

CHAPTER 5

Recent Monetary Policy Statement of Bangladesh Bank (July 2009) *An Analytical Commentary*

Debapriya Bhattacharya

Towfiqul Islam Khan

5.1 INTRODUCTION

Monetary policy is the process by which the central bank of a country controls the supply of money, the availability of money, and the cost of money or rate of interest, in order to attain a set of objectives oriented towards the growth and stability of the economy. Fiscal policy induced "demand management" approach as propagated by Keynes, which was popular in the post-Great Depression period, later made way to monetary policy led "stabilisation" approach in the period of high inflation of 1970s. While traditional fiscal policy solutions were useful in confronting unemployment by increasing spending and cutting taxes, counter-acting inflation entailed reducing spending or raising taxes.

The growing importance of monetary policy and the diminishing role played by fiscal policy in economic stabilisation efforts may reflect both political and economic realities. Monetary and fiscal policies differ in the speed with which each takes effect as the time lags are variable. Monetary policy is flexible (rates can be changed each month) and emergency rate changes can be made, whereas changes in taxation take longer to organise and implement. Also, considerable time may pass between the decision to adopt a government spending programme and its implementation.

During the period of "Golden Growth" covering late 1980s till the recent past, in the mix of macroeconomic policies, monetary policy continued to reserve a place of prominence. However, in the backdrop of global financial meltdown and subsequent confusion in macroeconomic theories, a new quest has emerged in redefining the role and instruments of macroeconomic policy in fostering economic development.¹

It may be recalled that the main objectives of a classic monetary policy are to maintain a stable and low rate of inflation, high capacity utilisation to sustain a low rate of unemployment, and a high trend of economic growth and effective exchange rate management to maintain stability between exporters' and consumers' interests. Explicit articulation of monetary policy at the behest of an independent central bank ensures transparency in the economic policy making, and has become popular in managing expectations of the major stakeholders.

In Bangladesh, Monetary Policy Statement (MPS) was first issued by the Bangladesh Bank in January 2006. The intention was to present information on Bangladesh Bank's outlook on real sector and monetary developments over the immediate future and the monetary policy stance it will pursue, based on its assessment of the developments over the preceding period. In continuation to this tradition, on 19 July 2009, the eighth issue of half yearly Monetary Policy Statement was announced for July-December, FY2009-10 period.

The present analytical commentary sets off by providing a brief overview of evolution of monetary policy stances of the Bangladesh Bank as espoused in its recent policy statements. This has been followed by review of the macroeconomic objectives along with a catalogue of the monetary policy instruments deployed in Bangladesh. The paper then subsequently examines behaviour of the monetary aggregates in view of their targets and achievement. Excess liquidity and agriculture credit, the two major issues that should influence the monetary policy this year, has been discussed in the following section. A selected set of critical issues, but missing in the current MPS has been discussed at the penultimate

In the backdrop of global financial meltdown and subsequent confusion in macroeconomic theories, a new quest has emerged in redefining the role and instruments of macroeconomic policy in fostering economic development

Explicit articulation of monetary policy at the behest of an independent central bank ensures transparency in the economic policy making, and has become popular in managing expectations of the major stakeholders

The intention was to present information on Bangladesh Bank's outlook on real sector and monetary developments over the immediate future and the monetary policy stance it will pursue, based on its assessment of the developments over the preceding period

¹On "crisis" of macroeconomic theories in the context of the ongoing global economic crisis, see The Economist (2009a and 2009b).

section. The paper rounds up with a few concluding remarks on implementation of the MPS for the first half of the current fiscal year (FY2009-10).

5.2 EVOLUTION OF MONETARY POLICY STANCE: AN OVERVIEW

Macroeconomic management in FY2007-08 had been challenging, particularly due to aggravated inflationary pressure which was largely underpinned by high commodity prices including that of fuel, food and fertiliser

5.2.1 Policy Stance in FY2008-09

Macroeconomic management in FY2007-08 had been challenging, particularly due to aggravated inflationary pressure which was largely underpinned by high commodity prices including that of fuel, food and fertiliser. Taking note of the trends in global commodity markets, the Bangladesh Bank in its MPS for the first half of the FY2008-09 set the inflation target at 9.0 per cent (which was already in double digit at that time), and programmed adequate credit growth in order to support the gross domestic product (GDP) growth target of 6.5 per cent (Bangladesh Bank 2009b). Priority was accorded to credit which would support creation and expansion of output capacities, e.g. promoting agricultural and small and medium enterprise (SME) loans, and discouraging expenditures on ostentatious consumption. In order to reduce money supply, the Bangladesh Bank also announced that Cash Reserve Ratio (CRR) should not be less than 4.5 per cent, up from 4.0 per cent, in any day of the month; although, CRR on bi-weekly average remained unchanged at 5.0 per cent. The central bank also mentioned that any bank that fails to adhere by its CRR guidelines, will be penalised at bank rate plus 5 per cent on the difference of the reserves. Bangladesh Bank also enhanced its Repo and Reverse Repo interest rates by 25 basis points in September and November 2008 respectively to 8.75 and 6.75 per cent to slowdown the pace of private credit growth.

During the last quarter of FY2008-09, Bangladesh Bank introduced a 13 per cent interest cap on lending

As inflationary pressure started to cool down since October 2008, the Bangladesh Bank revised the inflation projection downward to 8.5 per cent in its second MPS of FY2008-09. On the other hand, as the global economic recession weakened domestic economic activities, the Repo and Reverse Repo rates were brought down to their earlier level in March 2009. The central bank also made engagement in agriculture lending mandatory for all commercial banks including private and foreign banks during this time. During the last quarter of FY2008-09, Bangladesh Bank introduced a 13 per cent interest cap on lending (through directive instead of "moral suasion"), except credit card and consumer loans, and allowed rescheduling of loans without any down payment until September 2009 to four export-oriented sectors which were affected by fall in external demand, viz. for frozen food, jute, leather and textiles.

Bangladesh remained one of the very few low-income countries that demonstrated significant resilience of its economy

Thus, one observes that the monetary policy stance of the central bank in Bangladesh underwent a few adjustments in response to domestic and global economic developments. As a result of these adjustments as well as due to other policy and institutional interventions, Bangladesh economy, at an aggregate level, performed quite appreciably in FY2008-09, with a near-six per cent GDP growth and four and a half per cent per capita income growth. Agriculture sector (particularly crop sector) posted significant achievement to improve food security. Most of the macroeconomic indicators, notwithstanding their structural flaws, exhibited overall robustness. At the end of the fiscal year, lower than estimated inflation rate was realised (7 per cent) compared to revised target of 8.5 per cent. Balance of payment (BOP) was in a comfort zone, to a large extent due to buoyant foreign remittance flow, steady export revenue and lower import demand. Consequently the foreign exchange reserve rose to USD 7.5 billion. Bangladesh remained one of the very few low-income countries that were able to record this level of performance in FY2008-09 and demonstrated significant resilience of its economy.

Notwithstanding such a comfortable kick-off benchmark for Bangladesh economy in a period of global economic crisis, apprehension about lack of investment demand moderated the growth outlook for the current fiscal year (FY2009-10). Thus an emphasis on promoting broad based economic growth has become incumbent on the monetary policy along with its other core objectives, particularly maintaining price stability.

5.2.2 Policy Stance for First Half of FY2009-10

The MPS for the first half of the FY2009-10 (Bangladesh Bank 2009b) indicates that the Bangladesh Bank has programmed the monetary aggregates to accommodate 5.5-6.0 per cent GDP growth, with 6.5 per cent inflation and a decline of 3.0 per cent in income velocity of money. Reviewing the MPS, one may highlight the following policy stances.

- i. Given the current large liquidity overhang in the system, the central bank believes it can adequately serve demands of both public and private sectors. This is possibly the essence of the declared "accommodative monetary policy." This is in line with the need for a "moderately expansionary monetary policy," as expressed in the national budget for FY2009-10.
- ii. To keep domestic borrowing conditions easy in a recessionary global environment, the central bank has refrained from Reverse Repo operations since the last quarter of FY2008-09, and has announced to continue it in the first half of the current fiscal year.
- iii. Emphasis has been given on utilisation of the foreign exchange inflows in growth supportive investments than on accretion of ever higher reserves.
- iv. The central bank signaled its intention of fostering cultural attitudes which pre-dominantly rely on equity-based rather than debt-based investments. One wonders how this discretionary foreign exchange financing will take place.
- v. The central bank underscored that it is set to strengthen its oversight on liquidity, capital adequacy and risk management in banks and financial institutions to protect the domestic financial sector from instabilities of the kind now afflicting markets in advanced economies. One does not find any specifics of these intended initiatives. This, however, requires review of the interfaces of the debt and equity markets, as well as cautionary development of the equity market.
- vi. It was informed that the government along with the central bank has finalised steps for obtaining sovereign credit rating for Bangladesh to lower costs for private sector borrowers and banks. There are, however, no immediate plans for the government borrowing on non-concessional commercial terms from the international market. The central bank possibly wants to create this window to respond appropriately to challenges for future domestic and external developments.

The central bank believes it can adequately serve demands of both public and private sectors

Emphasis has been given on utilisation of the foreign exchange inflows in growth supportive investments than on accretion of ever higher reserves

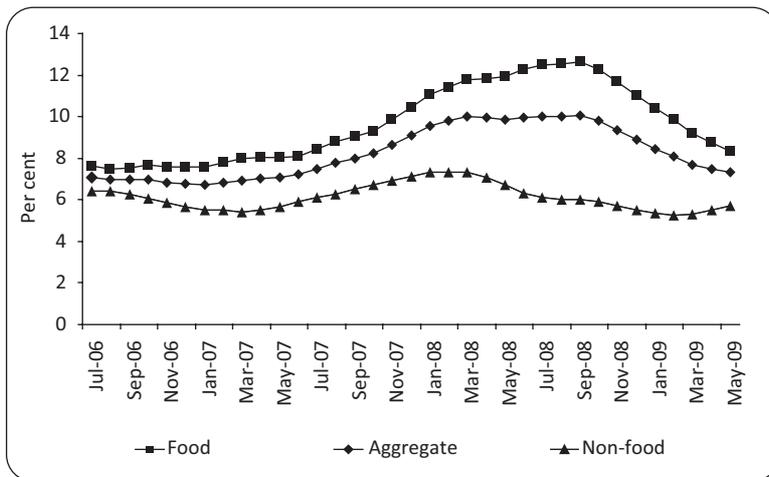
There are, however, no immediate plans for the government borrowing on non-concessional commercial terms from the international market

5.3 A REVIEW OF THE MACROECONOMIC OBJECTIVES

5.3.1 Inflation: Possibility of Kickback?

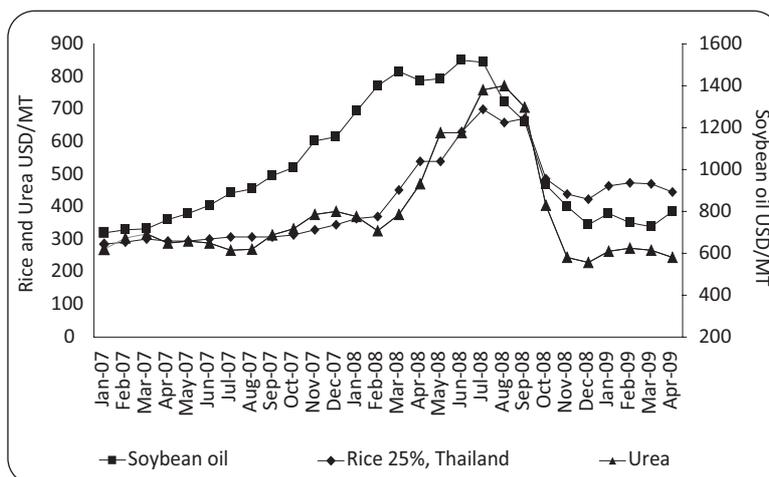
Considerable policy interest of the central bank has been focused on anchoring inflation expectations, if not targeting it. Inflationary pressure in recent times started to ease with good bumper crop harvest and with falling import prices of

Figure 5.1: Trends in Movement of Aggregate, Food and Non-food Inflation: July 2006 - May 2009



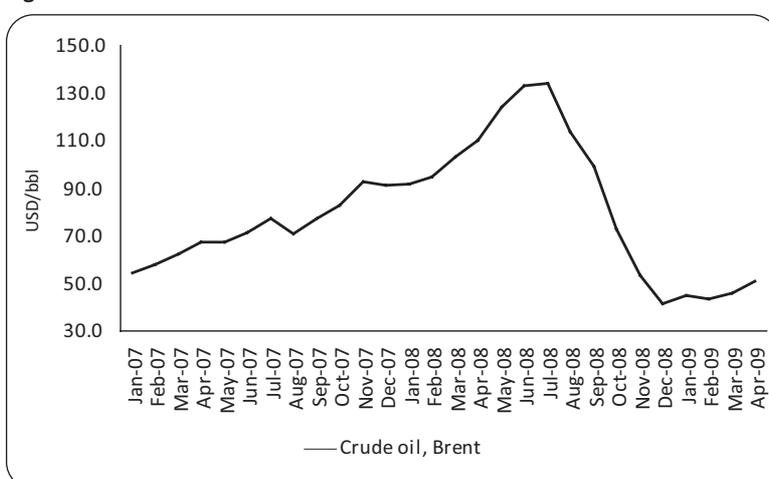
Source: Bangladesh Bureau of Statistics (BBS).

Figure 5.2: Movements of Global Commodity Prices



Source: Various issues of Pink Sheet, World Bank.

Figure 5.3: Movement of International Oil Price



Source: Various issues of Pink Sheet, World Bank.

fuel and other commodities. The average inflation (12-month moving average) came down to 7.3 per cent in May 2009 (Figure 5.1), a comforting circumstance compared to the earlier projected level of 8.5 per cent for the end of the fiscal year.

For FY2009-10, the targeted level of inflation at 6.5 per cent appears to be a realistic one given the fall in the global commodity prices and recent bumper foodgrain production at home. Global commodity prices (viz. rice, oil, urea and soybean oil) has been declining since September 2008 (Figures 5.2 and 5.3). Domestic price level has also responded to developments in global commodity markets.

However, with the developed and emerging economies showing signs of recovery (the "Green Shoots"), some of the commodity prices may take an upturn. International oil price has already been rising since January 2009 (Figure 5.3). At the moment the international oil price is hovering between USD 60 to USD 65 and can continue on this upward trend with world economy recovering in the later part of 2009 and early part of 2010.

In Bangladesh, food inflation generally drives the inflationary trend. As Figure 5.2 further shows that rice price (Thailand, 25 per cent broken) has stabilised at USD 440 metric ton (MT). Thus, on the domestic front it is rather important to attain targeted growth in crop production. However, soybean price has been going up while price of urea also been stabilised.

5.3.2 Kick Back from Monetary Expansion

The recent MPS has expressed its apprehension about the possible downside risks emanating from possible commodity price hike. The MPS has also expressed keen interest to facilitate growth acceleration, particularly in view of its broader objective of poverty reduction and employment generation. A trade-off between price stability and growth acceleration often seizes the centre of attention in macroeconomic policymaking. While many have argued for an

insignificant relationship between the two in the long run, it is hard to ignore the inherent trade-off in the short run. Thus, while concentrating on growth, the central bank would need to keep a vigilant eye on the inflationary trend so that imported inflation and/or expansionary monetary policy (largely induced by government borrowing) do not weaken the price stability.

5.3.3 Financing Budget Deficit: The Compositional Issue

Bangladesh Bank is committed to provide necessary resources to underwrite the programmed fiscal deficit of the government for FY2009-10. While the size of the deficit (5 per cent of GDP) is not an issue, the mode of financing it remains a concern. While borrowing from the banking system has the advantage of being less costly in terms of the interest payment burden, it has the disadvantage of being inflationary. Crowding out effects on private sector credit remain a concern, although, in view of the existing surplus liquidity in the system, this should not be a problem. On the other hand, non-bank borrowing, which is non-inflationary, involves higher debt servicing liabilities (DSL); availability of such resource could also be a problem. The government has opted for higher bank borrowing to meet the incremental budget deficit targeted for FY2009-10. The MPS assured the accommodation and raised no concern about the private sector borrowing being crowded out. Many studies including a recent one by Majumder (2007), have rejected the crowding out hypothesis in Bangladesh, rather provides evidence of crowding in effect given excess liquidity in the financial system.

The targeted growth of net credit to government sector seems to be realistic given the deficit financing requirement set at the budget. The ratio of fiscal deficit to monetary space during FY2008-09 was 87.0 per cent, whereas the targeted ratio is estimated to be 95.6 per cent.

However, if the foreign aid programmed for financing 40 per cent of the budget deficit does not get disbursed, and even worse, if domestic resource mobilisation targets are not met, and yet the government wants to go ahead with its development plan, then the government target has to be enhanced. Under those circumstances, the central bank has to do a judiciary balancing act to service the private investment demand.

5.3.4 External Sector: Subdued Outlook

The external sector related targets for FY2009-10, as contained in the Medium Term Macroeconomic Framework (MTMF) prepared by the Planning Commission, are informed by a cautious prospect. While export and import growth for this fiscal year is projected to maintain a double digit growth, the remittance growth is expected to fall to a modest 9.5 per cent from the buoyant figure of 22.3 per cent recorded during FY2008-09. While the impacts of global economic crisis have become slowly manifest only recently in Bangladesh, it is apprehended that these impacts will pass over with a time lag compared to the advanced and emerging economies. Thus, the targets of Bangladesh's external sector for FY2009-10 have been set modestly. The MPS also takes a subdued view regarding the external indicators, viz. foreign exchange reserve is set at a lower level compared to the earlier projections by MTMF.

5.3.5 Growth: "Conservatively Positive" Target

The MPS has "projected conservatively" that real GDP growth in FY2009-10 will be "in the range of 5.5 to 6.0 per cent," and may "outperform" given some positive developments at home and abroad. One may recall that the Centre for

While concentrating on growth, the central bank would need to keep a vigilant eye on the inflationary trend

The MPS assured the accommodation and raised no concern about the private sector borrowing being crowded out

While the impacts of global economic crisis have become slowly manifest only recently in Bangladesh, it is apprehended that these impacts will pass over with a time lag compared to the advanced and emerging economies

It is the performance of the industrial sector, at the margin, that will define realisation of the target figure for GDP growth

Repo and Reverse Repo rates are used as indirect instruments of monetary policy more frequently to inject liquidity or to mop up excess liquidity respectively from the market to smooth money market operations

Policy Dialogue (CPD), in its reactions to the national budget for FY2009-10, mentioned that the announced GDP target of 5.5 per cent is "rather conservative" compared to the almost 6 per cent recorded growth in the volatile year of FY2008-09 (CPD 2009a). Such a reassessment of the growth outlook for FY2009-10 is well appreciated.

Although the sectoral GDP growth targets for FY2009-10 are not clearly stated in the recent MPS, the central bank aims to pursue monetary policy to attain 4 per cent growth in agriculture sector. In the backdrop of high benchmark of agricultural production (4.7 per cent in FY2008-09) such a target will be pretty challenging. The earlier announced Agricultural Credit Policy of the Bangladesh Bank thus holds important policy leverage in this regard.

It is to be noted that given the structural composition of national income in Bangladesh, role of the service sector, with largest share in the GDP, cannot be understated. However, it is the performance of the industrial sector, at the margin, that will define realisation of the target figure for GDP growth. The industrial sector (more appropriately, the manufacturing sector), and to a large extent the service sector are currently beset with sluggish investment demand. The MPS does not pay any policy attention to this aspect.

5.4 DEPLOYMENT OF MONETARY POLICY INSTRUMENTS

The most common instruments that are used to control money supply and credit in a market or mixed economy structure include CRR and/or Statutory Liquidity Ratio (SLR), bank rate, directed credit and administered interest rates, Repurchase (Repo) and Reverse Repo and outright transactions in government securities (open market operations). There are more institutional instruments that a central bank can use to regulate the money market. Table 5.1 informs about the major monetary policy instruments used by the Bangladesh Bank.

Table 5.1: Status of Monetary Policy Instruments

Instruments	Current Rate (%)	Last Rate Changed	Comment
CRR	5.0	Increased from 4.5 per cent in 2006	Given the current excess liquidity one may opt for using one of these tools. However, this liquidity also provided the space for using moderate expansionary policy stance
SLR	18.0	Increased from 16.0 per cent in 2006	
Bank Rate	5.0	Decreased from 6.0 per cent in 2004	
Repo	8.5	Decreased from 8.75 per cent in March 2009	Frequently used
Reverse Repo	6.5	Decreased from 6.75 per cent in March 2009	Reverse repo operations are currently on hold

Source: Compiled by authors.

Bangladesh Bank frequently changed CRR, SLR, and the bank rate along with other instruments before implementing the financial sector reforms during the early 1990's. Since the beginning of the 1990's, the central bank switched over to open market operations mainly through government treasury bills (T-bills) auctions. Considering present excess liquidity in the banking system, the central bank may opt for using one of these instruments (Table 5.1). However, excess liquidity in the banking system also gives flexibility to the government for increasing amount of borrowing from the banking system. In order to streamline liquidity management and effective control of money supply, the Bangladesh Bank introduced Repo and Reverse Repo instruments in 2003. Bangladesh Bank uses short-term interest rates, e.g. Repo and Reverse Repo rates as indirect instruments of monetary policy more frequently to inject liquidity or to mop up

excess liquidity respectively from the market to smooth money market operations and ensure liquidity management, and bring stability in relation to reserve money targets. Currently, Bangladesh Bank frequently uses the Repo Rate as lending fund to other commercial banks. In practice, bank rate has become obsolete.

5.5 TRENDS IN MONETARY AGGREGATES: TARGETS AND ACHIEVEMENTS

The Bangladesh Bank through its MPS for the second half of FY2008-09 (Bangladesh Bank 2009a) introduced monitorable indicators by providing projections of monetary aggregates. Indeed, FY2008-09 has been an exceptional year characterised by high inflationary pressure. Whatsoever, in case of broad money (M2) growth, it is estimated that the target for FY2008-09 has been more or less achieved, i.e. 17.2 per cent as against the target of 17.5 per cent (Table 5.2). A 15.5 per cent growth target of money supply has been targeted for FY2009-10. However, during the last five years the average growth in M2 supply was 17.6 per cent per annum.

The M2/GDP ratio is expected to increase to 0.49 in FY2009-10 from 0.47 in FY2008-09, indicating a higher monetisation of the economy in the face of current global crisis (considering low case scenario of 5.5 per cent GDP growth). Considering the high case scenario of 6.0 per cent GDP growth rate, this ratio will come down, which means a lower monetisation in the economy. The central bank has targeted a 3.0 per cent decline in income velocity of money in FY2009-10, which indicates a lower economic activity. It may be noted that the income velocity of money declined by about 4.0 per cent in FY2008-09.

While the aggregate indicator of money supply was close to target in FY2008-09, the compositional elements of the monetary aggregates in practice were perceptibly different from the targets. Net foreign asset, set at a lower level with an expectation of the adverse impact of global recession, attained higher growth rate as a result of buoyant remittance flow. The Bangladesh Bank had to purchase around USD 1.5 billion during the last fiscal year from the local inter-bank to stabilise the exchange rate (i.e. to hold back appreciation of national currency). The projected figure of net foreign asset suggests that the central bank has once again taken a cautious stance on external sector in FY2009-10. This conservative target of money supply has been derived mostly from the squeeze in net foreign asset, which is (-)4.1 per cent for FY2009-10. In the backdrop of subdued outlook for the external sector and the central bank's plan to use forex reserve for import of investment and consumption goods, forex reserve is projected at a lower level. It is rather expected that net foreign asset may record positive growth during FY2009-10.

Domestic credit has been estimated lower than the projected figure largely due to the slowdown of credit for private sector growth in FY2008-09. Net credit to government has also been lower, perhaps a result of lower deficit financing requirement due to non-implementation of the annual development programme (ADP). The Bangladesh Bank has projected 18.7 per cent growth rate in total domestic credit for FY2009-10, which is higher than the estimated growth of last year (17.1 per cent). During the current fiscal year, incremental domestic credit

During the last five years the average growth in M2 supply was 17.6 per cent per annum

Table 5.2: Targets and Achievements of Monetary Indicators

Indicator	FY09 (Target)	FY09 (Estimate)	FY10 (Target)
Broad Money	17.5	17.2	15.5
Net Foreign Asset	14.3	23.9	-4.1
Net Domestic Asset	18.1	16.0	19.3
Domestic Credit	20.4	17.1	18.7
Credit to the Public Sector	27.3	24.5	25.3
Credit to the Private Sector	18.5	15.0	16.7
Inflation (MA)	8.5	7.0	6.5

Source: Compiled from Bangladesh Bank (2009b) and other sources of Bangladesh Bank.

Note: MA stands for 12-month annual moving average.

It is rather expected that net foreign asset may record positive growth during FY2009-10

Domestic credit has been estimated lower than the projected figure largely due to the slowdown of credit for private sector growth in FY2008-09

flow is expected to be driven by the government (net) credit with an increase of 29.6 per cent in comparison to an increase of 16.7 per cent to the private sector. However, the average growth of private sector credit in the last five years was 18 per cent. One wonders, if private investment demand really picks up, whether the central bank will have to make more fiscal space to accommodate the same.

If private investment demand really picks up, whether the central bank has to make more fiscal space to accommodate the same

Surprisingly, the central bank has projected a zero growth for credit to the "other" non-financial public sector. However, given the government's intentions to rejuvenate public enterprises, such target seems implausible.

5.6 ANCHOR(S) OF THE MONETARY POLICY

Intermediate objectives (anchors) are important for monetary policy. They provide guidelines to policymakers at times when ultimate objective (inflation or growth or both) responds with a lag. It also reduces the uncertainty and ensures transparency in policymaking (Crockett 2004) and (Lindsey and Wallich 1989). In this context, three most popular approaches in a monetary policy regime are the following:

- i. Exchange rate targeting
- ii. Monetary aggregate targeting
- iii. Inflation targeting

In Bangladesh, all of these approaches have been practiced for quite some time. While exchange rate targeting will be continued to keep the balance between the interests of the exporters and consumers, monetary aggregate targeting will be the intermediate objective to promote growth without dampening the macroeconomic stability in the present context.

The authorities target the aggregate money supply and that the shares are distributed accordingly, while theory suggests that it would be more efficient to target the components to achieve objectives and let the aggregate adjust automatically

From an analytical point of view, M2 perhaps has been the most dependable anchor variable for formulating monetary policy. This remains the most common practice, while the central banks around the world keep targeting inflation. To examine the stability of money supply and its different components over the last eight years, the present paper has calculated an Instability Index following the methodology developed by the United Nations Development Policy and Analysis Division (2004), as well as by Chatterjee and Shukayev (2006).

The log of M2 in the system, credit to the government (net), credit to other public sector and credit to the private sector covering the period from July 2001 to May 2009 (monthly data) were regressed against their respective trends. To this end, the standard error of the regression represents the instability of a particular indicator. The authors' calculation suggests that, trends in M2 are more stable than that of its components (Table 5.3). Among the components of M2, credit to

Table 5.3: Instability of Broad Money and its Components

Indicator	Broad Money (M2)	Credit to Government Sector	Credit to other Public Sector	Credit to Private Sector
Instability Index	0.000083	0.00047	0.00061	0.000070

Source: Authors' calculation.
 Note: Observations: 95.

private sector is the least volatile, followed by credit to the government. Credit to other public sector organisations demonstrates the most volatility; however, its share in total domestic credit is rather low compared to the other two components. This provides evidence that the authorities target the aggregate money supply and that the shares are distributed accordingly, while theory suggests that it would be more efficient to target the components to achieve

objectives and let the aggregate adjust automatically (Ramey and Ramey 1995). Moreover, given the circumstances it is rather advisable that monetary policy should use domestic credit as the anchor variable in view of the government's and private sector's credit requirement.

5.7 TWO IMPORTANT ASPECTS OF THE MONETARY POLICY

5.7.1 Excess Liquidity

Excess liquidity of the scheduled banks stood higher at Tk. 27,716.99 crore as of end April 2009, as against Tk. 12,988.58 crore as of end June 2008, i.e. recorded 113.4 per cent growth. Tk. 7,523 crore (27.1 per cent) of the excess liquidity is composed of the Bangladesh Petroleum Corporation (BPC) bonds, while the rest of the liquidity is possibly due to increase in investment on approved securities by commercial banks, as a result of lack of investment demand. The excess liquidity situation has been compounded by several factors.² Firstly, this fall in investment demand has been exacerbated by import and export slowdown, as a large share of the bank credit in Bangladesh goes towards letter of credit (L/C) opening. Further, fall in prices of majority of commodities in the global market implies lower money demand for financing imports. Secondly, because of the financial crisis, the business community has been prone to taking conservative steps with regard to business decisions. The decline of L/C opening for capital machineries also reflects this fact. Thirdly, credit requirement of the government for financing of fiscal deficit has also been moderate. It is now to be seen whether the economy responding to the stimulations designed by the national budget for FY2009-10 draws down the excess liquidity to its usual level in the coming months.

5.7.2 Agricultural Credit Policy

For FY2009-10, the central bank has fixed a (gross) disbursement target of Tk. 11,500 crore, which is about 24 per cent higher than the actual (gross) disbursement of FY2008-09. It is to be recalled that the central bank has made disbursement of the agriculture credit mandatory for all commercial banks. The central bank intends to take aggressive institutional steps for implementing the credit disbursement target. In line with this, Bangladesh Bank has announced a multisectoral and inclusive agricultural-cum-rural credit policy and programme. Priorities have been accorded to undeveloped areas, like *chars*, marsh lands and the coastal belt, as well as "higher productive areas" while disbursing credit. Special attention will be given to women entrepreneurs involved in agricultural production. A Tk. 500 crore fund will be disbursed among sharecroppers. National ID card (and Farmers' ID card) will be utilised in selection process. To ease access to credit by the disadvantaged people, the collateral requirements have been waived - banks can now accept recommendations from landowners, local influential persons, and even from neighbours while approving credit to the poor. The policy also kept provision for Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB) to disburse a portion of their fund through their NGO (non-government organisation) partners.

What is not immediately evident is that to what extent the incremental allocations will be disbursed from the loanable funds of the commercial banks and the specialised banks (i.e. BKB and RAKUB) and to what extent through the refinancing window of the Bangladesh Bank. These two channels of agricultural credit disbursement will have varying monetary implications.

²These explanations are also mentioned in CPD (2009b).

It is rather advisable that monetary policy should use domestic credit as the anchor variable in view of the government's and private sector's credit requirement

It is now to be seen whether the economy responding to the stimulations designed by the national budget for FY2009-10 draws down the excess liquidity to its usual level in the coming months

Bangladesh Bank has announced a multisectoral and inclusive agricultural-cum-rural credit policy and programme

Disbursement of industrial credit will greatly define the growth prospect of the manufacturing sector, which in turn will ensure at the margin, realisation of the GDP growth prospect

Effective implementation of the above mentioned features will require close monitoring and supervision of the entire lending operation. Bangladesh Bank has already set up "Agricultural Credit Monitoring System" to supervise and monitor disbursement of agriculture credits. Admitting the importance of rural credit flow in Bangladesh economy, one may like to be cautious against use of scarce capacity of the central bank on issues which are better left to scheduled (specialised) banks.

5.8 A SELECT SET OF MISSING ISSUES

5.8.1 Energising Industrial Term Loan

Industry sector has experienced a major downturn as disbursement of term loan declined by 9.6 per cent during July-March of FY2008-09 compared to similar period of FY2007-08 (Table 5.4). This trend has been corroborated by the fall in import of capital machineries during this period. However, disbursement of working capital increased by 15.5 per cent over the same period, indicating possibly greater use of existing capacity. In the backdrop of a gloomy prospect, the central bank on 17 March 2009, increased loan disbursement limits for the four state-owned commercial banks (SCBs). This should allow them to lend more aggressively. These banks will now be able to increase the amount of lending by 10 per cent over the preceding year (previously the growth was limited to 5 per cent). Additionally, the ceiling on single borrower exposure has been raised by another 5 per cent of paid-up capital. Together with the reduced Repo and Reverse

Table 5.4: Term Loan Situation in Bangladesh

	Jul-Mar FY08	Jul-Mar FY09	Growth (%)
Disbursement	14574.31	13174.22	-9.6
Recovery	9706.67	11232.27	15.7
Net Disbursement	4867.64	1941.95	-60.1

Source: CPD-IRBD database.

Repo rates introduced earlier, these measures are expected to enhance credit flow to productive sectors of the economy. The MPS did not present any indication of implication of these measures on off-take of industrial credit. Disbursement of industrial credit will greatly define the growth prospect of the manufacturing sector, which in turn will ensure at the margin, realisation of the GDP growth prospect; it would have been useful if the central bank would have attached adequate attention to this issue.

5.8.2 Addressing Non-performing Assets

Large amount of non-performing assets have been afflicting the financial sector of Bangladesh for a long time. Total classified loan for first three quarters of FY2008-09 stood at Tk. 23,586.22 crore (11.12 per cent of total outstanding loan), registering a decrease of (-)1.06 per cent over the corresponding figure of FY2007-08. Nationalised commercial banks (NCBs) made impressive progress in reducing the total classified loan, recording a decline of Tk. 952.73 crore, i.e. (-)6.7 per cent fall from the figure of FY2007-08. Introduction of BPC bond may have made a positive effect in this accounting. Provisions to write-off bad debts as well as collections prior to the national elections may have contributed towards improving the share of classified loans. Curiously, total classified loan of foreign banks increased significantly by 26.1 per cent during FY2008-09 (could be due to application of more stringent standards).

On 5 July 2009, the Finance Minister informed the Parliament that a total of 2,196 loan defaulters hold loans of Tk. 15,451 crore (covers only those with default of more than or equivalent to Tk. 1 crore). As of March 2009, the largest 2,196 defaulters held 65.5 per cent of total classified loan. A similar updated list is expected to be made public in the near future. The Prime Minister, on the other

Provisions to write-off bad debts as well as collections prior to the national elections may have contributed towards improving the share of classified loans

hand, on 21 July asked the Finance Ministry to prepare a report on those who have been systematic defaulters and/or have regularised loans using political connections. With these interventions from the highest policy level, a "forgotten issue" once again is being resurrected.

Given the pessimism about private investment demand as well as debate on high cost of borrowing, it was expected that the MPS would provide some policy guidelines about dealing with the existing bad debt overhang. As a significant share of the classified loans are attributable to public sector corporations, and as demands for funds of the non-performing public enterprises are expected to increase further in view of the government's decision to relaunch them, it would have been prudent for the central bank to lay down a prudential framework for financing the state-owned enterprises (SoEs).

5.8.3 Reducing Interest Rate Spread

Admittedly, high lending rate remains one of the major impediments of investment in Bangladesh. The MPS for the first half of FY2008-09 also addressed this issue. High interest spread underpins the problem (Bangladesh Bank 2008). Other reasons for high lending rates include high rates of various government-sponsored saving certificates, inefficiencies in the system, market segmentation, and lack of competition. Equity finance to stimulate and encourage capital markets can reduce demand for loanable funds and imply favourable effect on lending rates from the demand side. Loan default risk is another factor responsible for high lending rates, particularly in a country such as Bangladesh where non-economic factors also play a role in loan classification.

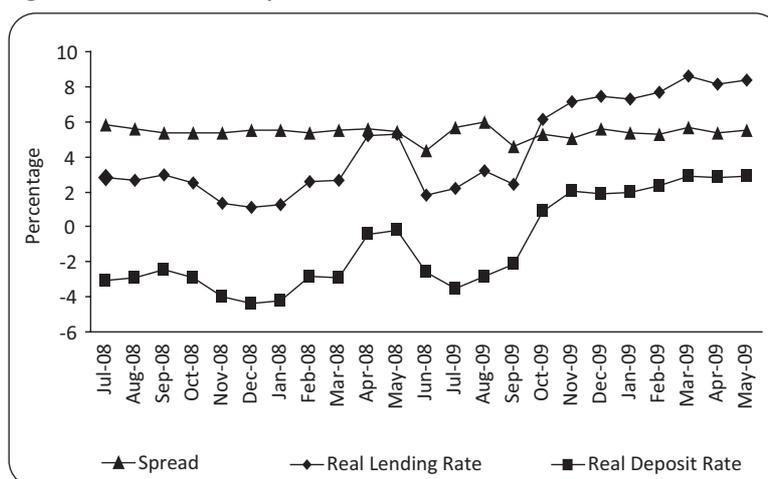
With the easing of inflationary pressure and introduction of 13 per cent cap for lending rate for major sectors, it was expected that the spread would be reduced to a reasonable level. However, the desired effect of the policy on spread may not be realised as several banks (by some account this group includes 20 banks) moved to reduce interest rates for fixed deposits by 1.5 percentage points. The latest statistics are also not encouraging; during May 2009 the interest rate spread remained as high as 5.5 per cent in comparison to 4.8 per cent at the end of FY2007-08 (Figure 5.4). The interest rate spread in India generally hovers around 4.0 to 4.5 per cent. The issue, regrettably, did not get a mention in the MPS of the first half of FY2009-10.

5.8.4 Integrating Microfinance

While not being a part of mainstream monetary sector, microfinance has been a major supplier of credit to private sector, particularly in the rural economy. At the end of FY2007-08, total outstanding microcredit was 7.1 per cent of total credit to private sector (private sector plus microfinance) and 2.7 per cent of GDP. Even though the microfinance institutions are regulated by a separate authority, it is time that microfinance variables are integrated in monetary aggregates. Regrettably, the first half MPS of FY2009-10, which demonstrated high level of sensitivity to financing the rural poor, opted not to integrate the issues relating to microfinance within its policy framework.

Given the pessimism about private investment demand as well as debate on high cost of borrowing, it was expected that the MPS would provide some policy guidelines about dealing with the existing bad debt overhang

Figure 5.4: Interest Rate Spread



Source: Calculated from Bangladesh Bank data.

Equity finance to stimulate and encourage capital markets can reduce demand for loanable funds and imply favourable effect on lending rates from the demand side

5.8.5 Institutional Measures (Basel II)

With a view to fully implement the Basel II framework of supervision and disclosure principles, and to protect the financial system from risks of overexposure, Bangladesh Bank introduced Basel II capital adequacy assessment for banks from January 2009 to instill precise quantitative awareness in banks about all material risks associated with their operations vis-à-vis their capital bases. However, there is a need for the MPS to provide clear indications and guiding principles of mandatory compliance for the banks. Curiously, no such specific intentions were stated by the central bank in its most recent MPS.

There is a need for the MPS to provide clear indications and guiding principles of mandatory compliance for the banks

5.9 CONCLUDING OBSERVATIONS

In a "fiscal dominant" regime such as Bangladesh, where the fiscal authority sets its budget independently of public sector liabilities, fiscal policy can affect monetary policy in different ways: first through the impact of government inter-temporal budget constraint on monetary policy; secondly through the effect of fiscal policy on a number of monetary variables, such as interest rates, interest spreads and exchange rates. In the backdrop of easing inflationary pressure, the trade-off between growth and inflation may have taken a back seat for the moment. However, as global economic development continues to show signs of recovery, the central bank needs to be vigilant to maintain macroeconomic stability. The effectiveness of this MPS will largely depend on the capacity of Bangladesh Bank to carry out its stated objectives and the effectiveness of related policy implementation (e.g. fiscal policy, supply-side response, governance reform). In the backdrop of continuing global economic recession, promoting inclusive economic growth and complementing the fiscal expansion proposed in the budget for FY2009-10 are the ultimate objectives of this MPS. In this connection, there would be strong need for the Bangladesh Bank to not only a supportive, but also an active monetary policy. Indeed, one would expect to see that the central bank is capable of making dynamic adjustments of its monetary policy in the course of its implementation across the current fiscal year.

The effectiveness of this MPS will largely depend on the capacity of Bangladesh Bank to carry out its stated objectives and the effectiveness of related policy implementation

On a related issue, the government will be well advised to set up an independent, high-powered and competent committee to reflect on the practical mechanisms to deal effectively with the bad debt overhang, to device mechanism for exit of sick industries with burden of bad loan, to infuse more competition in the financial sector, to reduce the interest rate spread, and to examine the rationale for borrowing of foreign currency denominated loans from external sources by the domestic private sector. In the backdrop of collapse of financial institutions across the world, the committee may also suggest ways and means to improve transparency and accountability of the domestic financial institutions.

REFERENCES

- Bangladesh Bank. 2008. *Monetary Policy Statement (First Half of FY2008-09)*. Announced on 17 July 2008.
- Bangladesh Bank. 2009a. *Monetary Policy Statement (Second Half of FY2008-09)*. Announced on 14 January 2009.
- Bangladesh Bank. 2009b. *Monetary Policy Statement (First Half of FY2009-10)*. Announced on 19 July 2009.
- CPD. 2009a. *An Analysis of the National Budget for FY2009-10*. Dhaka: Centre for Policy Dialogue (CPD). <http://cpd.org.bd/downloads/CPD%20Budget%20Response%20FY2009-10.pdf>
- CPD. 2009b. *Bangladesh Economy in FY2008-09: An Interim Review of Macroeconomic Performance*. Dhaka: Centre for Policy Dialogue (CPD).
- Chatterjee, P. and Shukayev, M. 2006. *Are Average Growth Rate and Volatility Related?* Bank of Canada Working Paper Series No. 2006-24. Canada: Bank of Canada.
- Crockett, A. 2004. "Central Banking in the New Millenium," in Ahluwalia, M.S., Reddy, Y.V. and Tarapore, S.S. (eds.) *Macroeconomics and Monetary Policy*. New Delhi: Oxford University Press.
- Lindsey, D.E. and Wallich, H. 1989. "Monetary Policy," in Eatwell, J., Millgate, M. and Newman, P. (eds.) *Money*. New York: The New Palgrave.
- Majumder, M.A. 2007. *Does Public Borrowing Crowd-out Private Investment? Evidence from Bangladesh*. Working Paper Series No. WP 0708. Dhaka: Bangladesh Bank.
- Ramey, G. and Ramey, V.A. 1995. "Cross-Country Evidence on the Link Between Volatility and Growth." *American Economic Review*, 85 (5): 1138-51.
- The Economist. 2009a. *The Other-Worldly Philosophers*. 18-24 July.
- The Economist. 2009b. *What Went Wrong with Economics*. 18-24 July.
- United Nations Development Policy and Analysis Division. 2004. *Calculation of Instability Index*. <http://www.un.org/esa/policy/devplan/profile/definitions.html>