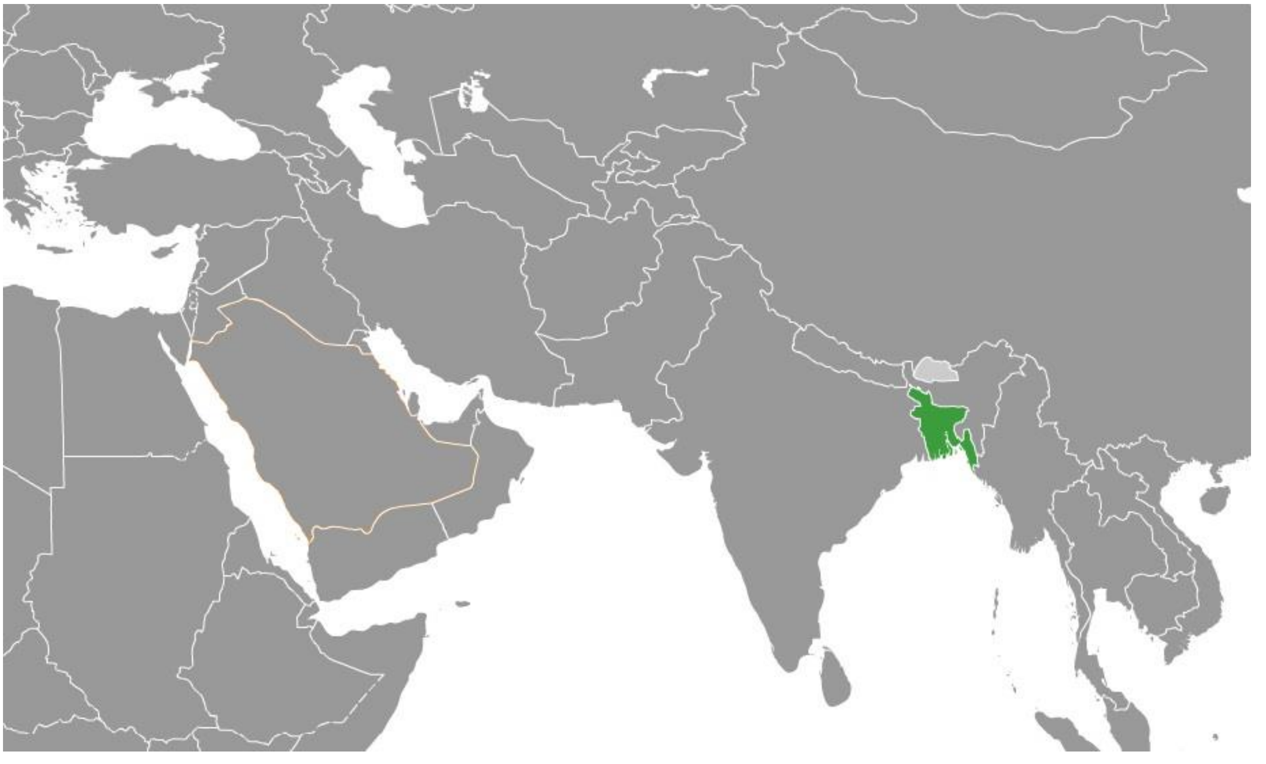


Monetary Policy Update

H2 FY19

Analyst: Saad Niamatullah
saad.niamatullah@lankabangla.com

January 30, 2019

Policy Stance	June 2019
Inflation Projection	**5.30%-5.60%**
Repo Rate	**6.0%**
Reverse Repo Rate	**4.75%**
Broad Money (M2) Growth	**12.0%**
Reserve Money (RM) Growth	**7.0%**
Domestic Credit Growth	**15.90%**
Public Sector Credit Growth	**10.90%**
Private Sector Credit Growth	**16.50%**
CRR	**5.50%**
SLR	**18.50%**

Source: Bangladesh Bank

Policy Highlights

- BB projects GDP growth of 7.50%-8.20% in FY19, against the government's target of 7.80%. GDP growth for FY18 was 7.86% against target of 7.40%.
- Inflation projections have been further reduced to 5.30%-5.60% from previous level of 5.40%-5.80% due to favourable global energy prices and domestic food production.
- Repo and reverse repo rates maintained at 6.0% and 4.75% respectively.
- CRR and SLR are maintained at 5.50% and 18.50% respectively.
- Projections for Broad Money (M2) and Reserve Money (RM) growth have been maintained at 13.30% and 12.0% respectively. An overall balance of payments deficit is likely to lead to contraction in net foreign asset (NFA) growth, making it difficult to meet M2 growth target.
- Domestic credit growth projection has been maintained at 15.90%. Public sector credit growth projection has been raised from 8.50% to 10.90% while private sector credit growth has been reduced slightly from 16.80% to 16.50%.

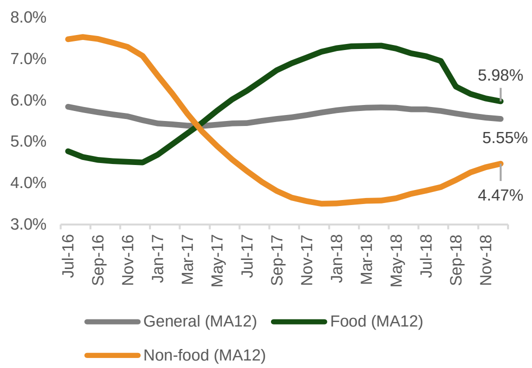
Key Observations

The H2FY19 Monetary Policy Statement (MPS) is the first MPS to be released under the tenure of the newly elected government, which assumed power after winning the general elections held on 30th December 2018. GDP growth hit a record high of 7.86% in the past fiscal year (FY18), driven by strong domestic demand and robust public and private sector investment. Exports and remittances have picked up in FY19, and expectations of a stable political situation for the next five years have raised expectations of continued robust growth for FY19 and beyond.

However, headwinds are steadily building up, with FY18 recording a current account deficit of USD 9.78 billion, which was equivalent to 3.6% of GDP. As a result, an overall balance of payments deficit of USD 885 million was recorded, leading to negative net foreign asset (NFA) growth (-4.2% in Jun-18), which consequently led to lower broad money (M2) growth and tighter domestic liquidity conditions. The current account deficit has moderated somewhat in FY19, shrinking by 42% y-o-y in the July-November period of FY19. However, due to a parallel reduction in the financial account surplus, the overall balance remained in a deficit of USD 837 for the same period, compared to a deficit of USD 885 million for the whole of FY18. The central bank has sold USD 1.1 billion during H1FY19 in order to keep the BDT stable in face of the balance of payments deficits, resulting in reduction in foreign exchange reserve levels and import coverage. Foreign exchange reserves were sufficient to cover only 5 months of import payments as of November 2018, against 6.3 months in June 2017. Addressing the balance of payments deficit and the tighter domestic liquidity conditions are the main challenges that lie before the central bank in the short term.

The H2FY19 MPS takes a conservative approach in order to guard against inflation in the post-election period. The broad money and reserve money growth targets have been maintained at previous levels, while domestic credit growth target remain unchanged. The MPS mentions increasing the exchange rate flexibility and introducing market-based pricing of national savings certificate (NSC) instruments, but it remains to be seen whether those policies can be introduced in the face of potential political opposition. The MPS aims to increase credit flows towards job-creating sectors as a priority, in order to ensure employment for the large numbers of young people joining the workforce each year. The MPS also aims to bring down non-performing loans (NPLs) in the banking sector by instilling strict lending and recovery discipline.

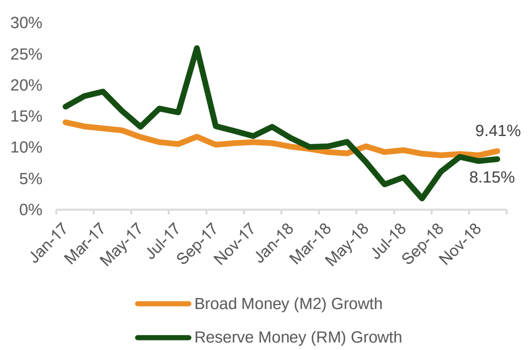
Chart: Inflation



Inflation Outlook

Inflation has steadily come down in H1FY19, reducing from 5.78% in June 2018 to 5.55% in December 2018. The downward trend was mainly due to a fall in food inflation, which reduced sharply from 7.13% in June 2018 to 5.98% in December 2018. Food inflation had spiked up due to supply shock caused by floods damaging rice harvests, but subsequent harvests and import of food grains has been successful in bringing down rice prices, and hence food inflation. Non-food inflation, on the other hand, witnessed a rising trend throughout 2018, rising from 3.51% in January to 4.47% in December. The fall in international oil prices in late 2018 and adequate domestic production is likely to lead to low food inflation. On the other hand, non-food inflation is likely to rise due to expectations of exchange rate depreciation and domestic fuel price hike.

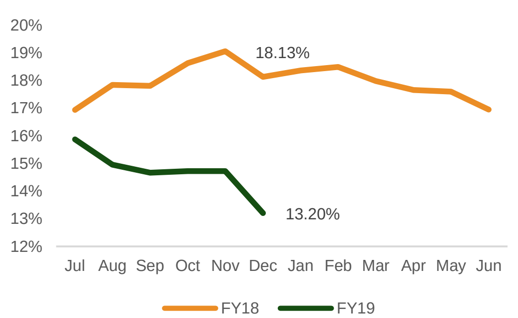
Chart: Growth of Reserve and Broad Money



Broad Money (M2) and Reserve Money (RM) Outlook

Broad money and reserve money growth stood at 9.40% and 8.20% in December 2018 against MPS target of 10.20% and 8.00% respectively. Growth in M2 and RM aggregates have been on a continuous downward trend since January 2017. Sales of NSCs and reduction in net foreign assets due to balance of payments deficit are the main contributing factors leading to reduced M2 growth. The latest MPS has kept targets for M2 and RM growth unchanged at 12.0% and 7.0% respectively, but M2 growth was only 9.41% in December 2018. Lower M2 growth will help in keeping inflation levels under control, but tighter liquidity conditions are expected to lead to higher interest rates and to constrain private sector credit growth, which could negatively affect GDP growth.

Chart: Pvt. Sector Credit Growth (%)

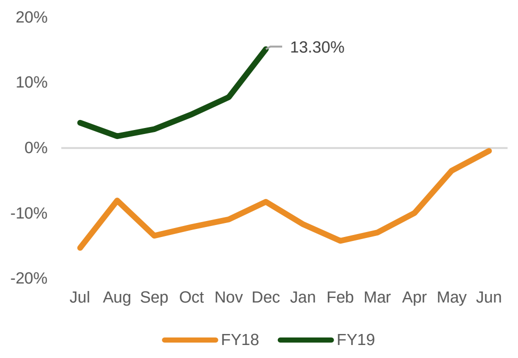


Source: Bangladesh Bank

Private Sector Credit Growth target reduced

The FY18 period saw high private sector credit growth as a result of greater political stability and low interest rates. However, the reduction of the Advance-Deposit Ratio (ADR) in January 2018 caused banks to cut back their lending activities leading to a decline in private sector credit growth. Private sector credit growth continued to decline ahead of general elections, and hit a low of 13.20% in December 2018. The MPS target reduced the private sector credit growth target from 16.80% to 16.50% for June 2019 on the expectation that private sector credit will bounce back after the elections. Going forward, a favourable political situation is expected to lead to higher private sector credit growth, but lower M2 growth might act as a restraint.

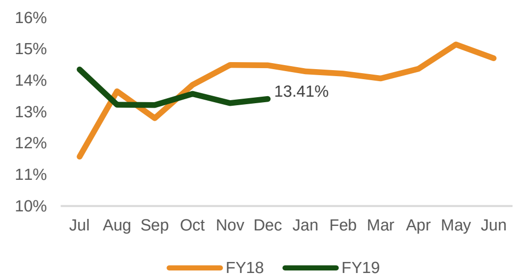
Chart: Public Sector Credit Growth (%)



Public Sector Credit Growth target increased

Lower tax revenues and higher election-related expenditure resulted in higher government borrowing from banks leading to a sharp reversal of the declining trend of public sector credit growth in FY19. Public sector credit growth accelerated throughout FY19 to reach 13.30% growth in December 2018, exceeding the H1FY19 MPS target of 8.60%. The H2FY19 MPS has raised the target to 10.90% by June 2019. Greater borrowing by the government from the banking system might crowd out private sector borrowing and cause tighter liquidity situations and higher interest rates. The introduction of the new VAT law from FY20 is expected to raise revenues to ease the need for the government to borrow from the banking system.

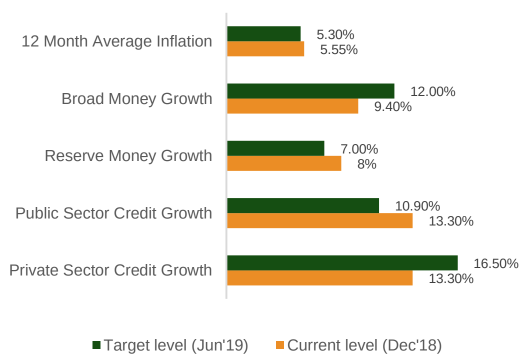
Chart: Total Domestic Credit Growth (%)



Domestic Credit Growth target unchanged

Total Domestic Credit growth registered 13.30% growth in December 2018 against the H1FY19 MPS target of 15.90%. The increase in public sector credit growth was offset by the decline in private sector credit growth during the period. The H2FY19 MPS has kept the target unchanged at 15.90% for June 2019. Given the low bank deposit rates, diminished levels of excess liquidity in the banking system combined with the reduction in M2 growth, it will be challenging for the economy to meet the domestic credit growth target, which might constrain GDP growth.

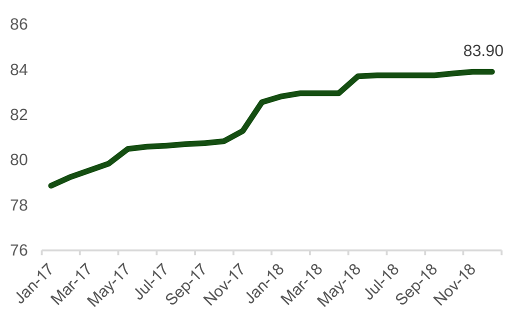
Chart: Current Status vs June'19 Targets



Policy Rates unchanged

The H2FY19 MPS keeps CRR and SLR rates unchanged at 5.50% and 18.50% respectively. The CRR was previously cut in April 2018 to ease the tightened liquidity conditions which arose as a result of the revision of the advance-to-deposit ratio (ADR) in January 2018. Repo and reverse repo rates are also kept unchanged at current levels of 6.0% and 4.75% respectively. The repo rate was also reduced from 6.75% to 6.0% in April 2018, and repo tenors of 7, 14 and 28 days were introduced.

Chart: Exchange Rate (BDT/USD)



Source: Bangladesh Bank

Exchange Rate Outlook

The BDT stayed largely stable in H1FY19, depreciating by a negligible 1.64% despite an overall balance of payments deficit of USD 837 million in the July-November period of FY19. This was possible due to Bangladesh Bank selling over USD 1.1 billion to keep the BDT stable. The BDT has depreciated to a lower degree than peer countries, and the real effective exchange rate has appreciated by 6% as a result. The H2FY19 MPS has indicated the need for greater exchange rate flexibility, and given the balance of payments situation and limited foreign exchange reserves, there is a high probability of depreciation of the BDT in the near term.

Table: External Sector

Indicator	FY15	FY16	FY17	FY18	FY19*
Export Growth Rate	3.40%	9.80%	1.70%	5.81%	14.42%
Import Growth Rate	0.20%	6.00%	8.70%	25.23%	6.64%
Remittance Growth Rate	7.70%	-2.50%	-14.40%	17.32%	8.06%
Current Account Balance (USD mn)	2,875	4,382	-1,480	-9,780	-2,558

* - Latest available figures, Source: Bangladesh Bank

External Sector

The current account deficit stood at USD 9,780 million in FY18, which was equivalent to 3.6% of GDP. This was the highest deficit ever recorded in the history of the Bangladesh economy, driven by strong import growth of over 25%, reflecting higher imports of capital machinery for infrastructure development projects and emergency imports of food grains due to floods destroying rice harvests. Export growth registered meagre growth of only 5.81% due to factory remediation work and relocation of leather industries. Remittance levels started to recover after a period of decline, registering 17.32% growth due to larger number of workers going abroad combined with depreciation of the BDT. The financial account registered a surplus due to increased aid inflows, resulting in an overall balance of payments deficit of USD 885 million in FY18.

In FY19, the current account deficit is moderating, driven by lower imports growth of 6.64% and higher export growth of 14.42%. The lower import growth is due to the slowdown in private sector investment ahead of the elections in December 2018, the fall in international oil prices since September 2018 and lower food grain imports. Exports have picked up owing to the trade war between the US and China resulting in Bangladeshi products becoming relatively cheaper in the US compared to competing Chinese products. Remediation works in RMG factories have also largely been completed, allowing RMG exporters to use full capacity to take advantage of export opportunities in the US. Remittance growth rates also held steady, registering 8.06% growth. As a result, the current account deficit in the July-November period of FY19 stood at USD 2,558 million compared to a deficit of USD 4,744 million for the same period of FY18.

In contrast to the moderating current account balance, the financial account balance has noticeably reduced in the July-November period of FY19, standing at a surplus of USD 2,058 as against a surplus of USD 4,096 for the same period of FY18. The result has been that the overall balance of payments deficit for July-November FY19 stands at USD 837 million, compared to an overall balance of payments deficit of USD 885 million for the entire FY18 fiscal year. A few significant foreign direct investment deals are in the pipeline, and it remains to be seen if these deals can contribute enough to the financial account to cancel out the overall balance of payments deficit. If not, then there is a chance of significant depreciation of the BDT.

NSCs continue to hinder interest rate flexibility

National Savings Certificates (NSC) are risk-free government securities with fixed interest rates which are significantly above market rates. The BB has long identified NSCs as a barrier to monetary transmission mechanism which affect how short-term policy rates of the BB affect medium- and long-term interest rates faced by borrowers in the capital markets. The BB has identified improving the monetary transmission mechanism as preconditions for developing financial markets. However, the government is reluctant to rationalize NSC rates owing to political reasons and it remains to be seen if and when it moves to reduce the disruptive impact of NSCs on the country's financial system.

NPLs to be tackled through greater supervision

Rising amounts of non-performing loans create a long-term threat to the stability of the financial system, and to the economy as a whole. NPLs at current levels on average contribute around 1% to the spread between deposit and lending rates, reducing economic growth through higher interest rates. BB is looking to tackle NPLs through implementing risk-based supervision and upgrading banks' internal risk management practices and corporate governance.

Disclaimer

This document ("the Report") is published by LankaBangla Asset Management Company Ltd ("LBAMCL") for information of its clients only. All information and analysis in this Report have been compiled from and analyzed on the basis of LBAMCL's own research of publicly available documentation and information. LBAMCL has prepared the Report solely for informational purposes and consistent with Rules and regulations of SEC. The information provided in the Report is not intended to, and does not encompass all the factors to be considered in a best execution analysis and related order routing determinations. LBAMCL does not represent, warrant, or guarantee that the Report is accurate. LBAMCL disclaims liability for any direct, indirect, punitive, special, consequential, or incidental damages related to the Reports or the use of the Report. The information and analysis provided in the Report may be impacted by market data system outages or errors, both internal and external, and affected by frequent movement of market and events. Certain assumptions have been made in preparing the Report, and changes to the assumptions may have a material impact on results. The Report does not endorse or recommend any particular security or market participant. LBAMCL, its analysts and officers confirm that they have not received and will not receive any direct or indirect compensation in exchange for expressing any specific recommendation, opinion or views in its Report. The information and data provided herein is the exclusive property of LBAMCL and cannot be redistributed in any form or manner without the prior written consent of LBAMCL. This disclaimer applies to the Report in their entirety, irrespective of whether the Report is used or viewed in whole or in part.

LankaBangla Asset Management Company Ltd

M A Faisal Mahmud	Chief Investment Officer	faisal@lankabangla.com
Simon Ibn Muzib	Fund Manager	simon.muzib@lankabangla.com
Azmal Hossain Rafi	Research Analyst	azmal.hossain@lankabangla.com
Mostafa Noman	Research Analyst	mostafa.noman@lankabangla.com
Abdullah Al Shaekh	Research Analyst	abdullah.shaekh@lankabangla.com
Bilkish Barkat Ali	Research Analyst	bilkish.ali@lankabangla.com
Md Rakibuzzaman	Alternative Investment Analyst	rakib.zaman@lankabangla.com
Saad Niamatullah	Alternative Investment Analyst	saad.niamatullah@lankabangla.com

LankaBangla Asset Management Company Limited
Corporate Office
Praasad Trade Center (4th Floor)
6 Kemal Ataturk Avenue
Banani C/A, Dhaka-1213
Phone: +880-2-9820219-21
Fax: +880-2-9822159
Email: amcl@lankabangla.com
Website: www.lbamcl.com

LBAMCL's research reports are also available on

http://www.lbamcl.com