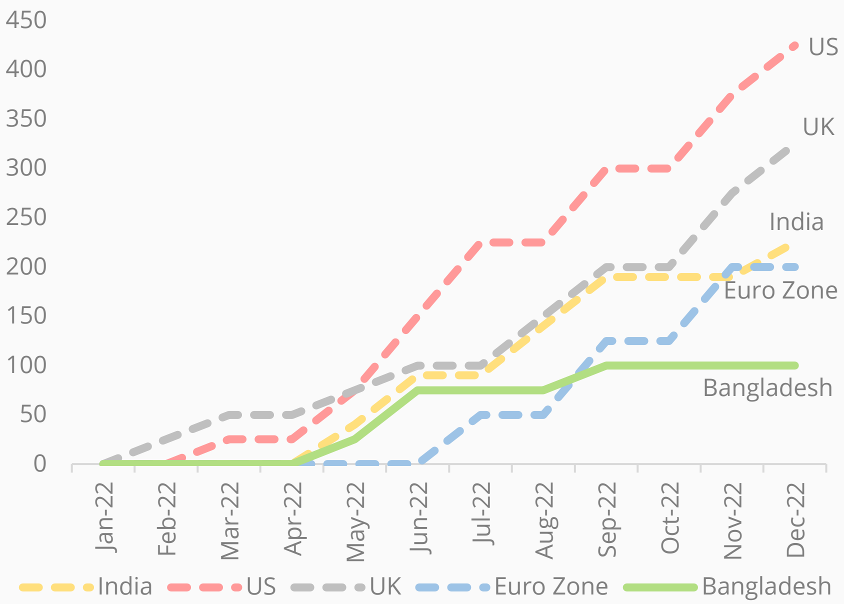
January 16, 2023

Flash note: Monetary Policy Review H2FY23 (January-June)

Bucking the trend

As major global central banks continue a synchronized tightening cycle in 2023, the Bangladesh Bank (BB) has chosen to maintain its accommodative stance, putting a higher priority on fostering economic growth over curbing inflation and reducing pressure on the exchange rate.

Policy rate hikes by global central banks in 2022 (bps):



CAL outlook for Q3FY23:

Macro Indicators	CAL's Outlook
Inflation (%)	9%
Repo Rate (%)	Up to 6.25%
Exchange Rate (BDT/USD)	114.6

The highlights of the announcement are as follows:

- GDP growth target revised to 6.5%, inflation rate to 7.5%
- The policy rate increased by 25 bps to 6.0% and the reverse repo rate to 4.25%
- The lending rate cap remains at 9.0%, except for consumer loans and credit cards. The lending rate cap for consumers' credit has been relaxed to vary up to 12.0%
- The floor on the deposit rate has been removed
- Aiming for a market-based, flexible, and unified exchange rate regime (within a 2% variation) by FY2023.
- The public sector credit growth target increased by 170 bps to 37.7%
- The private sector credit growth target remains unchanged at 14.1%
- Broad money growth ceiling set at 11.50%, down from 12.1%

CAL's VIEW:

- **Economic Growth:** BB is facing a delicate balancing act between promoting economic growth and containing inflationary and exchange rate pressures. The current monetary policy prioritizes growth. However, acknowledging impending challenges, the central bank has revised the GDP growth rate target to 6.5% in FY2023, which is consistent with our expectations. However, we expect nominal GDP to remain above 14.0% in FY2023 against 12.64% in FY2022.

- **Inflation:** Despite the central bank raising its target inflation rate to 7.5%, we believe that the current accommodative monetary policy stance may not be sufficient to bring down inflation from its current levels. The reliance on domestic borrowing is expected to increase in H2FY23, which is reflected in the upward revision of the public sector credit growth target by 170 basis points to 37.7%. Under the current environment, this may accelerate the pace of asset purchases by the central bank stoking further inflation. We expect the upward adjustment to electricity and gas prices, injection of new money, and depreciation of the BDT to push inflation at 9% by the end of Q3FY23.

- **Interest Rate:** The lending rate caps that remain in place for most loan categories will keep borrowing rates low for companies facilitating growth and reduce an aggressive build-up of NPLs in the Banking sector. The central bank removed the rate cap for consumer loans and credit cards and provided guidance in the monetary policy that it will remove the remaining lending rate cap under favorable economic conditions. The ongoing lending rate cap will continue to impede the effective transmission of monetary policy throughout the economy.

  We expect the central bank to hike policy rates by an additional 25 basis points by Q3FY23, assuming the Federal Reserve maintains its current projections. We anticipate 364 days T-bills rate to converge towards 9% during the same period.

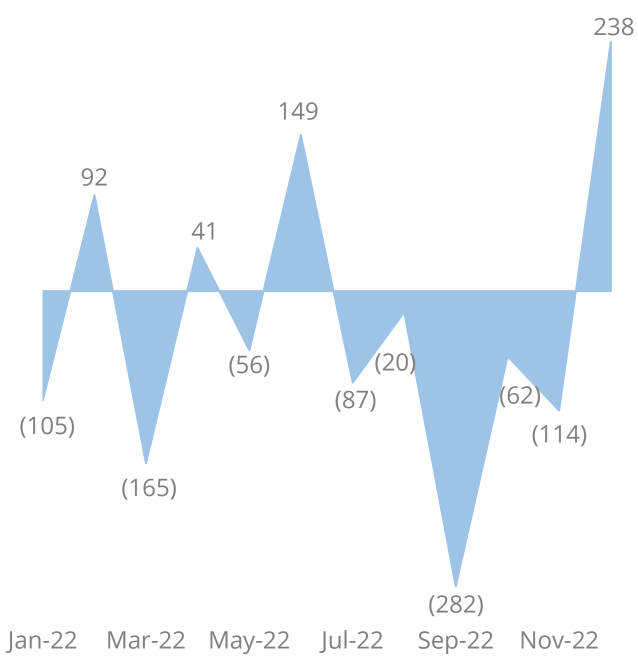
- **Exchange Rate:** The quantitative tightening policy by the US will exert further pressure on the value of the BDT against the USD. The current low level of reserves at BDT 33.63bn suggests that a bigger brunt of such pressures may be absorbed by the BDT rather than utilizing reserves for defense. The central bank's continued focus on interest rate targeting and increased reliance on domestic borrowing to finance budget deficits will continue to inject new money into the economy putting further pressure on the currency.

  Lower borrowing costs will sustain high credit growth and continue import momentum and motivate speculation on the currency outlook in import and export trade. However, further depreciation in the currency would provide some short-term advantages to export businesses with higher local value addition.

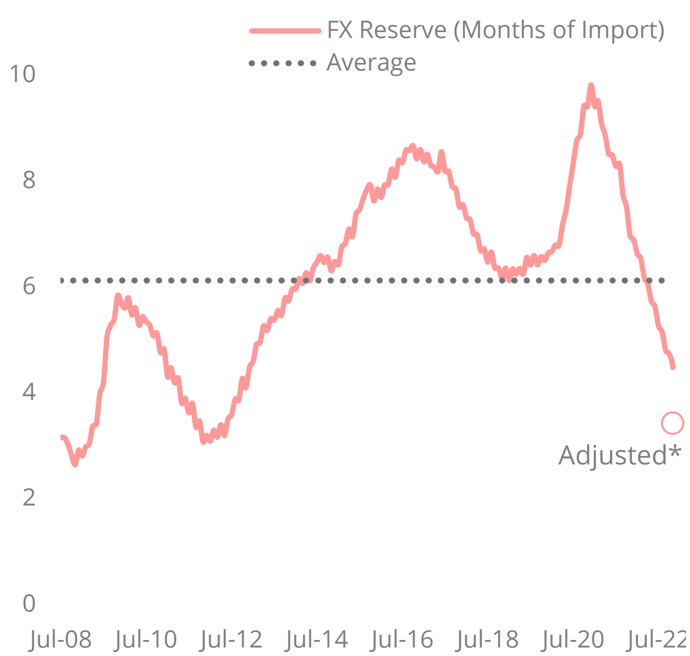
The exchange rate movement is likely to be largely determined by the scale and pace of monetary tightening. Holding our view of a balanced approach from the BB, we expect the BDT to continue its depreciating trend (expected 8%) and end Q3FY23 at BDT 114.6.

A steady depletion in forex reserves due to currency defense has reduced the central bank's ability to intervene in forex markets in 2023. This will further amplify the effects of further asset purchases and increase the money supply.

Liquidity injection (BB's asset purchase less dollar sales_ BDT Bn)



Forex reserve (Months of Import)



*EDF fund is excluded from the reserve.

- **Asset Price:** A moderate rise in interest rates from current levels and continued injection of liquidity may encourage investors to seek out risky assets as a hedge against inflation. This can result in short-term rallies in the stock market.

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