Monetary Policy for H2 FY18 (January– June 2018)

Policy Stance

5.7-6.0%	*Inflation Projection*
6.75%	*Repo rate*
4.75%	*Reverse Repo rate*
13.30%	*Broad Money Growth*
12.00%	*Reserve Money Growth*
15.80%	*Domestic Credit Growth*
8.30%	*Public Sector Credit Growth*
16.80%	*Private Sector Credit Growth*
6.50%	*CRR*
19.50%	*SLR*

Source: Monetary policy statement January-June 2017

Policy Highlights

- A new directive regarding banks' Advance/Deposit ratios would be issued to curb unproductive lending. Banks would be provided until June'18 for adjustments.
- Slight upwards adjustments made in inflation outlook, as weather related supply shocks and rising global commodities prices have caused food inflation to edge upwards.
- BB's projects 7.1-7.4 % real GDP growth in FY18, against the government's target of 7.4%.
- Repo and Reverse Repo rates are kept unchanged at 6.75% and 4.75% respectively.
- BB projection for broad money growth has been revised down to 13.3% from 13.9% in the last MPS while reserve money growth expectation is unchanged at 12.0%.
- Domestic credit growth projected of 15.8% has been retained for Jun'18. Private sector credit growth target has been increased to 16.8% (50bps increase from last MPS) while public sector credit growth target has been reduced to 8.3%.
- Emphasis has been made to increase capital market depth by developing bond market as an alternate source for long-term investment financing
- Despite some concerns regarding the nature of policy revisions, we think this MPS sets out to convey its cautious tone in a gradual way, rather than giving systemic shocks which would disrupt the financial system.

The H2FY18 Monetary policy statement comes at a critical time, with shrinking balance of payment putting pressure on the currency and the reserve while robust private sector credit has lead to some over-exuberant lending in the banking system. Protecting against inflationary pressures, maintaining balance of payments (BOP) sustainability and curbing imprudent unproductive lending appear to be key objectives of the monetary policy.

Potential Changes in Banks' Asset-Liability Management

Due to high credit demand, private sector credit growth reached 19% in November'17 and eventually ended the year at 18.1% in December. As credit growth outpaced deposit growth, the average Advance/Deposit Ratio (ADR) of banking sector raised from 73.9% in June 2017 to 75.9% in December 2017. Although current ADR limits for traditional banks is set at 85% (the limit is 90% for Islamic banks), the ADR for private commercial banks stood at 89.4% for the private commercial banks on September 2017. The continuation of such aggressive lending could have repercussions for the liquidity situation of the whole financial sector.

As such, this MPS describes a few macro-prudential steps to curb imprudent and unproductive lending. These are:

- Intensive surveillance on compliance of Asset-Liability Management and Forex Risk Management guidelines
- Issuing a new directive requiring banks to rationalize their Advance/Deposit Ratios
- Increased surveillance on the end use of bank loans including import finance

These measures would focus on quality and sectoral composition of credit flows and prioritize implementation of existing standards, rather than regulations directly restricting access to credit for productive pursuits. Also, the governor of central bank said on a press briefing that banks would be given 6 months to make necessary adjustments to ensure compliance to new regulations.

In terms of the capital market related implications of these steps, a few banks with ADR numbers much higher than the prescribed ceiling would have to slow their loan disbursement and increase their deposit base. With interest rates already picking up, deposit growth is expected to naturally increase. Banks with good governance practices should be able to strengthen their deposit base instead of largely slowing loan disbursement. So, a few banks' loan growth and profitability could be hurt but we expect fundamentally strong banks to sustain business growth despite this regulation change.

Inflationary outlook

Inflation in Bangladesh had been on a declining trend since the beginning of FY15, reflecting favorable domestic production and reduced prices in the global commodity markets. This declining trend continued in the first half of FY17. General P2P inflation got down to 5.03% in Dec'16. However, inflation started to rise again in Jan'17 driven largely by higher food prices. This was caused largely by the flash floods in the country's Northeastern region which resulted in huge loss of crops. Higher crude oil and rice prices and a depreciating BDT further augmented inflationary pressure. General P2P inflation rose to 6.12% in September 2017 and crossed the 6.00% mark for the first time since it went down below this level in Jan'16. However, inflation went down somewhat over the last quarter of 2017 and the 12 month average inflation in Dec'17 was 5.70%, slightly below the upper limit of the inflation projection of 5.5%-5.9% in the last MPS.

During the remainder of the fiscal year, food inflation pressure is expected to ease slightly from boro rice harvests. BB projections have been upwardly revised to show average inflation to be around 5.7%-6.0% in June 2018, assuming no further domestic or external shocks and a relatively favorable global inflation outcome. Previously, the Government of Bangladesh, in the national budget for FY18 had set the target for FY18 inflation at 5.50%.

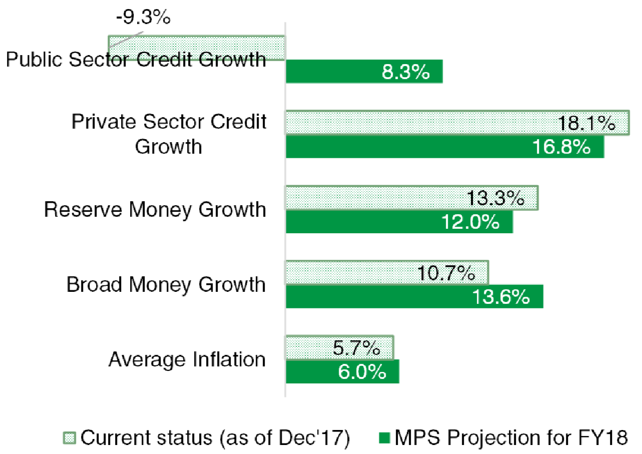
In the near term, the slight upward direction of inflation is unlikely to affect the capital market directly. Sustained inflationary pressure could lead to upward correction of interest rates.

Broad Money and Reserve Money growth targets reduced

Broad money growth stood at 10.7% as of December'17, while Reserve Money growth was 12.8% against previous MPS target of 13.9% and 12.0% respectively for FY18. BB has reduced its target for both M2 in the latest MPS, while leaving the Reserve money growth expectations unchanged. Due to imports ballooning in FY18, net foreign asset growth in FY18 is expected to be flat. This coupled with continued negative govt borrowing from banking system has caused the downward revision of M2 growth. The moderate outlook for reserve money is retained at moderate levels. These growths are seen as close enough to the initial targets for meeting the inflation and economic growth targets.

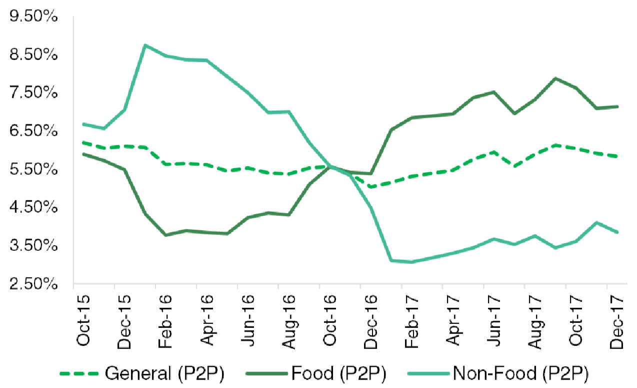
The M2 statistic indicates the overall money supply into the economy. The downward revision of the number reinforces the overall cautionary stance of the central bank. This is in contrast with expansionary fiscal policies, particularly ones showed in the budget. But with majority of other monetary indicators left un changed, we don't think the overall monetary policy stance has become contractionary.

Chart 1: Current Status vs Jun'18 Targets



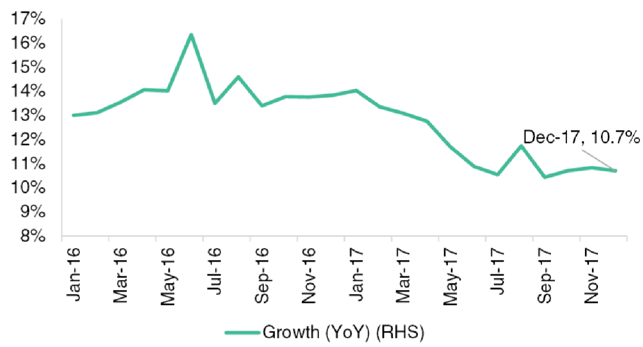
Source: Bangladesh Bank

Chart 2: Inflation Rates (2005-06 Base) (%)



Source: Bangladesh Bureau of Statistics

Chart 3: M2 Growth (YoY)

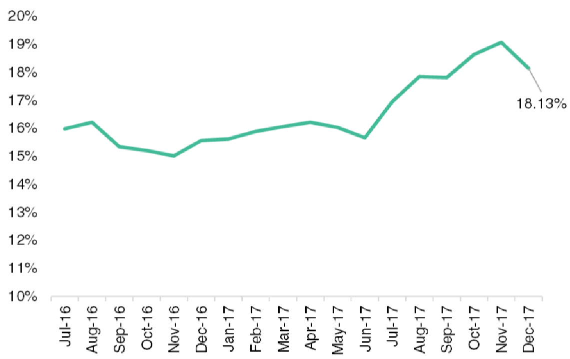


Source: Bangladesh Bank

Policy rates remains unchanged

After keeping policy rates fixed since Feb'13, both repo and reverse repo rates were cut by 50 basis points to 6.75% and 4.75% respectively in the MPS for H2FY16. The declining trend of inflation was supportive for such policy easing. The aim was to put further push to the already declining interest rates and stimulate higher investments. Since then, the market interest rates have bottomed out, the bank spreads have shrunk, and, most importantly, credit growth has picked up to such a level that slightly cautionary tones have been adopted in this MPS. Policy rates have been kept unchanged for the time being. We think rate correction could occur if the market rates see significant correction over the remainder of the fiscal year.

Chart 4: Private sector Credit Growth (YoY)



Source: Bangladesh Bank

Private Sector Credit growth expectations revised upwards

The MPS for H2FY17 set private credit growth target at 16.8% for Jun'17, up by 30 bps compared to the last MPS estimate. As of December'17, the achieved growth in private sector credit stood at 18.1% and is expected to be very close the target or, slightly exceed it at the end of Jun'17, despite the revised asset liability regulations soon to be declared. The six month adjustment period for banks and increase in deposit rates should help loan disbursement capacities but the figure would likely come down from the December 2017 number.

Public credit growth target reduced, Domestic credit target retained

The H1FY18 MPS set the public sector credit growth ceiling at 12.1% by Jun'18. However, as of December '17, credit to the public sector declined by 9.3%. The H2 FY18 MPS reduced public credit growth projection to 8.3% by Jun'18. The public credit growth is almost certain to be in the negative with NSC being the primary mode of public financing.

Domestic credit growth target for June 2018 has been retained at 14.5%. We think the overall strategic thinking behind the target is to provide private sector credit growth some room to grow without actually raising the private sector growth number too high. A combination of private sector credit growth number slightly over shooting the current MPS estimate and public credit figure underachieving compared to the target would lead to domestic credit number around the 14.5% target figure.

Table: External Sector

Economic Indicator	FY13	FY14	FY15	FY16	FY17	FY18 Outlook
Export Growth Rate (%)	11.2%	11.7%	3.4%	9.8%	1.7%	Likely to increase
Import Growth Rate (%)	5.0%	8.9%	0.2%	6.0%	8.7%	Likely to increase
Remittance Growth Rate (%)	12.6%	-1.6%	7.7%	-2.5%	-14.4%	YOY growth expected
Current Account Balance (mn USD)	2,388	1,406	2,875	4,382	(1,551)	(4,340)
Forex Reserve(mn USD)	15,315	21,508	25,025	30,138	33,407	N/A
Exchange Rate (BDT/USD)	77.80	77.60	77.67	78.27	79.12	N/A

Source: Bangladesh Bank

External Sector Outlook

The Current Account Balance (CAB) in FY16 was USD 4,382 mn in surplus. However, in FY17, strong import growth (8.7% YoY), low export growth (1.7%) and sharp decline in remittance (-14.4% YoY) dragged CAB into the negative territory, which is estimated to be USD 1,551 mn in deficit. Current account (CA) balance is already in the red by USD 4,432 mn and overall Balance of Payment (BOP) is at a USD 479 mn deficit, for the first five months of FY18.

The H2FY18 MPS does not provide specific targets for external sector. However, export is expected to pick up, with improved competiveness after BDT depreciation and wider market access as a result of bilateral and multilateral trade negotiations by the government. Regulatory initiatives taken to curb remittance inflow through illegal challenge seem to be successful with remittances picking up this fiscal. Import growth is expected to ease by BB as a large portion of public sector mega projects would be funded through reciprocal receivables from foreign sources. However, consider ing the current condition and near future outlook, BB projects deficit of USD 4,430 mn in the CAB in FY18, which has been revised down from 2,723 mn CA deficit in the H1 FY18 MPS. in FY18. Supported by strong capital and financial account performance, overall BOP is forecasted to be positive USD 393 mn for FY18 which has also been revised down from the previous FY18 BOP surplus projection of USD 2,254 mn. Given the FY18 external sector performance so far in FY18. the projections for BOP and CAB look to be quite optimistic.

Depreciation pressure on BDT expected to ease in H2 FY18

The sliding BOP and slow remittance put downward pressure on the exchange rate of taka throughout 2017. during the calendar year, BDT depreciated by ~10% in nominal effective exchange rate (NEER) and by ~7% I real effective exchange rate (REER) terms, according to BB statistics. Higher public sector funding through reciprocal receivables as well as improving remittances, an additional USD 700 mn import financing through BB's two specialized funds, easing of food imports in H2 FY18 due to new crops all are acting as supporting point for the central bank's expecta tion of BDT depreciation pressure easing over the rest of the fiscal. Having said that, BB also mentioned that it had sold USD 1.1 billion worth of dollars into the open market over H1 FY18 and stressed the importance of maintaining adequate reserve coverage is critical.

Economic Growth Outlook

The real GDP growth of Bangladesh was 7.28% in FY17 exceeding the government's 7.2% target. This phenomenal growth was the result of high public sector spending and strong domestic demand-led manufacturing sector, which more than covered for the weaker external sector performance, while the service and agricultural sectors also fared very well. For FY18, the government targeted real GDP growth of 7.4%. BB, based on sectoral developments and economic estimates, projected FY18 real GDP growth in the range of 7.1-7.4% in the last MPS. In the latest MPS, this outlook has been retained.

NSC rate reduction still a priority

Higher yields of National Savings Certificates (NSC) than bank deposits has been attracting huge public demand for these instruments over the past few years. As a result, during the past three fiscal years, the government's non-bank deficit financing through NSCs much exceeded the budgetary stipulations. Effectively, government's lower cost bank borrowing is being paid off with high-cost NSCs borrowings. This problem was acknowledged in the H1 FY18 MPS and tethering returns on NSCs had been marked as urgent priority. Although NSC sales numbers remain high in ab solute terms, NSC sales grew by 1.5% in the first half of FY18. There has been a rate cut of NSCs since the H1 FY18 MPS. Due to the slowdown in NSC sales growth, market rate lined rationalization of NSC pricing is now noted as an important priority, rather than an urgent one.

Focus given bond market development

As part of the macro-prudential steps for optimization of Banks' asset liability management, the current MPS encourages banks to avoid unduly high medium- or long-term investment financing exposures, instead suggesting them involve themselves in the corporate bond issuance process. An active bond sector has been sorely lacking from the country's capital market. It remains to be seen whether any concrete steps are taken in this regard.

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