Would the monetary policy still be useful after 9pc interest rate?

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The big question on economists' mind is, how will the 9 per cent ceiling on bank lending rates impact the conduct of monetary policy?

Currently, the Bangladesh Bank practises a quantity-based monetary policy framework. At the beginning of the fiscal year, the BB announces reserve and broad money targets to support the GDP growth and inflation objectives. The monetary programme does not set the level of interest rates or the exchange rate.

These are left to be market-determined through practices customary in the lending-borrower (interest rate) and buyer-seller (exchange rate) relationships embedded within a set of regulatory code of conduct.

Remember, under a market-determined setting, there is no such thing as "the interest rate".

Deposit rates vary by types and tenure, while lending rates vary by borrower risk profile and loan tenor. Supply and demand forces generally determine the level of interest rates in each market segment.

The BB influences interest rates by influencing the quantity of liquidity available at any given point in time in the money market subject to its stance in the foreign exchange market.

The regime under which the BB can conduct the monetary policy will change from April 1, 2020. Interest rate will be fixed at 9 per cent for most lending (except credit cards).

But the BB notice promulgating the interest rate ceiling is silent on the deposit rate. So, formally only the lending rate is being capped.

The assumption appears to be that the lending rate cap will automatically lower the deposit rate below 6 per cent. After all, how many banks, if any, can afford to operate with just 3 per cent spread?

The key question is whether the BB is left with any choice on setting the levels of reserve and broad money.

Note that the 9 per cent ceiling is binding for most bank loan market segments. Interest rates on loans to large corporates, small- and medium-sized enterprises (SMEs) and home owners are in double digits, ranging between 9.5 and 16.5 per cent.

The imposition of interest rate below these market rates makes it a binding ceiling. Other things equal, this will reduce the supply and increase the demand for loanable funds, thus creating excess demand at the ceiling rate.

Since lenders cannot be forced to lend more than what they are willing to, the short side of the market will prevail, i.e. the total amount lent will equal the total the lenders are willing to lend -- and not the total the borrowers are willing to borrow.

The BB has the option to make it equal the amount the borrowers are willing to borrow.

It can do this by lowering prudential controls such as the cash reserve ratio (CRR), increasing the loans-deposit ratio or providing liquidity support at reduced policy rates.

The BB implemented a mixture of these policies in 2018 and 2019. Yet the average lending rate stayed above 9 per cent. More will, therefore, be needed to accommodate the excess credit demand resulting from the 9 per cent ceiling.

Absent such regulatory and/or direct BB accommodation, the impact of the ceiling will be contractionary as the supply of liquidity in the economy will fall through credit rationing.

This, in turn, will decrease consumption and investment demand because of tighter financing constraints.

The high-risk sectors such as the cottage, micro and small enterprises are more likely to be excluded as will all borrowing categories where the marginal cost of providing loans (including risk premia) exceed 9 per cent.

The demand-induced recession in the excluded sectors may subsequently ripple through the rest of the economy -- with consequences for the overall level of employment and incomes.

The alternative is to accommodate the increased demand for loanable funds.

> *Fixing lending rate uniformly at a predetermined level is equivalent to not only shooting the messenger but also disabling the monetary policy apparatus.*

The ability to relax regulation to increase the supply of loanable funds has its limits. The CRR can at best be zero and the loan-deposit ratio cannot exceed 100 per cent.

Policy rates can, in theory, be negative, but in practice it is highly unlikely in Bangladesh.

The BB can engage in open market operations to inject liquidity directly into the banking system.

Whatever the method used, the immediate impact will be to increase the supply of loanable funds beyond the level demanded before the interest rate ceiling became effective.

A monetary expansion will ensue.

Sustaining the ceiling at 9 per cent over time will require the BB to fully accommodate the growth in demand for credit irrespective of what the macroeconomic targets of the monetary programme warrant.

Such expansions risk rising inflation that is already cost-pushed by gas, electricity and water price increases.

The bottom line is that the space for manoeuvring monetary policy when faced with expanding demand for credit is severely constrained by the interest rate ceiling.

Interest rate can no longer respond to upside aggregate demand shocks to stabilise the economy. For instance, in the absence of the ceiling, a rise in demand for credit will increase both the quantity of money traded in the credit markets as well as the interest rate.

The latter will soak part of the initial increase in demand, thus limiting its impact on aggregate demand for goods and services and hence on inflation.

A binding ceiling will prevent such increase in the lending rates and allow credit to expand as much as originally because of accommodation from the BB. All that the central bank can choose is how to accommodate the excess demand.

It can administer a yet-to-be-fully-specified set of directives to banks for allocation of credit to various sectors at the desired level and ensure that they have enough liquidity to implement such directives.

The known unknowns in this case are the credit market outcomes.

One possibility is a fall in credit in the absence of monetary accommodation.

Another possibility is a rise in credit made possible by easing regulatory controls while introducing directives on credit allocation and ensuring their enforcement.

If this proves to be inadequate, the BB can inject additional liquidity.

The extent of liquidity decline if it decreases and that of liquidity increase if it increases will depend on the extent of monetary accommodation and the effectiveness of credit directives at the level of borrowers and lenders.

A variety of intermediate outcomes are conceivable between these two extremes.

Interest rate ceiling will eat up monetary policy space through increased fiscal dominance.

Any increase in domestic financing of budget deficit will create pressure for monetary accommodation.

If non-bank borrowing is used, the supply of loanable funds to the private sector will dry out. This will need to be met by regulatory easing and forbearance, of which there is not much room, or direct liquidity support from the BB.

Using bank borrowing will have the same effect on the supply of loanable funds, the difference being a possible rise in risk-free rates available to banks, which further acts as deterrent to lending to the private sector at the ceiling rate.

Note that there are no ceilings on the risk-free T-bills and T-bonds rates. Yields on these instruments of short and long maturities currently range between 7 and 9.1 per cent.

Domestic financial markets in Bangladesh do not have enough depth to absorb the placement of public debt.

The BB will have no option but to accommodate increased domestic financing needs of the government to mitigate any adverse effect on private credit growth due to expanded options to banks to place funds at attractive risk-free rates.

This will amplify the impact of fiscal expansion on aggregate demand.

The exigencies of the budget will take precedence over controlling inflation and supporting growth. Fiscal policy considerations will get primacy in conducting monetary policy.

The above discussion assumes the regulatory changes introduced to make it easier for banks to lend at 9 per cent do not have any unintended consequences. Such consequences are likely when monitoring and enforcement are weak.

Credit misallocation and asset price bubbles often result from lending rate repression both in theory and in practice.

Influential borrowers availing excessive cheap credit may put them to speculative investments in asset markets, thus causing credit misallocation and asset price bubbles.

Rise in financial disintermediation cannot be ruled out either. By increasing systemic risk to financial stability, these will create formidable new challenges for financial regulation.

If we accept the proposition that interest rates in Bangladesh are high because risk premia are high, and not predominantly because of non-competitive behaviour by banks, then the ceiling cure is most likely to be worse than the disease.

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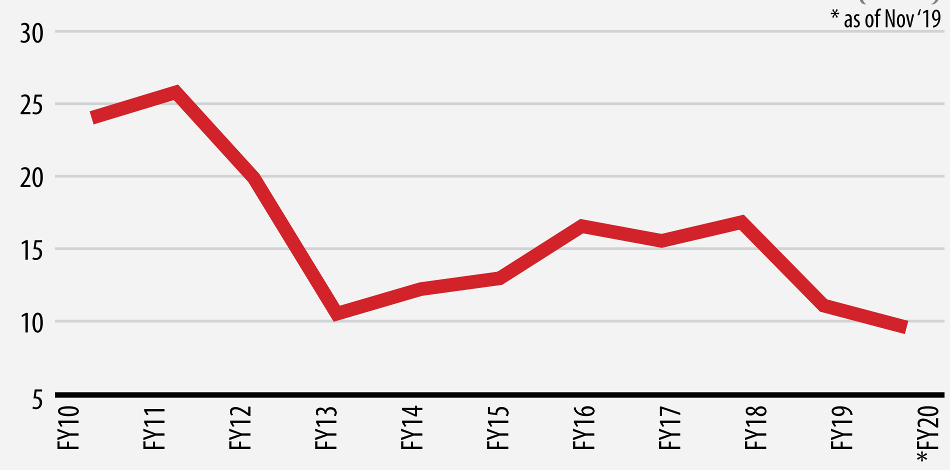
PRIVATE SECTOR CREDIT GROWTH OVER THE DECADE

(in %)

* as of Nov '19

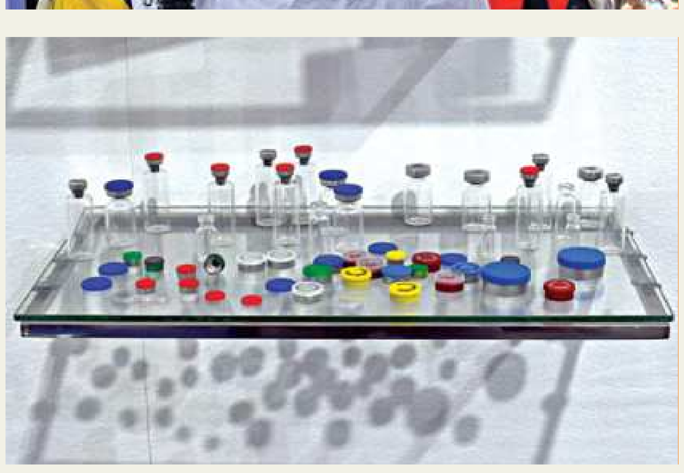


EXISTING INTEREST RATES OF BANKS (in %)

Farm loans	4-9
Term loan to large, medium industries	6-16.5
Term loan to small industries	8-20.5
Working capital to large, medium industries	6.75-17
Working capital to small industries	8-17
Export credit	6.75-7
Trade financing	6.75-16
Home loans	7-16
Consumer credit	7.99-20
Credit to non-banks	6.75-20.5

SOURCE: BANGLADESH BANK

PHARMACEUTICALS INDUSTRY IN FOCUS



The 12th edition of 'Asia Pharma Expo-2020' organised by the Bangladesh Association of Pharmaceutical Industries in collaboration with GPE Expo Private at the International Convention City Bashundhara in Dhaka concluded yesterday. Professionals and solution providers shared knowledge and technological advancements of the pharmaceuticals industry in the exhibition, where about 530 companies from 18 countries participated.

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