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POLICY BRIEF

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Highlights

The monetary policy of FY2021–22 appears to be a cautious policy during the chaotic times of the pandemic.

The central bank has refrained from taking any active steps to reduce the prevailing excess liquidity in the banking system, but has assured that it will not hesitate to act if the need arises.

The targets set for private sector credit growth and economic growth may not be met.

Inflation targets should be practical and based on an updated consumption basket.

Reforms in the banking sector remain outside the radar of the central bank at present.

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CPD's Reaction to the MPS FY2021-22

To What Extent Does Monetary Policy Meet the Needs of the Economy?

Fahmida Khatun and ***Syed Yusuf Saadat***

1. Introduction

On 29 July 2021, the Monetary Policy Statement (MPS) for the fiscal year (FY) 2021–22 was announced by Bangladesh Bank. This was the second MPS during the ongoing COVID-19 pandemic. At present, an economic crisis has developed as a result of the disruption in production and supply chains which has led to economic contraction, loss of employment and increased poverty. At the same time, inflation is creeping up which will have impact on purchasing power and demand, particularly of the poor and low-income families. Therefore, monetary policy has a crucial role in addressing the challenges created due to the pandemic.

The banking sector has been responsible for disbursing the loans under the stimulus packages announced by the government. However, there are a number of pre-existing challenges facing the banking sector which need to be resolved in order to have a disciplined financial sector in the country. In the above context, how the MPS for FY2021–22 will be able to achieve the targets delineated in the policy and also meet the requirements of the economy, are issues to be examined. This policy brief highlights a select set of current problems in the banking sector, and scrutinises whether the proposed MPS of FY2021–22 will be appropriate and adequate in addressing the current economic challenges.

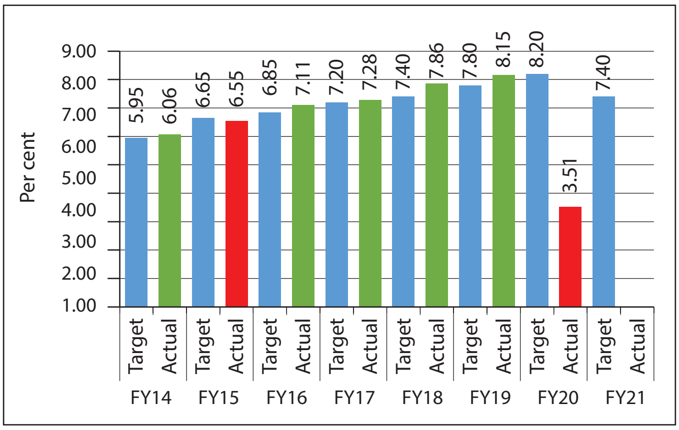
Globally, central banks have pursued several strategies in view of the pandemic, which may be categorised into four groups: i) rate cuts; ii) liquidity provision and credit support; iii) regulatory easing; and iv) asset purchases. Bangladesh has opted for all of these policies, except asset purchases, to address the pandemic. For Bangladesh Bank, three major areas are important for MPS of FY2021–22: i) pursuing traditional monetary policy tools for addressing the pandemic; ii) governance in the banking sector; and iii) administration of stimulus packages. The present analysis is based on these three prisms.

2. Brief Review of Monetary Policies in Recent Years

Economic growth targets set in previous monetary policy statements were either met or exceeded in six out of the last eight years for which data are available (Figure 1). However, since data on actual growth of the gross domestic product (GDP) in FY2020–21 is not yet available, it is not possible to ascertain whether monetary policy in the past one year has been successful in supporting economic growth during the COVID-19 pandemic.

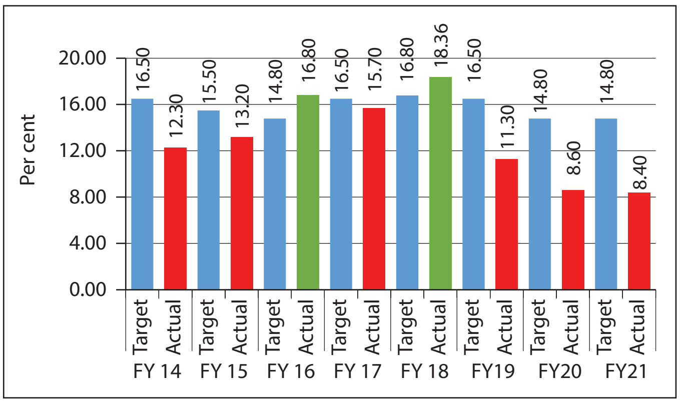
Despite stellar economic growth in the pre-pandemic years, private sector credit growth targets were not met in FY2013–14, FY2014–15, FY2016–17, and FY2018–19 (Figure 2). In response to low private sector credit growth, the central bank had to reduce its monetary policy targets in several years. Weak private sector credit growth in an economy is indicative of low private sector investment.

Figure 1: Economic Growth—Monetary Policy Targets vs. Actual



Source: Authors' illustration based on the data from Bangladesh Bureau of Statistics (BBS, 2021) and Bangladesh Bank (Bangladesh Bank, 2021a).

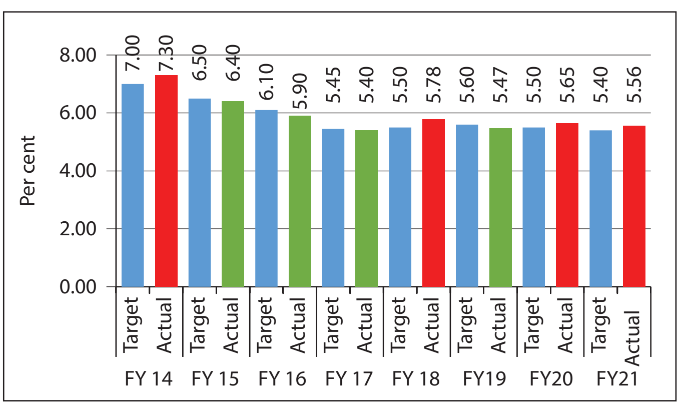
Figure 2: Private Sector Credit Growth—Monetary Policy Targets vs. Actual



Source: Authors' illustration based on the data from Bangladesh Bank (Bangladesh Bank, 2021a).

Inflation during COVID-19 slightly exceeded the monetary policy targets set in FY2019–20 and FY2020–21, due to a host of factors, such as sporadic shutdowns and lockdowns due to spikes in COVID-19 cases and death rates in Bangladesh. Prior to the pandemic years, inflation targets were met in FY2014–15, FY2015–16, FY2016–17 and FY2018–19, although in reality, the cost of living kept rising (Figure 3).

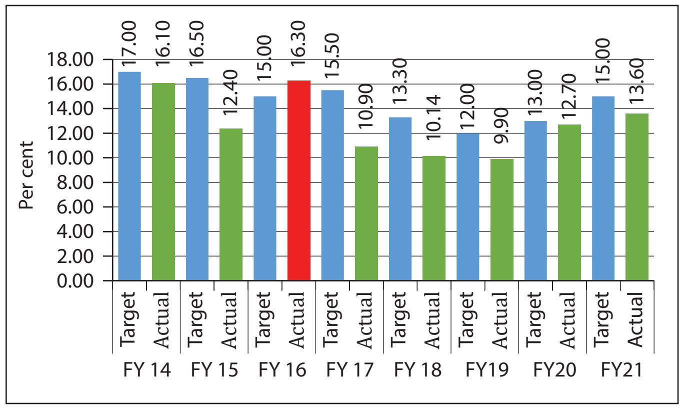
Figure 3: Inflation—Monetary Policy Targets vs. Actual



Source: Authors' illustration based on the data from Bangladesh Bank (Bangladesh Bank, 2021a; Bangladesh Bank, 2021b).

Broad money growth was within the targets set by the monetary policy in FY2019–20 and FY2020–21. During FY2013–14 to FY2018–19, broad money growth was always below the target set by the monetary policy, except in FY2015–16 (Figure 4).

Figure 4: Broad Money—Monetary Policy Targets vs. Actual



Source: Authors' illustration based on data from Bangladesh Bank (Bangladesh Bank, 2021a).

3. Highlights of Monetary Policy for FY2021–22

MPS of FY2021–22 sets an ambitious economic growth target of 7.2 per cent. Such a target appears to be based on the most optimistic scenario of recovery from the pandemic. According to the World Bank's Global Economic Prospects Report June 2021, Bangladesh's real GDP growth rate at market prices in FY2019-20 was estimated to be 2.4 per cent (World Bank, 2021). Although real GDP growth rate at market prices is forecasted to rise, it will not reach pre-COVID levels even in FY2022-23 (World Bank, 2021).

Targeting the monetary aggregates has been particularly weak in the area of credit to private sector. Indeed, credit to private sector has been largely on a declining trend since March 2018, and has been below 10 per cent since November 2019 (Bangladesh Bank, 2021a). Nevertheless, MPS of FY2021–22 has set private sector credit growth target of 14.8 per cent, which is very high compared to the trend in the recent past (Bangladesh Bank, 2021a).

MPS of FY2021–22 sets an inflation target of 5.3 per cent. Analysis of data shows that the 12-month average food and non-food inflation rates have fluctuated in a cyclical pattern over the past several years. However, it appears that the inflation rate has lost its relevance to the real world. Poor and low-income groups are increasingly finding it difficult to make the ends meet in the face of dual blows from purchasing power erosion and income erosion.

Consumer price index (CPI) of medical care and health expenses increased from 156.1 in July 2012 to 251.9 in June 2021 (Bangladesh Bank, 2021b). Inflation rate of medical care and health expenses increased from 0.18 per cent in April 2020 to 2.42 per cent in May 2020, amid rising COVID-19 cases (Bangladesh Bank, 2021b).

Engel's law states that, as income increases, people spend a smaller proportion of their total income on food (Norton, Alwang, & Masters, 2014). In Bangladesh, nominal household income increased by 7.86 per cent per year on average and real household income increased by 0.16 per cent per year on average between 2010 and 2016 (BBS, 2019). Food expenditure as a share of income

Table 1: Consumption Basket vs. Consumption Pattern

Food expenditure as a share of income (in per cent)			
	National	**Rural**	**Urban**
2000	42	48	32
2005	45	50	36
2010	53	57	45
2016	46	52	37
Food expenditure as a share of consumption expenditure (in per cent)			
	National	**Rural**	**Urban**
2000	55	59	45
2005	54	59	45
2010	55	59	48
2016	48	50	43
Weights used for food in calculation of CPI (base year 2005)			
	National	**Rural**	**Urban**
2000	-	-	-
2005	56	61	47
2010	56	61	47
2016	56	61	47

Source: CPD based on the data from Bangladesh Bureau of Statistics (BBS, 2019; BBS, 2011).

decreased from 53 per cent in 2010 to 46 per cent in 2016, whereas food expenditure as a share of total consumption expenditure decreased from 55 per cent in 2010 to 48 per cent in 2016 (BBS, 2019). However, the weights used for food in the calculation of the CPI are significantly higher than the share of food expenditure in either income or consumption expenditure. As it is, the consumption basket used for calculating overall general inflation was created in 2005 and does not reflect the current consumption pattern of consumers or the actual prices in the market (Table 1).

Crowd-sourced data of prices of 5,621 items contributed by 449 respondents during November 2019 to November 2020 show that: i) share of non-food items in actual consumption expenditure was 16 per cent higher than the weight in CPI; ii) share of rent in actual consumption expenditure was 2 per cent higher than the weight in CPI; and iii) share of transport in actual consumption expenditure was 15 per cent higher than the weight in CPI. Thus, the consumption basket used for calculating non-food inflation does not accurately portray the behaviour of the consumers at present or the market prices prevailing at the moment (Table 2).

Table 2: Weights Used for Calculating CPI vs. Actual Distribution of Consumption Expenditure

	Weights used for non-food items in calculating CPI (base year 2005)	**Distribution of consumption expenditure based on crowd-sourced data**
Non food	44	60
Clothing	7	3
Rent	15	17
Transport	6	21
Recreation	4	7

Source: CPD based on data from Bangladesh Bureau of Statistics and Numbeo (Numbeo, 2020).

Therefore, for calculating CPI, a new consumption basket should be formulated based on rigorous research of consumer behaviour and expenditure patterns. All targets, projections and plans in the monetary policy, as well as the 8th Five Year Plan (8FYP), should be revised in accordance with this new consumption basket for CPI and new base year for inflation.

MPS of FY2021–22 sets a broad money growth target of 15 per cent. Analysis of data shows that there is a unidirectional causal relationship running from the supply of broad money and the price level in Bangladesh (Table 3). Therefore, the central bank should exercise caution in the conduct of monetary policy, lest inflationary pressures overburden the economy.

Table 3: Results of Granger Causality Test

Null hypothesis	**F statistic (p value)**	**chi square statistic (p value)**	**Interpretation**
M2 growth does not Granger-cause CPI growth	4.06 (0.0599)	4.78 (0.0288)	Unidirectional causality running from M2 growth to CPI growth
CPI growth does not Granger-cause M2 growth	0.47 (0.5006)	0.56 (0.4554)	
Log of M2 does not Granger-cause log of CPI	8.83 (0.0082)	10.30 (0.0013)	Unidirectional causality running from log of M2 to log of CPI
Log of CPI does not Granger-cause log of M2	2.71 (0.1171)	3.16 (0.0754)	

Source: Authors' calculations.

Note: i) One period lag chosen; ii) M2 growth is defined as percentage change in supply of broad money; iii) CPI growth is defined as percentage change in consumer price index, base year 2005–06; iv) M2 data from Bangladesh Bank and CPI data from BBS; v) Granger causality implies predictive causality and not true causality.

4. Implications for the Banking Sector

Excess liquidity in the banking sector has nearly doubled from BDT 103 thousand crore in January 2020 to BDT 202 thousand crore in April 2021. During the same period, excess liquidity has more than doubled in state-owned commercial bank (SCBs) and more than tripled in Islamic banks (IBs). Excess liquid assets comprised 48 per cent of the total liquid assets of the banking sector in April 2021. Signs of excess liquidity were also manifested in the call money market, as the monthly average call money market borrowing and lending rates both tumbled down from June 2020 onwards. The low cost of funds in the call money market indicates that there was very low demand for funds, since the majority of banks most likely had excess liquidity. Excess liquidity is also a sign that the demand for loans is low, which is likely since the real economy is still experiencing the repercussions of the COVID-19 shock. The advance-deposit ratio (ADR) of all banks fell to a three-year low of 0.81 in November 2020. The plummeting ADR points indicate that economic activity has declined during the third wave of COVID-19. Excess liquidity in the banking system has led to a fall in the interest rates, which were already quite low even prior to 2020. During the pandemic, the weighted average lending rate in all scheduled banks has come down sharply and the weighted average borrowing rate in all scheduled banks has also declined. As a result, the interest rate spread has come down, adding to the woes of the commercial banks.

Excess liquidity in the banking system may induce commercial banks to behave in ways which may jeopardise the stability of the financial system and make it difficult for the central bank to achieve its monetary policy goals. Banks may attempt to offset their losses from holding excess liquidity by giving out risky loans which may lead to higher volume of non-performing loans (NPLs), higher inflation and the creation of asset bubbles. Excess liquidity in the banking system also weakens the interest-rate transmission mechanism of monetary policy, making monetary policy less effective in fine-tuning aggregate demand. When there is excess liquidity in the banking system, commercial banks may perceive the opportunity cost of holding excess balances at the central bank to be low, and hence be slow to act to reduce excess liquidity. As a result, the central bank would find it more challenging to determine the ideal level of desired and excess reserves.

Data from Bangladesh Bank shows that in 2020, excess reserves of all banks increased from BDT 6.74 thousand crore, or 2.15 per cent of total liquid assets, in January 2020, to BDT 48.22 thousand crore, or 11.56 per cent of total liquid assets, in April 2021. Since excess reserves represent un-invested cash, holding excess reserves is costly for banks. Banks have also increased their holdings of unencumbered approved securities, which are zero risk rated assets issued or guaranteed by the government. In 2020, holdings of unencumbered approved securities of all banks increased from BDT 211 thousand crore, or 67.15 per cent of total liquid assets, in January 2020, to BDT 279 thousand crore, or 66.83 per cent of total liquid assets, in April 2021. The decision of commercial banks—to hold excess liquidity in the form of unencumbered approved securities instead of funds for lending—shows that commercial banks perceive that the yields on risk-free unencumbered approved securities are better than the risk adjusted returns on interest-bearing loans that come with default risk. This implies that commercial banks are hesitant to lend, as they probably believe that economic activity is yet to pick up, and hence, their loans may have a high probability of turning bad.

5. COVID-19 Stimulus Packages

The Government of Bangladesh (GoB) had responded to health and economic emergencies caused by COVID-19 by announcing a number of liquidity support and fiscal stimulus packages targeting various sectors and people. The amount of stimulus packages is about 4.4 per cent of Bangladesh's GDP. The liquidity support was channeled through the banking sector which has proven to be the weakest link in the economy of Bangladesh for the past decade. Since about 80 per cent of the government's COVID-19 response funds are in the form of liquidity support, banks are expected to play a central role in view of recovery of the pandemic-affected economy. Bangladesh's fiscal stimulus package is less than 1 per cent of its GDP, and falls far short of the 11 per cent of GDP that is estimated to be required to mitigate the socioeconomic impacts of COVID-19 (UNESCAP, 2020).

CPD had previously pointed out that the nature and design of Bangladesh's COVID-19 relief funds could encourage financial malpractices. Bangladesh Bank has issued more than 100 circulars related to the liquidity support packages over the past year. But the regulatory gaps have not been addressed yet. This has made some of the government's liquidity support packages available also for the banks which are weak and poorly governed; these supports were also made accessible to loan defaulters. It is not clear what the real situation of NPLs in the banking sector is at present. Also, it is uncertain as to how large NPLs may actually turn out to be in the future when the moratorium is lifted. Since the highest share of COVID-19 related liquidity support has been offered to large industries, crony capitalists may take advantage of their strong political foothold to use the banks to obtain more than their fair share of funds. Commercial banks must exercise their own judgement to decide which potential loan seekers have been "affected" by COVID-19, since no clear, objective and quantitative criterion for defining the term "affected" has been stipulated by the central bank.

The transparency and accountability of Bangladesh's COVID-19 stimulus plan will be key to its successful operationalisation and implementation. Hence, it is critical to make sure that the beneficiaries are selected based on clear, objective, and quantitative criteria and vested interests are not allowed to intervene. Without connections with the local powerful people, it has proved to be difficult to get included in the list of beneficiaries. Widespread corruption has been reported to have taken place in the distribution of government's relief items. Such malpractices have been reported in the media at a time when the economy was reeling from the worst effects of the COVID-19 crisis. Since the vast majority of Bangladesh's COVID-19 relief funds will be distributed through banks, there is an opportunity for unscrupulous individuals to profit from humanitarian aid without coming into the limelight.

Moreover, the varying speed of implementation of the various liquidity support packages has created an unequal turnaround as bigger firms have rebounded more strongly, owing to quick access to liquidity packages, while smaller firms have been largely left behind. From the outset of the announcement of the COVID-19 liquidity support packages by the government, banks have been more willing to lend to large borrowers, but were hesitant to lend to small borrowers. In a "k" shaped economic recovery curve, the COVID-19 recovery path splits in two directions. Large firms and public-sector institutions with direct access to government and central bank stimulus packages will make some areas of the economy recover fast but leave behind small and medium-sized enterprises (SMEs), blue-collar workers, and the under-pressure middle class. The design of the stimulus packages and their distribution are driving a mostly "k" shaped economic recovery path in Bangladesh.

Liquidity support cannot be treated as philanthropy, and banks cannot provide loans to anyone on humanitarian grounds. Any bank must follow its due diligence whilst providing loans, meaning that banks are generally more inclined to provide loans to their old borrowers who are familiar to them rather than new borrowers who are unfamiliar. As a result, new borrowers with no credit history and limited records of business-related bank transactions found it difficult to obtain loans from any bank under any liquidity support package regardless of how badly affected they were due to the pandemic. Liquidity support through bank loans is not the best way to cater to the needs of small borrowers and new borrowers as well as those who are the poorest and most vulnerable. There is a lack of awareness among women, and the general public at large, regarding the government's liquidity support. A large portion of people, who are actually poor and in dire need, did not receive any form of support from the government—whether in the form of relief items, liquidity support or fiscal stimulus.

6. Concluding Remarks

The current ailing banking system cannot sustain the ambition of high growth in the country. The severity of high NPLs is currently invisible due to the measures taken to ease loan classification. However, once loans are classified without any special considerations, the volume of NPL may rise significantly. At present, problems of the banking sector are being tackled with the government's support. This is possible since banking assets are only about 56 per cent of GDP. When banking assets will increase, the government may not be able to do so. As Bangladesh prepares for graduation from a least developed country (LDC) to a developing country and from a lower middle-income country to an upper middle-income country, it is crucial to develop a sound financial system to ensure finance for development, not finance for crony capitalism.

Stimulus packages provided through banks have created new avenues for corruption and malpractices. Repayment of loans provided through stimulus packages may turn into a cause of concern in the coming days. Once the moratorium on loan classification is eventually lifted, the level of NPLs may also rise suddenly. Liquidity support and fiscal stimulus packages rolled out without prior assessment of ground realities may not be able to address the needs of the most vulnerable groups in the society. In particular, providing loans to vulnerable individuals and small businesses may not yield the expected results. Hence, it is urgent for the government to reconsider liquidity support as the primary mode of economic response to COVID-19, and increase fiscal stimulus and direct cash transfers to the poor.

Sound macroeconomic management and prudential supervision must be rooted in established economic theory and high-quality empirical evidence. Unfortunately, lack of data integrity in recent years has seriously compromised the effectiveness of the government's policies and the central bank's directives, thus jeopardising the overall economic progress of the country. Calculating CPI on a base year and consumption basket which is 16 years old appears to be naïve at best and manipulative at worst. When the middle-class struggle to make the ends meet, it seems unlikely that long-term inflation is going to decline. It is apprehended that actual inflation may likely be significantly higher than the reported values.

Overall, the monetary policy of FY2021–22 appears to be a cautious policy during the chaotic times of the pandemic. The central bank has refrained from taking any active steps in reducing the prevailing excess liquidity in the banking system, but has assured that it will not hesitate to take action if the need arises. The overall stance of the policy is expansionary, and in the words of the central bank, "accommodative". It appears that the targets set for private sector credit growth and economic growth may not be met, considering the rapid worsening of the COVID-19 situation. Finally, governance of the banking sector will be an important determinant for better recovery of the economy. Unfortunately, reforms in the banking sector remain outside the radar of the central bank.

7. Recommendations

- Loan defaulters should not be allowed to access any of the COVID-19 related liquidity support packages.
- Weak and poorly-governed banks should be barred from participating in the COVID-19 related liquidity support packages. Banks, which are not fully compliant with BASEL III or the Banking Company Act, should be not be allowed to participate in the COVID-19 related liquidity support packages.
- Clear, objective, and quantitative criteria should be declared to properly identify "affected" businesses and individuals.
- Transparency and accountability mechanisms should be built into all COVID-19 related liquidity support packages, and more disaggregated data on the implementation status of all liquidity support packages should be published on a monthly basis.
- Disbursement of the government's COVID-19 liquidity support for small businesses, farmers, and low-income professionals should be expedited immediately.
- The policymakers should acknowledge the actual scale of the COVID-19 crisis and then formulate a specific and target-oriented post-COVID recovery plan that aims to build back better.
- A thorough needs assessment should be conducted to understand the extent of damage caused by COVID-19, the amount of support required, and the people who need the support the most.
- Public awareness about the liquidity support and fiscal stimulus packages should be raised through nation-wide campaigns so that the general population can clearly understand what kinds of support are being provided by the government, who are eligible for such support, and how to obtain that.
- Liquidity support is inappropriate for small borrowers and new borrowers, as well as those who are the poorest and most vulnerable. Therefore, direct cash support should be provided by the government so that these groups can adjust to the shocks of COVID-19.
- A multi-stakeholder taskforce with representatives from the various ministries, central bank, commercial banks, trade bodies, civil society, non-government organisations (NGOs) and academia should be formed for monitoring the delivery of the COVID-19 liquidity support and fiscal stimulus packages and assessing their effectiveness.
- Banks with excess liquidity should be discouraged by the central bank from taking unnecessary risks.
- A goal-specific, time-bound, inclusive, transparent, unbiased and independent Citizen's Commission on Banking should be set up in order to bring transparency in the prevailing situation, identify the root causes of the manifest problems, and suggest credible measures for improving the situation sustainably.
- A new consumption basket should be formulated for calculating CPI inflation, based on rigorous research of consumer behaviour and expenditure patterns. All targets, projections, and plans in the monetary policy and the 8FYP should be revised in accordance with this new consumption basket for CPI and new base year for inflation.

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