Monetary Policy Statement (January-June, FY 2017-18): A Rapid Assessment

Bangladesh Economic Update

January 2018

উন্নয়ন অন্বেষণ
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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 2017-18 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 cautions that targeted private sector credit growth may fail to boost private investment in absence of a business enabling environment. Rising food inflation may further challenge the effectiveness of the policy. Failure of growth in private sector credit to boost private investment and consequential unemployment especially of youth is likely to challenge the efficacy of current monetary policy strategies. It is, however, feared that without increasing the quality, mere growth in private sector credit by the targeted level - 16.8 percent for the second half and 16.3 percent for the first 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.

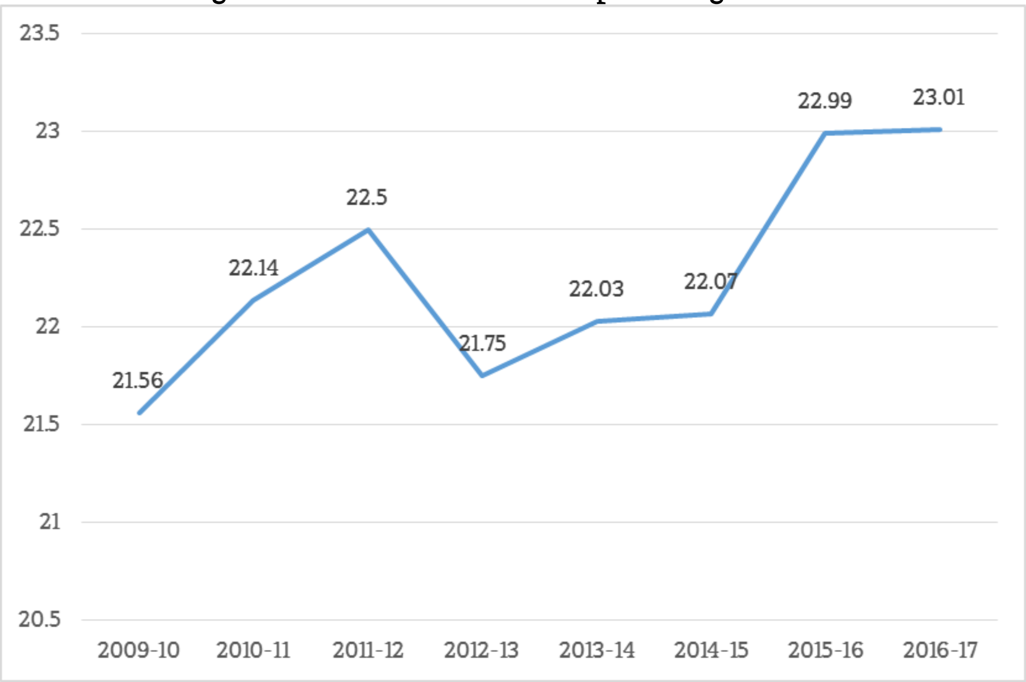
2. Macroeconomic Background

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 7.26 percent in FY 2016-17.

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. Private investment as percentage of gross domestic product (GDP) has increased by less than one percent on average during the period between FY 2010-11 and FY 2016-17. Private investment as percentage of GDP stood at 22.50, 21.75, 22.03, 22.07, 22.99, and 23.01 percent in FY 2011-12, 2012-13, 2013-14, 2014-15, 2015-16, and 2016-17 respectively.

Figure 1: Private Investment as percentage of GDP



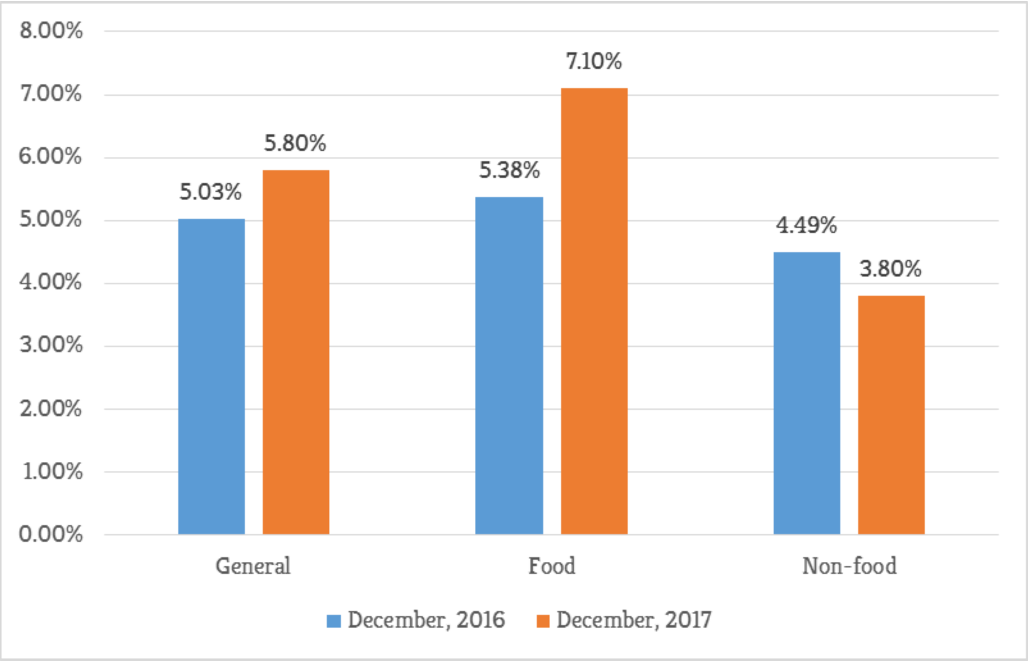
Source: Ministry of Finance, 2017

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

General inflation increased from 5.03 percent in December 2016 to 5.83 percent in December 2017, while food inflation increased from 5.38 percent to 7.1 percent during the same period of time. The twelve-month average consumer price index (CPI) inflation has assumed an upward trend in recent time as well.

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



Source: Bangladesh Bank, 2017a

4. Private Sector Credit Growth

From 15.7 percent in June 2017, private sector credit growth increased to 17.8 percent in September, and then further increased to 18.1 percent in December 2017. Taking account of the recent trend, it is cautioned that the target of 16.8 percent growth in private sector credit for second half of the current fiscal year may fail to boost private investment given the current economic environment.

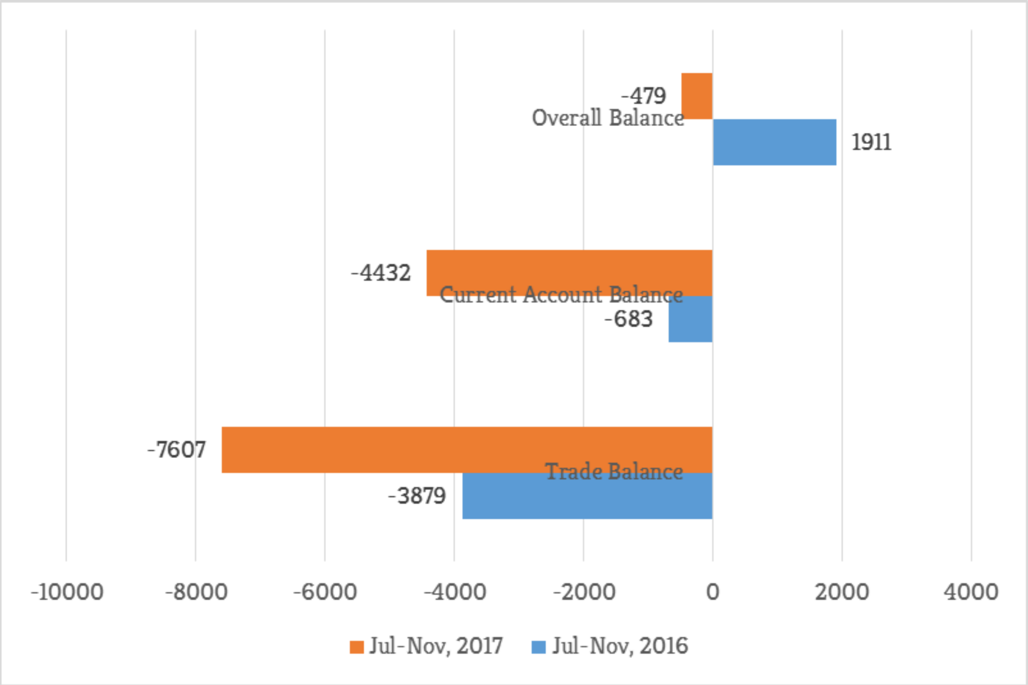
Figure 3: Trend in Private Sector Credit Growth

Source: Bangladesh Bank, 2017a

5. Current Account Balance

The current account balance recorded a deficit of USD 4432 million during July-November 2017 compared to that of USD 683 million during July-November 2016. As a consequence, the balance of payment experiencing a surplus of USD 1911 million in July-November 2016 marks a deficit of USD 479 million in the corresponding period of 2017. Previously, the current account balance recorded a deficit of USD 1.76 billion during July-April 2017, whereas a surplus of USD 3.53 billion was observed during the same period of previous fiscal year. Current unsatisfactory performance of the sector is due to higher import growth, lower export growth, and slowdown in remittance inflows.

Figure 4: Trends in Current Account Balance (in Million USD)



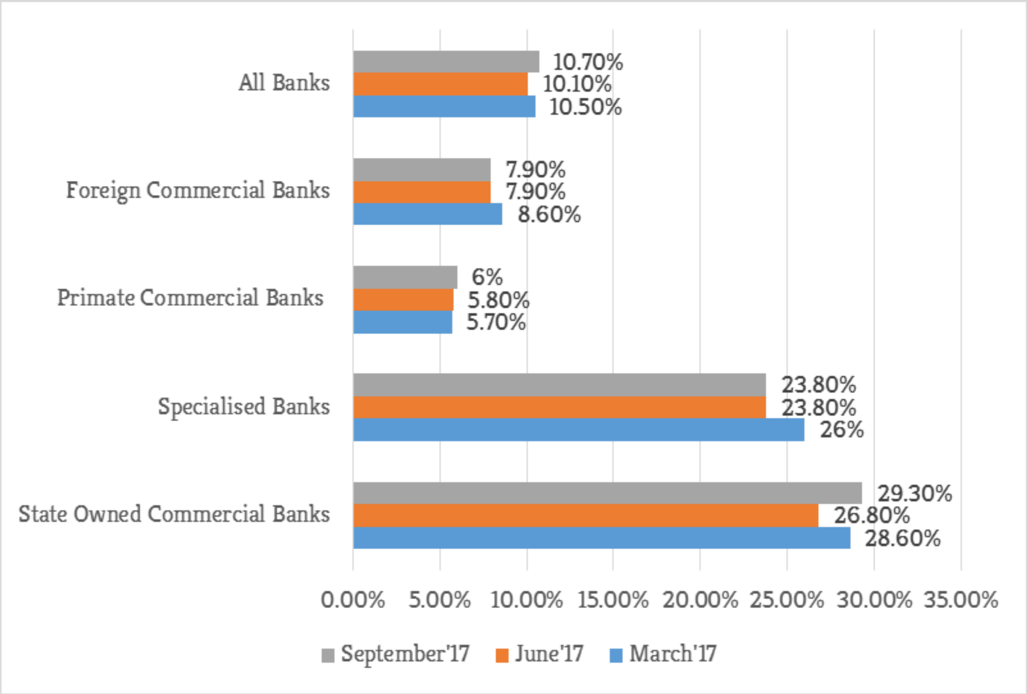
Source: Bangladesh Bank, 2017b

6. 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. that the ratio of gross NPL to the total outstanding loans further increased from 10.1 percent in the last quarter of FY 2016-17 to 10.7 percent in the first quarter of

FY 2017-18. Gross NPL ratio for private commercial banks (PCBs) is the lowest among different bank groups in the first quarter of FY 2017-18 (rising modestly from 5.8 percent to 6.0 percent) and provision remains adequate. NPLs in SCBs increased to 29.3 percent in September 2017, reflecting a weaker provisioning.

Figure 5: Gross NPL Ratios by Type of Banks



Source: Bangladesh Bank, 2017b

7. 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 at around six percent has been posing the foremost challenges for the central bank in articulating appropriate monetary policy stances. Recent decreasing growth in private sector credit does not meet the investment demand; rather the government has been expending the money in a way that has not yet much needed crowding in effect in the economy. 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 the central bank 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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