July 1, 2022

Flashnote: Monetary Policy Review FY 2022-23

Beginning of the Tightening Cycle

Bangladesh Bank (BB) opted to increase the policy rate, signaling the beginning of a tightened monetary cycle to contain inflation and easing pressure on the exchange rate.

The highlights of the announcement are as follows:

- Bangladesh Bank has increased the policy rate by 50 bps to 5.5%, while reverse repo remains unchanged at 4.0%.
- The private sector credit growth target has been set at 14.1% for FY23, which is 70 Bps lower than the last year's ceiling.
- The broad money growth target has been set at 12.1%, down from 15% last year.
- The lending rate cap will remain fixed at 9.0%.
- BB to introduce a new refinance line of credit for import-substituting products, while LC margins for luxury goods and other non-essential items will be increased to discourage their imports aiming to contain pressure on the exchange rate.

CAL's VIEW: While the stated objective of BB to tighten monetary conditions further is in line with our expectations, we believe it will have to move further and faster in order to contain macro pressures

Interest rate expectation:

- BB has now raised monetary policy rates by 75bps this year. BB's efforts thus far to ensure an orderly depreciation of the currency have also resulted in a tightening of liquidity conditions, pushing up treasury yields as well.
- We expect the rate hikes announced thus far to bear the signaling effect of BB's tightening objectives this year. However, we expect further rate hikes throughout the year to keep pace with global central banks which are moving in tandem to tackle inflationary pressures. Provided the US Fed follows current projections, we expect BB to hike policy rates by a further 150-200 bps in the remainder of 2022.

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- With the increase in underlying interest rates, the existing lending rate cap is no longer tenable. Banks will naturally be incentivized to invest in government securities viz a viz lending in the wider market. The rate cap also prevents the effective transmission of monetary policy into the wider economy. CAL believes that policymakers are likely to revisit the lending rate cap shortly in order to address this mismatch.

- Pursuing a policy target where broad money growth is lower at 12.1% compared to private sector credit growth at 14.1% is likely to induce a liquidity shortage.

Exchange rate expectation:

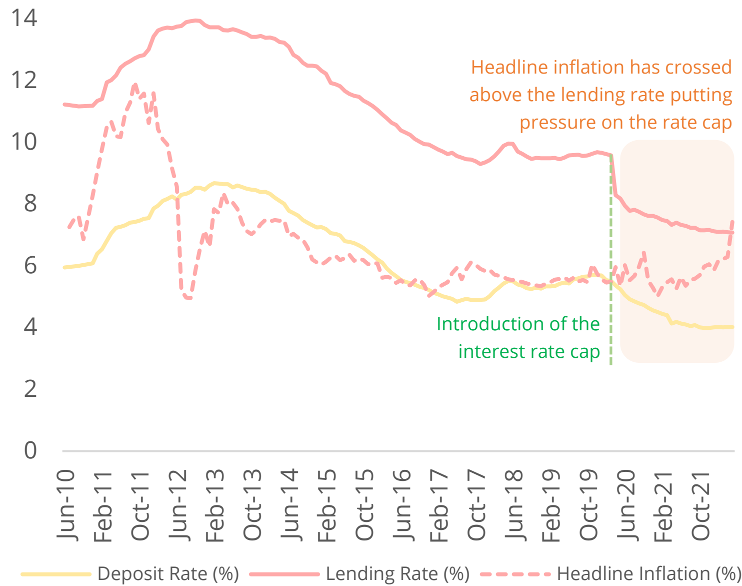
- The movement of the exchange rate is likely to be largely determined by the scale and pace of monetary tightening. Holding our view of a balanced approach from the BB, we expect that the BDT is likely to continue its depreciating trend (expected 6-7%) and end the year at BDT 104.

- We condition this expectation on a gradual increase in interest rates from BB. A slower than expected tightening could place further pressure on the BDT, while a faster and more effective move could contain BDT below 100 against USD.

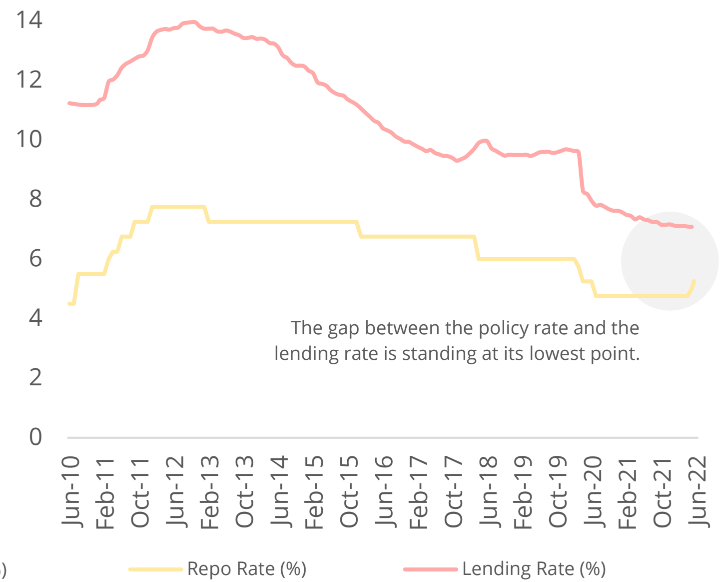
- Further increasing LC margins for luxury goods and other non-essential items may reduce pressure on the exchange rate. However, it is likely to fuel further inflationary pressure. Introducing a new refinance line of credit for import-substituting products may end up stoking additional demand for foreign exchange owing to the dependence on imports to support import-substituting products.

Inflationary Pressure to Persist

Inflation (%) vs Interest Rate (%)



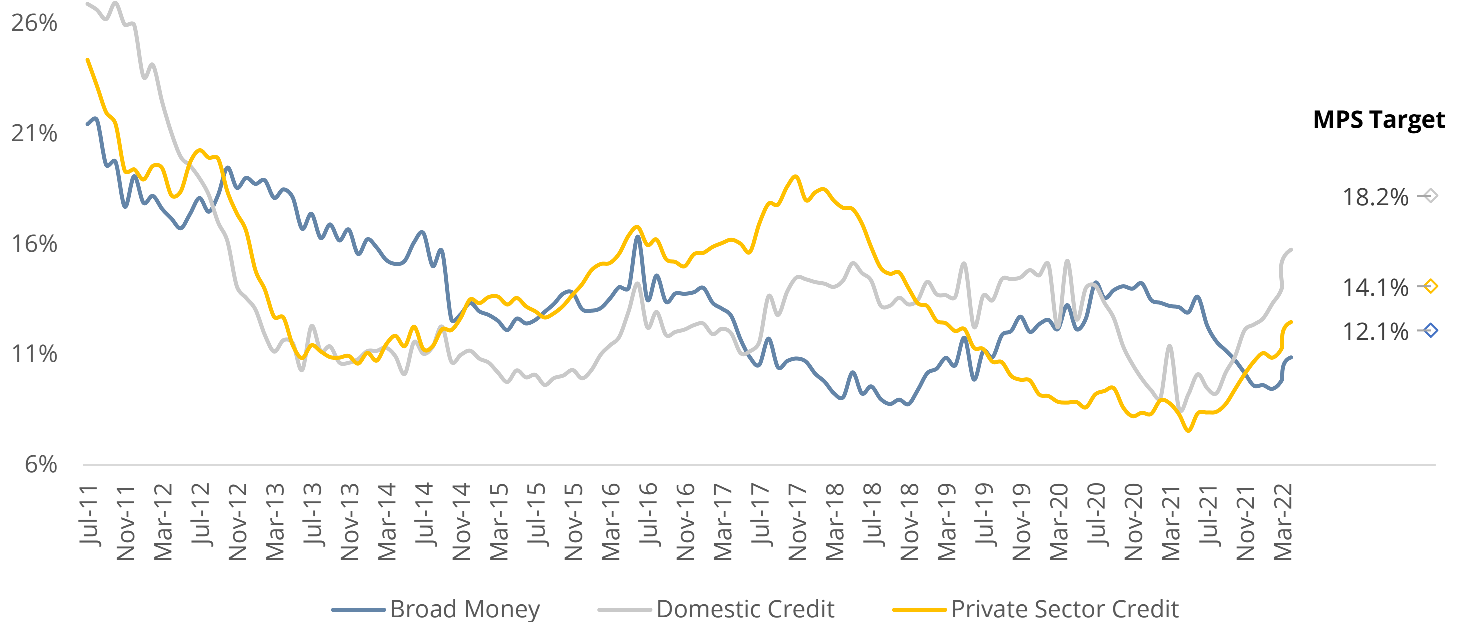
Repo rate (%) and Weighted Avg. Lending Rate (%)



On the supply side, the impact of the MPS will be limited as inflationary pressure will continue to linger owing to supply chain disruptions along with elevated global commodity prices. Moreover, pending upward adjustments of fuel and energy prices is likely to feed through into higher inflation. On the demand side, an increase in the policy rate will have a muted effect due to the existing cap on the interest rate. As the gap between the policy rate (5.5%) and lending rate (7.08% in May) continues to shrink while headline inflation (7.42% in May) crosses over the lending rate, CAL expects the central bank to revisit the prevailing interest rate cap.

Dominant Public Credit Target to Squeeze Private Sector Borrowing

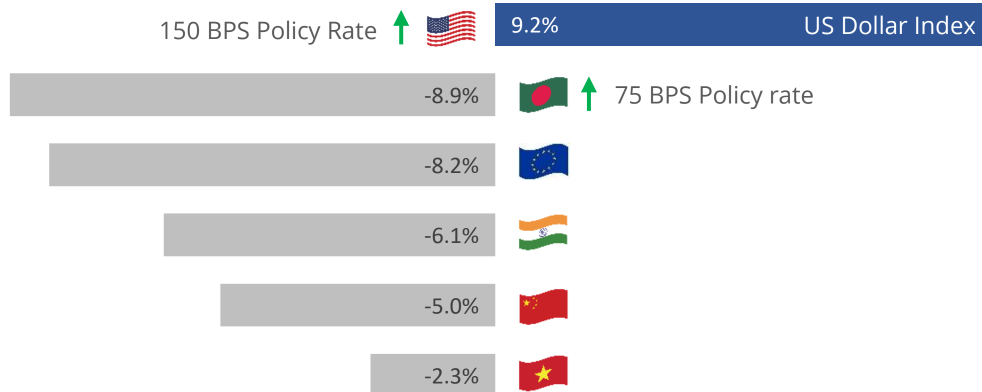
Broad Money Growth (%) and Credit Growth (%)



BB has targeted 18.2% domestic credit growth driven by a 36.3% growth in public sector credit. A 22% increase in the budgetary borrowing target from the banking system will leave little room for the private sector. As a result, the target for the private sector credit growth has been reduced by 70 Bps to 14.1% in FY23. However, a reduction in the broad money growth target of 12.1%, down from 15.0% a year earlier, may help when the central bank is looking to contain down the demand-pull inflation.

Taka to Remain Volatile

Depreciation of selected currencies against the US Dollar (YTD)



The current interest rate structure may fail to attract capital inflows while inducing currency speculation. A 9.2% YTD appreciation in the dollar index following a series of rate hikes (+150 Bps) by the U.S Federal Reserve as well as higher import bills stemming from increased global prices of fuel, food, and fertilizer is likely to keep the taka under pressure. CAL expects the taka to depreciate further against the USD as a 75 Bps policy rate hike under a fixed interest rate regime is likely to be inadequate compared to 150 Bps US FED rate hikes.

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