Strategies for Bangladesh Bank—II
Supervision of banking sector
Sharjil M Haque concluding his two-part article on 'Strategies for Bangladesh Bank'

Since the Asian financial crisis, central bankers in Asia have recognised the intricate link between macroeconomic performance and financial stability. Numerous reforms have since been initiated, which have improved macro-financial linkages in several Asian economies.

Regrettably, the story is quite different in Bangladesh. Despite impressive performance in GDP (gross domestic product), trade and other macro-economic drivers, Bangladesh often experiences unprecedented volatility in its financial sector. Strong macroeconomic indicators are not always reflected through financial sector performance.

In other words, macro-financial linkage in Bangladesh is weak. This section addresses key issues which Bangladesh Bank (BB) needs to address to enhance macro-financial channels and banking sector performance in Bangladesh.

INTEGRATING WITH GLOBAL CAPITAL MARKETS: Capital openness is expected to benefit capital-scarce countries like Bangladesh and link the macro-economy with global financial sector. For Bangladesh, capital account liberalisation may be a key step in breaking the current 6.0 per cent GDP 'growth-trap'.

As the Asian Development Bank (ADB) recently pointed out, Bangladesh’s Investment-GDP ratio (currently at 29 per cent) needs to rise to 35 per cent to go beyond 7-plus growth rates and to around 38 per cent to reach 8.0 per cent growth rate. Greater integration with global financial markets can pave the way for this much-needed investment.

The downside is naturally capital outflow, generally in response to higher external interest rates, resulting in currency devaluation or foreign exchange depletion (in case the exchange rate is pegged such as Bangladesh’s is at present).

India’s currency crisis in 2013 in response to US announcement of asset tapering is a prime example. Also, with the US economy looking stronger than ever, capital outflow from emerging markets is once again on the cards.

Until 2008, foreign borrowing was virtually negligible in Bangladesh. With improvements in balance of payments and surge in foreign reserves, the government has slowly started to liberalise such borrowing.

This can be seen by rising amounts of foreign borrowing. According to BB, net outstanding foreign currency denominated loans stood at US$ 1.52 billion in 2012 and US$ 1.74 billion in 2013.

The BB needs to carefully regulate this process utilising a time-bound strategy where capital controls are gradually removed parallel to macroeconomic improvements in Bangladesh.

Ensuring that capital controls are removed during strong macroeconomic conditions reduces the risk of capital outflow and keeps Bangladesh attractive to foreign investors looking to diversify their portfolios.

Additionally, as the central bank allows foreign borrowing, it has greater responsibility in terms of rigorously monitoring the amount of foreign loans availed by the private sector and credit-worthiness of individual firms and integrity of respective managements.

ADDRESSING BANKING DILEMMA: For Bangladesh, capital account liberalisation has another indirect effect. It will obligate local banks to lower their exorbitant lending rates. At present, lending rate in Bangladesh is around 12-13 per cent - significantly higher than 7.0 per cent-8.0 per cent rates which the private sector can avail if they borrow from international capital markets.

Only when foreign borrowing becomes easily accessible, will the domestic banking sector be compelled to adopt the discipline necessary to compete with foreign lenders. This involves greater emphasis on monitoring of the credit worthiness of clients, focusing on the most productive sectors and bringing down aggressive lending and lending based on political obligations.

But even in such improved scenario, banks will not be able to match the international rates if inflation remains at 7.0 per cent - real rate of return will be zero or negative.

Therefore, the BB also needs to strengthen its fight against inflation to allow banks the room needed to bring down lending rates. In addition to monitoring sector-wise credit exposure of banks, the BB needs to collaborate with the government to reduce supply-side bottlenecks in order to achieve the 5.0 per cent inflation target by 2017.

MONITORING CAPITAL FLIGHT: Any discussion on capital openness is incomplete without mentioning the issue of
capital flight. According to the latest study conducted by Global Financial Integrity, capital flight from Bangladesh tripled last year to almost US$ 1.8 billion.

This amount is huge, in both absolute and relative terms. For one thing, this is more than half the amount budgeted for construction of Padma Bridge!

The BB has definitely put in strong efforts to combat this issue, including strengthening of the Financial Intelligence Unit. But the process is far from over. A strong focus for the BB should be to create systems which detect trade mis-invoicing.

The effectiveness of the commendable 'Dashboard', an electronic monitoring system used to detect fraud in the banking system, needs to be evaluated in the light of the fact that capital flight has increased. Furthermore, the BB needs to work closely with the National Board of Revenue to create automated systems which share information on foreign trade.

Finally, the BB has to collaborate with Swiss banks and off-shore financial centres which are often rumoured to be the likely destinations of illegal money flowing out of Bangladesh.

A communication and monitoring channel needs to be created with these overseas destinations to reduce and ultimately prevent capital flight.

MAINSTREAMING MACRO-PRUDENTIAL REGULATION: Macro-prudential tools like Cash Reserve Ratio (CRR) are generally used to protect the financial system from changing credit cycles.

CRR, a quintessential macro-prudential tool, has been changed only eight times in the last 24 years. We pick a recent three-year sample during which CRR was changed twice, to study cyclicality of macro-prudential practice in Bangladesh.

In October 2009, the Bangladesh Bank increased CRR to 5.0 per cent from 4.5 per cent at a time when excess liquidity (the difference between total and required liquid assets in the banking sector) stood at around BDT 350,009 million (Source: BB).

In May 2010, when excess liquidity came down to approximately BDT 307,000 million, the BB raised CRR again on grounds of containing inflation. But this policy only reduces liquidity from the system further - in other words, the central bank showed pro-cyclical tendencies.

Macro-prudential tools like Cash Reserve Ratio, Capital Requirement, Loan-to-Value Ratio (and others) are generally utilised to prevent pro-cyclicality of the financial system. These tools should be utilised counter-cyclically to hedge against changing credit conditions and prevent a credit bubble or credit crunch.

Recently, we can see better counter-cyclical practices by the central bank. The CRR was raised to 6.0 per cent in June 2014 as excess liquidity rose to BDT 1,022,230 million. This is definitely a good sign. But excess liquidity has been building up ever since political turmoil began before 2014 elections. Why wait for such a long time to raise the CRR?

Encouragingly, the BB has directed commercial banks to start implementation of Basel III which mandates utilisation of macro-prudential tools counter-cyclically. However, the implementation time-frame is five years and liquidity conditions in Bangladesh can change several times during this period.

As such, the BB needs to mainstream macro-prudential tools into its own operational framework, and utilise Cash Reserve Ratio counter-cyclically to protect the financial system from credit shocks.

DEALING WITH NPL CHALLENGE: The issue of high Non-Performing Loans (NPL) is a long and steadily worsening one. While the number stands well below 5.0 per cent for countries like China, India and Malaysia, NPL in Bangladesh is at around 10 per cent.

A cursory glance at NPL ratios by type of banks makes it evident that bulk of the problem is due to the state-owned banks. Weak governance, influence from political forces and sacrificing quality in place of quantity (when it comes to seeking borrowers) are some of the major reasons for this predicament.

To add to the growing lack of discipline in the banking sector, the government recently recapitalised the scam-hit state-owned banks. As many have pointed out, this is nothing but a gross misuse of public resources.

Significant reforms in managing NPL are imperative now. From macro-policy perspectives, the central bank needs to negotiate with the government to obtain full control and authority over the state banks.

Next, the BB needs to create a committee which regularly monitors exposure of the banks to different sectors.

Since sectors such as ship-breaking and real estate have turned out to be quite risky exposures, the BB needs to create a guideline which limits exposure to different sectors based on factors such as productivity and growth prospects; this can be adjusted as an industry’s outlook changes.

From a more micro-perspective, while every bank has its own internal risk management system, the central bank needs to create a team to identify whether these risk management frameworks are truly being followed.

It is well known that the quality of employees vary significantly across the banking sector and some industry experts have conjectured that employees often use 'judgment' rather than the actual risk management tools and frameworks to assess riskiness of loans.

The BB needs to identify how prevalent this activity is, and bring it to the attention of the top management in these banks.

Admittedly, some of the strategies outlined are more long-term oriented. Designing them will not only require
time, but careful consideration of the interlink between monetary, macro-financial and banking aspects.

But the BB's strong track record of ensuring price stability, inclusive growth and rising vigilance against financial sector indiscipline shows it certainly has the capacity to undertake these strategies.

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