Monetary Policy Statement (January-June, FY 2016-17): A Rapid Assessment

Bangladesh Economic Update

January 2017

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1. Introduction

The current issue of the Bangladesh Economic Update focuses on the recently announced half-yearly Monetary Policy Statement (MPS) for the period of January-June of FY 2016-17 by the central Bank, Bangladesh Bank (BB). The Update examines the current MPS in the background of two major economic issues affecting the growth of the economy – sluggishness in private investment and crisis in banking sector due to increase in default loan. The Update reveals that declining growth in private sector credit resulting in stagnant private investment and consequential unemployment especially of youth is likely to challenge the efficacy of current monetary policy strategies. It is, however, cautioned that without increasing the quality, mere growth in private sector credit by the targeted level – 16.5% for the second half of the current fiscal year – may prove inefficacious in boosting private investment and achieving the target of growth in gross domestic product (GDP).

Following the inflation-GDP trade off rule, BB has been adopting monetary policy for several periods to keep the inflation level low in order to fasten growth of GDP. Many argue that consecutive tight monetary policies of BB remain successful in cutting inflation as recently the inflation is on downward trajectory. In Bangladesh, inflation is, however, more related to the cost of production than to monetary variables.

A strong financial system is needed for successful implementation of monetary policy. The running crisis in the banking sector due mainly to increase in default loan reflects the institutional weakness in financial system in the country. Banking sector gets caught in trap characterised by increased default loan, low credit growth in private sector, poor risk management, excess liquidity, decrease in government borrowing and slack surveillance over the system. This situation is more upsetting in the State Owned Commercial banks (SCBs) and Development Financial Institutions (DFIs) for which they face huge capital shortfall. Government recapitalises the shortfall with taxpayer's money instead of correcting the faults of the institutions which not only increases the burden on taxpayers but also causes a loss to the economy.

Huge illegal capital flight becomes a concern for the economy. The amount of money flown out of Bangladesh through illicit means is increasing every year riding mainly on trade misinvoicing. Increase in Import of capital machineries vis-a-vis industrial credit growth and increasing savings –investment gap are the signals of illegal capital flight. Besides, hundi, hot money transfer (balance of payment leakage), transfer of illegal money through tax evasion are the facets of capital flight. This unaccounted transfer of money is a big blow for the economy as it means lost investments and revenue income for the government.

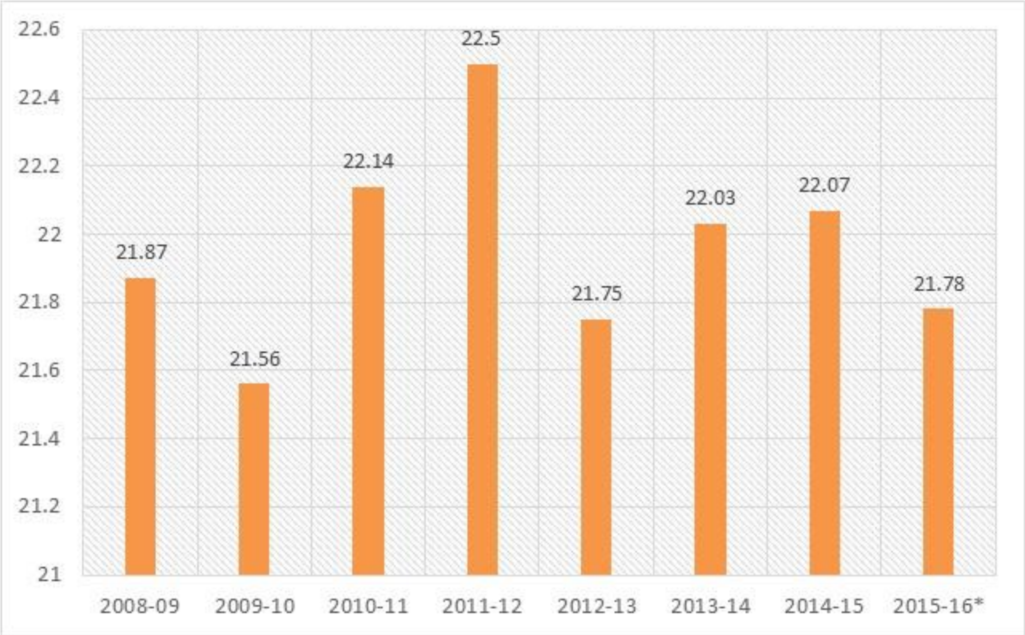
2. Macroeconomic Background

The current MPS has been taken by the central bank when the country's economy is facing with major challenges such as increasing savings-investment gap, unsatisfactory collection of revenue vis-à-vis target, infrastructural underdevelopments, and institutional weaknesses. Stagnant investment together with low rate of ADP implementation and shortfall of revenue is impeding the expected rate of growth in GDP. Besides, underdeveloped infrastructure and crisis in banking sector have been exerting adverse effect on the economy causing the rate of growth to decelerate. Country's banking sector being characterised by poor risk management, fraudulence, captured governance and lax oversight, resulting in lower profitability to the shareholders is caught in trap. Besides this backdrop, questions are being raised concerning the far-sighted deregulation of the financial sector. Finally, poor energy infrastructure and underdevelopment in road and transportation system are directly related to below the target performance of the economy and cause the rate of growth to slow down. Large amount of investment and good governance are, however, needed in order to improve the infrastructure to ensure sustainable path of economic growth.

The investment in private sector occupies the primary role, which has traditionally accounted for more than 70 percent of total investment. While the investment in private sector has been stagnant since FY 2011-12, the investment in public sector has increased from 5.76 percent in FY 2011-12 to 6.64 percent in FY 2012-13, and then further increased to 6.55 percent in FY 2013-14, 6.90 percent in FY 2014-15, and 7.6 percent in FY 2015-16.

However, this increase could not raise the total rate significantly as the share of public sector in total investment is meager and is largely spent to meet the non-development expenditure. However, continuous sliding down of private investment from 21.75 percent in FY 2012-13 to 21.39 percent in FY 2013-14 to 22.07 percent in FY 2014-15 to 21.78 percent in FY 2015-16, increase in public investment from 6.64 percent in FY 2012-13 to 6.55 percent in FY 2013-14, to 6.90 percent in FY 2014-15 and to 7.6 percent in FY 2015-16 has failed to create much needed crowding in of private investment.

Figure 1: Private Investment as percentage of GDP



Source: Ministry of Finance 2016

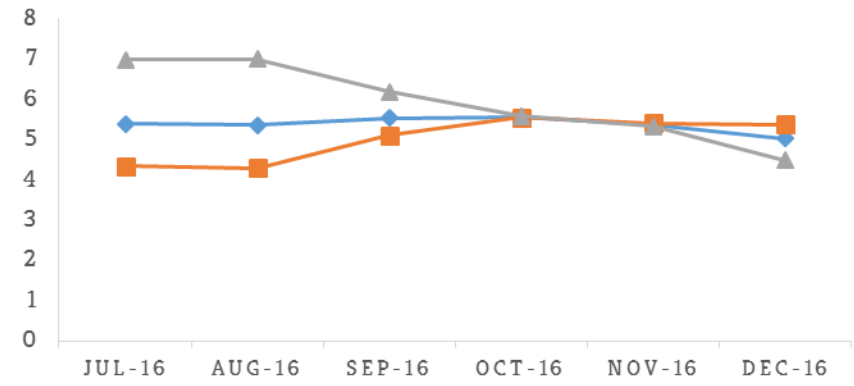
With a growth rate of 3.88 percent (from 1995-96 to 2010), the number of total civilian labour force in 2010 increased to 57.1 million. In 1995-96, total civilian labour force was 36.1 million out of which 30.7 million was male and only 5.4 million was female. Out of total civilian labour force, 40.2 million was male and rest 16.9 million was female. A total of 34.8 million were employed and 1.4 million were unemployed in 1995-96, which increased to 54.5 million and 2.6 million respectively in 2010 (BBS, 2011). The number of unemployed population increased at an annual rate of 5.29 percent during the period of 2000-2010 and increased from 1.70 million in 2000 to 2.60 million in 2010 while 10.6 million people were day laborers who did not have job security. Taking this trend into account, it is calculated that the country needs to increase employment opportunities by two percent in order to enter the middle income group by 2021. When underemployment is taken into account in assessing the status of the labor force in Bangladesh, the perception of the labor market significantly changes. The information on hours worked shows that a total of 10.99 million (which is about 20.31 percent of the employed labor of 54.1 million) were underemployed in 2010. This shows an extremely high level in the number of the people who work less than 35 hours per week. Also the information shows high incidence of underemployment in rural areas and among the female labor force.

3. Trend in Inflation

The twelve-month average consumer price index (CPI) inflation has assumed a slowly declining trend for the last couple of years. CPI inflation has been steadily coming down to 5.03 percent (point-to-point) in December 2016, pulling down annual average to 5.5 percent, benefitting from both favorable food and nonfood inflation dynamics. Non-food inflation has eased to 4.5 percent (point-to-point) in December, down from 7.1 percent a year agoreflecting favorable domestic production and global commodity prices.

Despite the current stability in consumer price index (CPI) inflation, there exists concern over the fact that average core inflation (non-food, non-fuel), a traditional measure of long-term inflation scenario, remains elevated at around 7.6 percent in December, indicating inflation can pick up if buffeted by adverse events.

Figure 2: Trend in General, Food and Non-Food Inflation



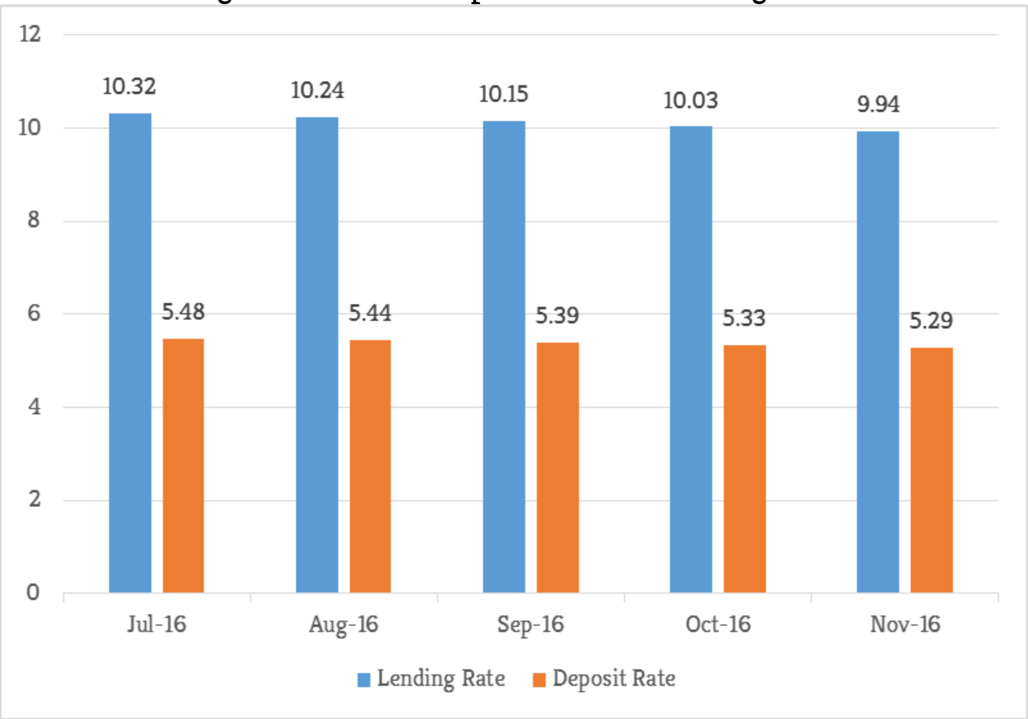
	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16
General	5.4	5.37	5.53	5.57	5.38	5.03
Food	4.35	4.3	5.1	5.56	5.41	5.38
Non-Food	6.98	7	6.19	5.58	5.33	4.49

Source: Bangladesh Bank 2016a

4. Interest Rate

The trend in interest rate has remained stable over the first half of the current fiscal year. As stated in the monetary policy statement announced for the second half of the current fiscal year, "During June-November 2016, the average (weighted) lending and deposit rates have declined by 45 and 25 basis points to 9.94 and 5.29 percent, respectively, leading to a narrowing of average spread by 20 basis points to 4.65 percent. The decline in interest rates reflects favourable inflation performance, ample liquidity, and an increase in competition in the banking system. That said, the average figure masks significant variation within the banking system."

Figure 3: Trend in Deposit Rate and Lending Rate



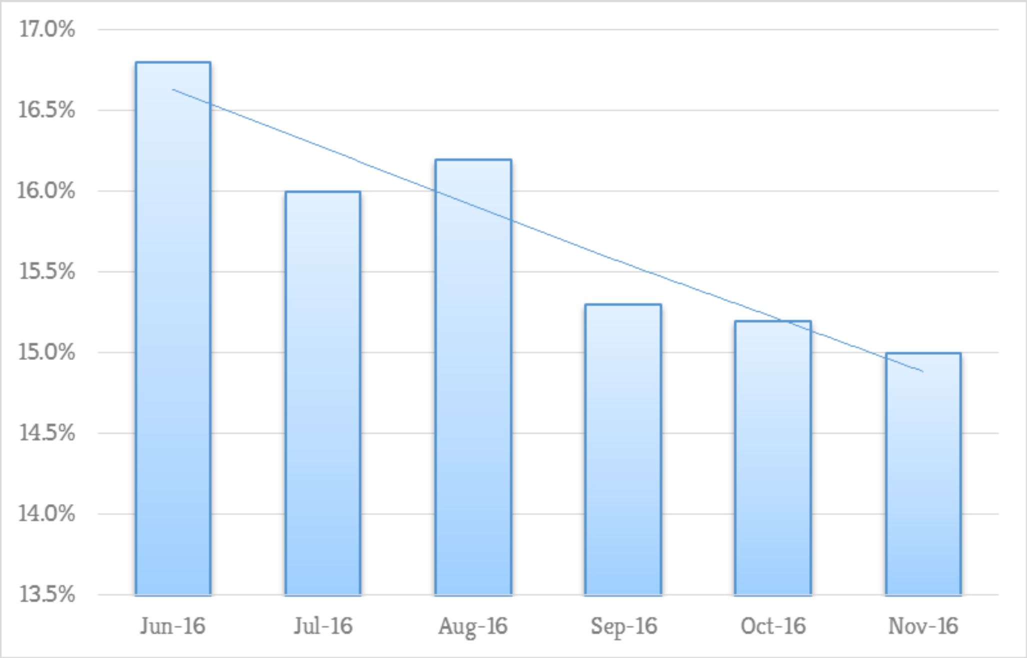
Source: Bangladesh Bank 2016c

5. Private Sector Credit Growth

From 16.8 percent in June 2016, private sector credit growth declined to 16.2 percent in August, 15.3 percent in September and 15 percent in November 2016. Taking account of the recent trend, it is feared that the target of 16.5

percent growth in private sector credit for second half of the current fiscal year may remain unachieved causing further stagnation in private investment. However, Private sector credit growth took an upward trend at the end of the FY16. While it was 10.8 percent in June 2013, private credit growth reached as high as 16.4 percent in May FY16.

Figure 4: Trend in Private Sector Credit Growth



Source: Bangladesh Bank 2016a

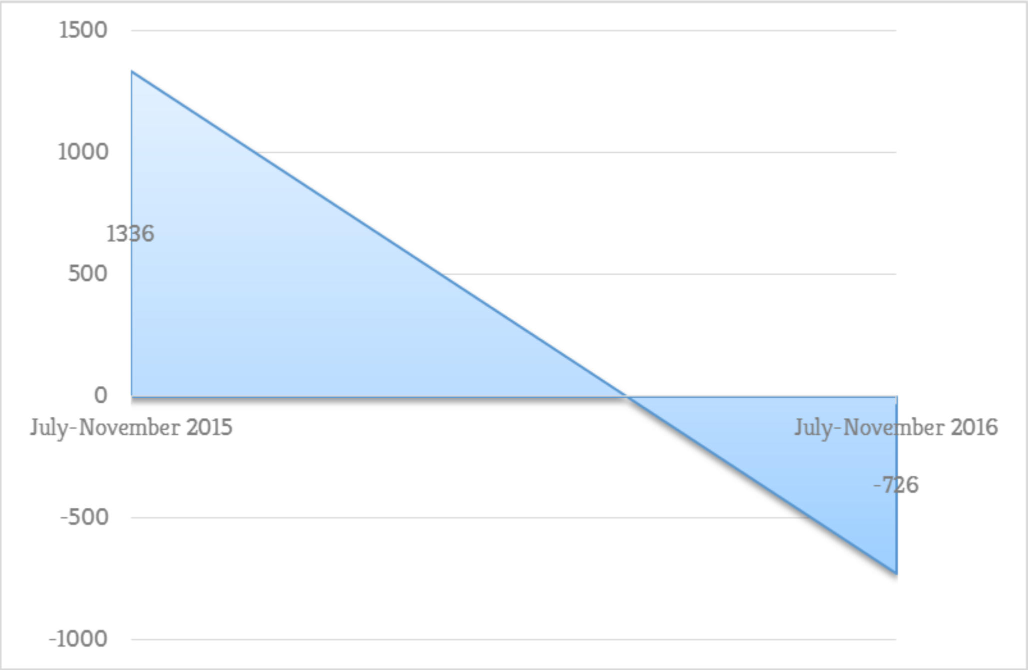
6. Current Account Balance

The current account balance recorded a deficit of USD 0.7 billion during July-November 2016, whereas a surplus of USD 1.3 billion was observed during the same period of previous fiscal year. Current unsatisfactory performance of the sector is due to higher import growth (9.5 percent), lower export growth (6.2 percent), and slowdown in remittance inflows (-15.6 percent) during corresponding period of current fiscal year.

Trade deficit increased by 12.52 percent to 2777 million USD in July-October 2016 from 2468 million USD in July-October, 2015. Export increased by 6.78 percent whereas import increased by 7.93 percent during July-October 2016.

As a result of deterioration in the balance of all four components of current account – trade balance, services, primary income and secondary income, the current account balance declined substantially in July-October 2016 compared to the corresponding period of the previous fiscal year. The current account balance exhibited a surplus of 1241 million USD in July-October 2015, whereas it shows a deficit of 16 million USD in July-October 2016.

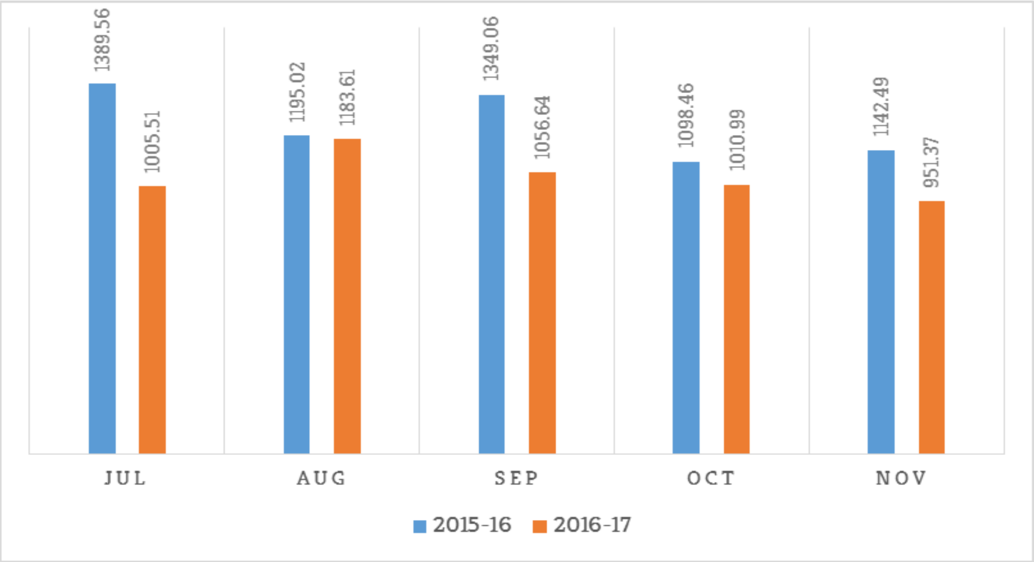
Figure 5: Trends in Current Account Balance (in Million USD)



Source: Bangladesh Bank, 2016b

A declining trend is observed in the inflow of workers' remittance in the first five months of FY 2016-17 compared to the corresponding period of the previous fiscal year. Inflow of workers' remittance declined by 15.65 percent to 5208.12 million USD in July-November 2016 from 6174.59 million USD in July-November 2015. In November 2016, inflow of remittance declined by 16.73 percent to USD 951.37 million from USD 1142.49 million in November 2015. Receipts of workers' remittance inflow in October 2016 decreased by 8.56 percent and stood at USD 1.01 billion as compared to September 2016. It also decreased by 11.88 percent in September compared to August 2016 and by 22.69 percent compared to the corresponding month of the previous year. Total receipts of workers' remittance decreased by 15.43 percent during July-October, 2016 and stood at USD 4.26 billion as compared to the same period of the previous fiscal year. The inflow of remittance declined by 27.64 percent and amounted to USD 1005.43 million in July 2016 compared to the corresponding month of 2015. In addition to decreasing inflows of remittances, recent incidences of restriction to overseas employment of Bangladeshi unskilled workers is likely to aggravate the declining remittance growth and adversely impact the country's external balance.

Figure 6: Trends in inflows of remittance (in million USD)

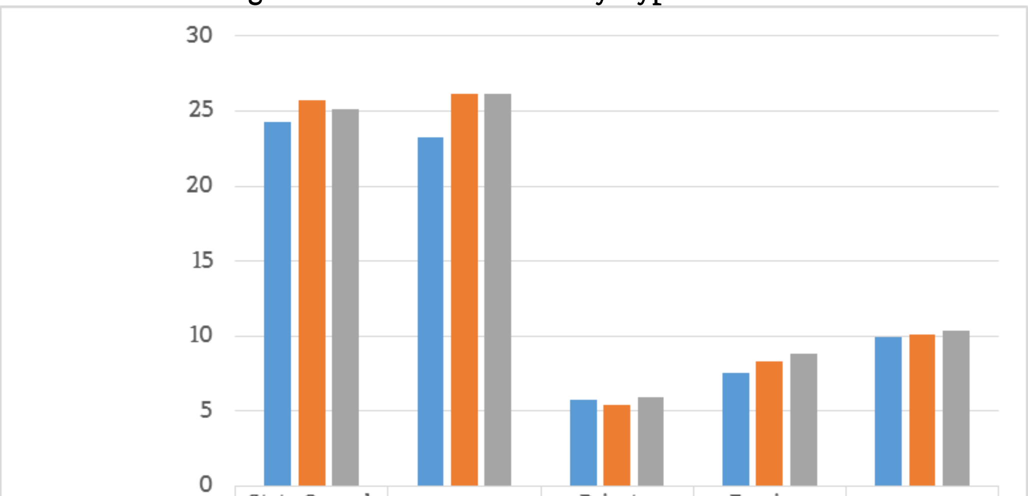


Source: Bangladesh Bank, 2016b

7. Non-Performing Loan

Of late crisis in the banking sector has made the financial sector in Bangladesh worst among the emerging Asian countries reflecting the poor risk management ability of the central bank. A strong financial system is needed for successful implementation of monetary policy. The running crisis in the banking sector mainly due to increase in default loan reflects the institutional weakness of the financial system in the country. Recent consecutive heists in banking sector again shake the financial system as well as the economy. Continuous default loans, scams, and heist cause increased cost of fund and shortfall in capital in the banks. This situation is more upsetting in the State Owned Commercial banks (SCBs) and Development Financial Institutions (DFIs) for which they face huge capital shortfall every fiscal year. Government recapitalizes the shortfall with taxpayer's money instead of correcting the faults of the institutions, which not only increases the burden on taxpayers but also causes a loss to the economy. The banking sector indicators showed some concern during first quarter of FY17 as gross non-performing loan (NPL) ratio crept up to 10.34 percent at the end of September 2016 from 10.06 percent at end June 2016. However, the ratio of net NPL in the banking sector declined to 2.77 percent from 2.81 percent during the same period due partly to some shrink in provision shortfall. The provision shortfall position of the banking sector narrowed to BDT (-) 43.8 billion at the end of September 2016 from BDT (-) 44.5 billion at the end of June 2016. The Capital adequacy ratio (CAR) remained unchanged at10.3 percent in September 2016. On the other hand, the spread of monthly weighted average interest rates for all banks fell to 4.76 percent in September 2016 from 4.91 percent in June 2016 owing to falling lending rates, while the weighted average call money rate decreased marginally from 3.70 percent in June 2016 to 3.64 percent in September 2016.

Figure 7: Gross NPL Ratios by Type of Banks



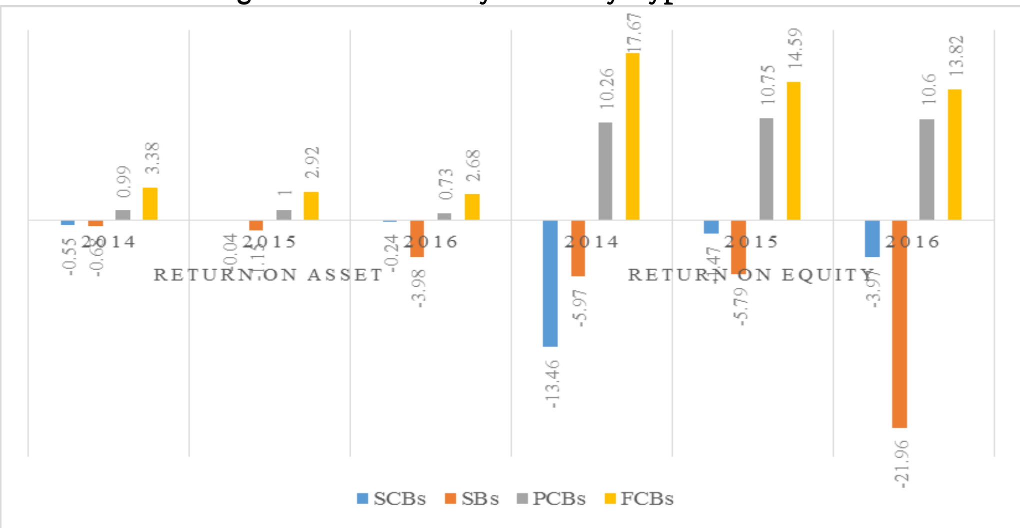
	State Owned Commercial Banks	Specialized Banks	Private Commercial Banks	Foreign Commercial Banks	All Banks
Quarter 1, 2016	24.27	23.24	5.75	7.51	9.92
Quarter 2, 2016	25.74	26.14	5.44	8.33	10.06
Quarter 3, 2016	25.16	26.14	5.9	8.85	10.34

Source: Bangladesh Bank, 2016b

The gross NPL ratio for SCBs, Specialized Banks (SBs), and Foreign Commercial Banks (FCBs) increased from 24.3 percent, 23.2 percent, and 7.5 percent respectively at the end-March 2016 to 25.7 percent, 26.1 percent and

8.3 percent respectively at the end-June 2016. However, the ratio of PCBs marginally decreased from 5.8 percent to 5.4 percent during the same period.

Figure 8: Profitability Ratios by Type of Banks



Source: Bangladesh Bank, 2016b

Return on assets (ROA) declined from 0.77 percent in December 2015 to 0.44 percent in June 2016. The ROA for SCBs, SBs, Private Commercial Banks (PCBs) and FCBs decreased from (-) 0.04 percent, (-) 1.15 percent, 1.00 percent, and 2.92 percent respectively in December 2015 to (-) 0.24 percent, (-) 3.98 percent, 0.73 percent, and 2.68 percent respectively in June 2016. Similarly, return on equity (ROE) of the banking industry decreased remarkably to 6.74 percent in June 2016 from 10.51 percent in December 2015. The ROE for SCBs, SBs, PCBs and FCBs decreased to (-) 3.97 percent, (-) 21.96 percent, 10.6 percent and 13.82 percent respectively in June 2016 from (-) 1.47 percent, (-) 5.79 percent, 10.75 percent, and 14.59 percent respectively in December 2015.

9. Conclusions

Considering the recent major challenges it seems that an investment friendly monetary policy is needed more than an inflation targeting policy in the present context. Recent hovering growth of Bangladesh economy around six percent has been posing the foremost challenges for the central bank in articulating appropriate monetary policy stances. The decreasing growth in private sector credit does not meet the investment demand; rather the government has been expending the money in different unproductive sectors.

As a result, both the private investment and the implementation of annual development program remain far away from the target which in turn do not create fiscal multiplier effect in the economy and thus decelerate the rate of growth of the economy.

At the time of sluggish investment, it was expected that there would be a signal for quantitative easing in the MPS when inflation is in control. This was the right time for moving towards accommodative monetary policies; however, unfortunately, the current monetary policy has failed to project this. A healthy and sound banking sector is needed for successful implementation of monetary policy which ensure proper channelling of funds thus stimulate the growth. But recent crisis in banking sector is increasing the opacity of the financial system. To get rid of this crisis BB must play a more active role through strong vigilance over banking system.

The central bank may demonstrate its prudence while harmonising monetary and fiscal policy through undertaking an expansionary monetary policy that will ensure private sector credit growth and a fiscal management that will increase government expenditure in productive sectors. Such a harmonisation of monetary and fiscal policy may foster both the investment and employment creation in the economy. Besides, the current pressure on economy can be checked by the policy harmonisation since increased private investment and employment creation will ensure the use of money in productive sectors and cause both the money and fiscal multiplier effects to work in the economy. As a result, the vicious causality (declined private sector credit growth decreases investment which, in turn, causes growth of the economy to turn down) can be neutralised through channeling adequate resources to productive sectors that will eventually restrain the inflationary pressure and ensure an increasing trend in economic growth in the country.

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