%, well below the treasury-bill rates, and do not indicate any serious effort toward absorption of excess liquidity by the BB.

What is the Downside Risk that Monetary Management May Become More Difficult?

- ❑ Such an outcome is unlikely, but may happen if capital inflows continue at the pace observed in recent weeks.
- ❑ We may be looking at an NFA increase of \$5 billion in FY10:
 - Foreign exchange reserves have been increasing by \$100 million or so every week; and
 - if that pace continues or accelerates due to continued lower import demand or transfer of savings by expatriate workers in response to higher return on assets in Bangladesh.
- ❑ Is BB ready for such a positive external inflow? If so how, will it manage the resulting surge in monetary base?
- ❑ Will it give up the inflation objective or engage in a massive sterilization program with high quasi-fiscal cost?

What is the Downside Risk that Monetary Management May Become More Difficult?...cont'd

- ❑ Sustainability of the current de facto pegged regime may also be questioned if the current pace of inflows continues.
- ❑ BB foreign reserves should reach \$10-11 billion within the next couple of months after taking into account the disbursement under the ADB Counter Cyclical Facility and budget support (\$740 million) and the SDR allocation of the IMF.
- ❑ With such an unprecedented level of foreign reserves, any major appreciation of the Taka against the dollar may easily wipe out BB's capital and income base. (China syndrome to a limited extent).

What is the Policy Package for BB Under These Circumstances?

- Engage vigorously in mopping up the excess liquidity and not be too concerned about the sterilization cost. The overnight rate must not stay below 1% level and reserve money expansion should come back to normal levels. The eventual cost otherwise will be too high.

- Support the expansionary fiscal stance adopted in the budget, and avoid the potential crowding out issue through mechanisms like additional budget support from the ADB and World Bank.

- Once the export situation improves with better external market outlook, allow the exchange rate to be more market based (if inflows continue) even if it entails some appreciation of the Taka.



What is the Policy Package for BB Under These Circumstances?...Cont'd

- ❑ The issue of high lending rates should be addressed through financial sector reforms (including rationalization of NSS interest rates), and moving away from interest rate ceilings in lending to priority sectors.
- ❑ The ceilings may over time divert credit away from the priority sectors, undermining the original objective.
- ❑ Overall, BB should focus more on its core mandate of maintaining price stability (including asset prices) through proactive management of monetary base and move away from distortionary micro interventions.