July 03, 2023

Flash note: Monetary Policy Review and Post-MPS Outlook H1FY24

Progressive Pursuit Amid Structural Shifts

The central bank has demonstrated flexibility by adapting its policy framework to include significant structural changes recommended by the International Monetary Fund (IMF) in the Monetary Policy for the first half of the fiscal year 2024. In our macroeconomic report titled "Navigating Rough Tides Ahead," published on June 16, 2023, we outlined two potential policy responses that the central bank could adopt: an "Aggressive Response" and a "Progressive Response." It appears that the central bank has chosen the progressive response, as outlined in our report, by hiking the policy rate by 50 bps along with an indication of the continuation of debt monetization which is consistent with that approach. However, CAL anticipates the progressive response might not be sufficient to anchor the macro variables.

Policy measures introduced in line with IMF Recommendations:

Interest Rate Targeting Framework

Interest Rate Corridor

Market Driven Reference Lending Rate

Unified Exchange Rate

The highlights of the announcement are as follows:

- GDP growth target revised to 7.5% and inflation rate to 6.0%.
- The policy rate increased by 50 bps to 6.50% and the reverse repo rate to 4.50% accompanied by a ±200 bps symmetric corridors consisting of a standing lending facility (SLF) rate at 8.5% and standing deposit facility (SDF) rate at 4.5%.
- Bangladesh Bank has introduced a market-driven reference lending rate called “SMART” (Six-months moving average rate of treasury bill).
- SMART plus a margin of up to 3% will be applicable for Bank loans while SMART plus a margin of up to 5% will be applicable for NBFIs. For CMSMEs and consumer loans, an additional fee up to 1% is subjected.
- Bangladesh Bank has adopted a unified and market driven single exchange rate regime and it will no longer quote specific rates for buying or selling foreign exchanges.
- Bangladesh Bank will publish gross international reserves (GIR) in line with IMF’s prescribed BPM6 method of reserve calculations.
- The private sector credit growth is projected at 11%.
- Broad money growth is projected at 10%.

(Projected data for June-2024)

CAL's view on the policy measures:

Embracing Tighter Monetary Conditions:

The adaptation of a contractionary monetary policy stance is a notable step towards achieving macroeconomic stability. The tightening of monetary conditions is expected to discourage unproductive financial flows and mitigate demand-side concerns to some extent. However, it is evident that the central bank is exercising caution to avoid overly rapid rate increases, as this could potentially impede economic growth and contribute to the accumulation of non-performing loans (NPLs) in the banking sector. Nevertheless, the success of this contractionary policy stance hinges on its effective implementation.

The Adoption of SMART:

The introduction of the market-driven reference lending rate, known as SMART, is expected to result in lending rates surpassing the 10% mark. While this move will increase the cost of borrowing, it is also anticipated to alleviate some inflationary pressure. However, the calculation method based on a six-month moving average rate of treasury bill will introduce a certain time lag in effectively incorporating real-time market dynamics into lending rates.

Implementation of Unified Exchange Rate:

The implementation of a market-driven single exchange rate regime from July 2023 is expected to facilitate the establishment of an equilibrium price for the currency. This adjustment will help smooth the supply of USD for trade settlements, enhancing stability in foreign exchange transactions. However, it is important to consider that achieving currency stability, in conjunction with the normalization of external trade, will depend on the timeframe for adopting the Unified Exchange Rate and its effective implementation.

Domestic and Foreign Asset Growth Projections:

The policy steps outlined above are crucial for restoring macroeconomic stability. However, two significant factors will greatly influence the implementation of these policies by December 2023. Firstly, the notable 16.8% growth in domestic assets forecasted in the MPS indicates that the central bank is likely to rely on debt monetization to finance the budget deficit. Secondly, the substantial 20.3% forecasted decline in foreign assets suggests that the central bank may continue to sell reserves until December in order to provide support for the currency.

While the current MPS policy response leans towards the progressive response, the indication of continued sales of USD by the central bank will add a new dimension to it. If the central bank persists in selling USD until December, a reduction in the forex reserve may raise additional challenges in meeting the IMF's Quantitative Performance Criteria (QPC) for December 2023.

CAL's Macroeconomic Outlook: December 2023

Key assumptions considered based on the MPS:

- Central bank continues debt monetization to finance the budget deficit.
- No further increase in the policy rate.
- Continued adherence to moral suasion to keep exchange rates at predefined levels.
- The sale of dollars from the forex reserve to provide support for the currency.
- Amount of debt monetization will exceed the liquidity mopped up through dollar sales.

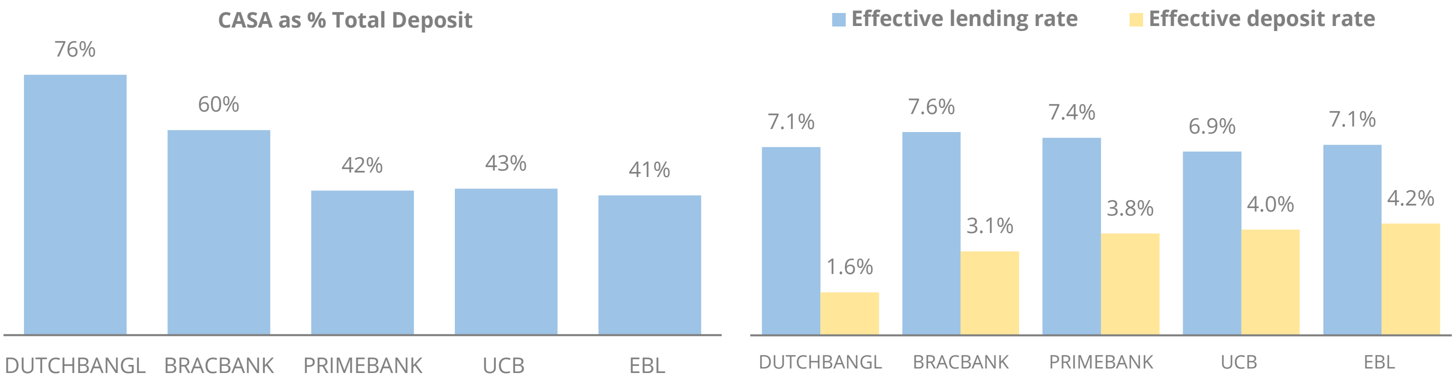
How will these policy measures translate into the macro variables?

- **Inflation:** CAL expects inflation to remain at elevated levels to around 10.0% to 10.5%, much higher than the 6.0% target set in MPS.
- **Interest Rate:** CAL expects the 364-day T-bill yield to will increase to a range of 9% to 9.25% on the back of a 50 Bps increase in policy rate as well as the continued sale of dollars from the forex reserve.
- **Exchange Rate:** Continued debt monetization and the absence of further policy rate hikes will limit the increase in interest rates. This, in turn, will result in lower interest rate differentials with developed economies, resulting in negative financial account balance, and limiting foreign fund inflows. Meanwhile, domestic assets growth will outpace foreign assets growth, building further pressure on BDT. However, if the central bank continues to sell USD supporting the currency, CAL expects BDT to depreciate by 8% to 10%. In the event that the central bank chooses to halt the sale of USD while continuing debt monetization, it is expected that the BDT may experience a notable depreciation of approximately 14% to 16%.
- **Economic Growth:** CAL anticipates that achieving a real GDP growth rate of 7.5% will be challenging due to the adverse impact of high inflation on domestic consumption. Additionally, the prolonged restrictions on imports have weakened the supply side, potentially resulting in reduced output. The persistence of power shortages may exacerbate the existing supply-side weaknesses, further impeding output.

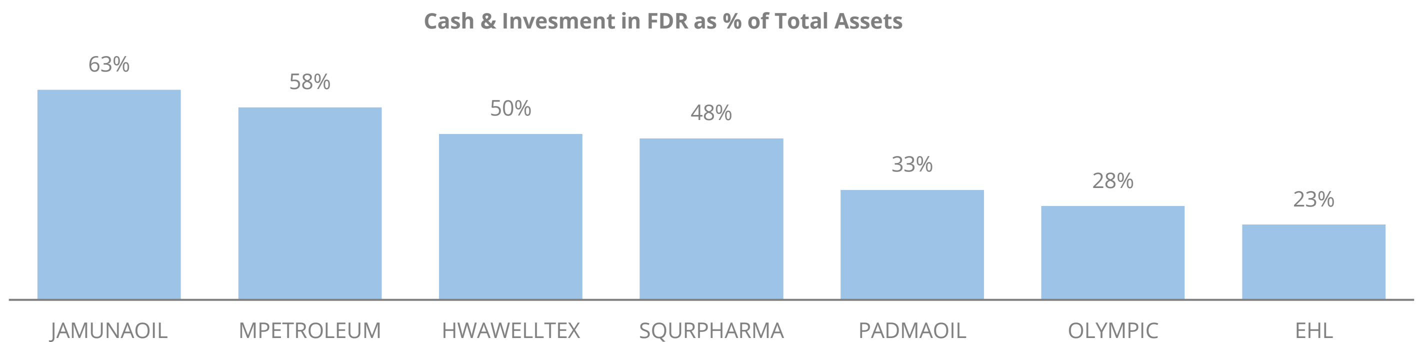
In the event of notable policy measure changes during the year by the central bank that deviates from our key assumptions, we will promptly revise our macroeconomic outlook to reflect these changes, including our view through a note.

Impact on Listed Equities:

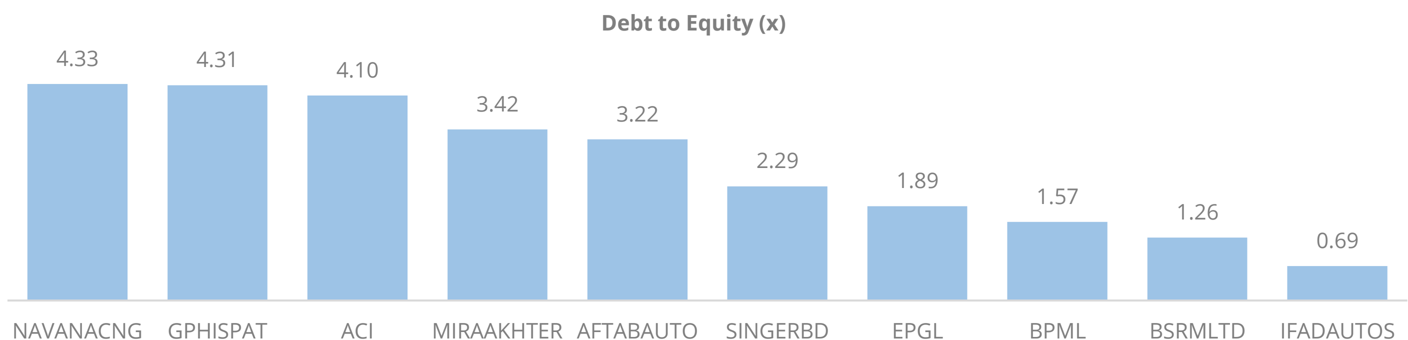
"SMART" rates to expand NIM: Banks and NBFIs are to be the key beneficiaries of the upward adjustment in lending rates following the introduction of benchmarked reference lending rates "SMART" (Six-months moving average rate of Treasury bill). As the lending rate gets adjusted, we expect Banks with higher CASA to see higher net interest margin expansions. However, it is important to note that this approach will involve a lag period for market dynamics to fully influence lending rates.



Interest income surge: In an upward interest rate cycle, companies with a significant portion of total assets invested in fixed deposits will see higher earnings from interest income.



High-interest expenditures to bite: Leveraged companies are going to be negatively impacted due to high-interest expenditures.



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