3 CHAPTER

Monetary Policy Statement of January-June 2011

A Critical Appreciation

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3.1

INTRODUCTION

The macroeconomic scenario of Bangladesh has been undergoing significant changes in FY2010-11. A number of developments – related to both domestic and global economy – have led to presence of perceptible tensions in key macroeconomic balances. These strains are showing up in wide ranging areas including revenue mobilisation, implementation of public investment programmes, management of fiscal deficit, inflationary trends, conduct of the capital market, import growth, remittance inflow, foreign aid offtake, foreign direct investment (FDI) and balance of payments (BOP) status. A number of structural impediments – e.g. continued crisis in gas and electricity supply, are further aggravating the investment climate. The above mentioned trends have the potential to not only undercut the macroeconomic stability, but also weaken the growth prospect in FY2010-11. At the same time, the commitments that the government will likely make to access the International Monetary Fund's (IMF) credit, will have implications for policy contours. The recently announced Monetary Policy Statement (MPS) by Bangladesh Bank, announced on 30 January 2011, lays out some of the changes in the anticipated policy framework. Thus, it is reckoned that a serious revisit of the policy framework is necessary for ensuring macroeconomic management to confront the visible and emerging realities. This has become particularly important as the government positions itself for the preparation of the upcoming budget and the soon-to-be finalised Sixth Five-Year Plan (SFYP).

Taking note of the significantly changed economic backdrop and using the recently announced MPS as a policy reference point, Section 3.2 of this chapter seeks to highlight the nature of the macroeconomic challenges that the economy is going to experience in the near future. In Section 3.3, the study reviews the recent MPS to explore to what extent the policy stance is adequate in terms of addressing the emergent challenges, while Section 3.4 articulates the challenges for monetary policy in FY2010-11. The penultimate section discusses the outlook for economic growth in view of the present macroeconomic challenges and proposed policy framework. The chapter rounds up with a few closing observations.

3.2

EMERGING ISSUES IN THE MACROECONOMIC FRAMEWORK

3.2.1 Fiscal Balance

The FY2010-11 will be marked as a period, charecterised by significant rise in government revenue expenditure in the backdrop of rising commodity prices and higher than projected subsidy requirement. On the other hand, slow pace of implementation of the Annual Development Programme (ADP) will likely help the government, in a rather perverse way, to arrest the widening of the fiscal deficit. ADP implementation remained low in the first half of FY2010-11, particularly its component concerning foreign-funded projects. Only 27 per cent of an ambitious ADP of Tk. 38,500 crore has been implemented in the first six months of FY2010-11, while the implementation rate was 29 per cent in the reported period of FY2009-10. Expenditure of local fund (Taka) was 32 per cent[1] of

[1]Share of domestic resources in ADP is 60 per cent.

Table 3.1

ADP Implementation of Top 10 Ministries/Divisions during FY2010-11 (July-December)

(in Per cent)

Division/Ministry	Share of Allocation FY2011	Expenditure FY2011 (Jul-Dec)	Local Fund Expenditure FY2011 (Jul-Dec)	Project Aid Expenditure FY2011 (Jul-Dec)
Local Government Division	21.0	35.0	46.0	17.0
Power Division	13.0	18.0	17.0	20.0
Health and Family Welfare	9.0	23.0	21.0	25.0
Roads and Rail Division	9.0	19.0	25.0	9.0
Primary and Mass Education	8.0	41.0	46.0	33.0
Education	4.0	32.0	47.0	14.0
Water Resources	4.0	15.0	14.0	17.0
Bridge Division	3.0	6.0	14.0	3.0
Agriculture	3.0	31.0	32.0	24.0
Energy and Mineral Resources Division	2.0	15.0	13.0	25.0
Total ADP	100.0	27.0	32.0	18.0

Source: Authors' estimation from the Implementation Monitoring and Evaluation Division (IMED) data.

allocation, whereas only 18 per cent of project aid fund was implemented (Table 3.1). Failure of line ministries to negotiate, schedule, execute development schemes, and delays in pre-investigation on the part of the donor agencies, especially in case of foreign-funded projects, may be mentioned as reasons for this dismal performance. Lack of implementation of foreign-funded projects has also resulted in low foreign aid disbursement. This has not been very helpful in the backdrop of the tight BOP situation. Considering this implementation status, the Planning Commission is expected to lower the project aid budget by Tk. 3,000 crore to Tk. 12,300 crore, and at the same time bring down the total ADP allocation by the same amount. Thus, it is expected that at the end of the year, shortfall in ADP implementation would leave the total expenditure figure more or less unchanged despite a large upward revision of non-ADP expenditure.

It is encouraging to note that, the National Board of Revenue (NBR) is expected to exceed its stipulated target; however, the target for the overall revenue mobilisation may fall short. During the first half of FY2010-11, NBR achieved a significant 22.7 per cent growth, thanks mainly to the domestic sources of revenue (Table 3.2). On the other hand non-NBR tax and non-tax heads of revenue earnings are not likely to achieve their targets. The growth rate for non-NBR tax was to the tune of 8.3 per cent in the first quarter of FY2010-11 against an annual growth target of 25.8 per cent. Performance of non-tax revenue sources was rather dismal. Revenue collection from these sources declined by (-) 26.3 per cent against the formidable annual growth target of 27.4 per cent set for FY2010-11. In view of such sustained below-average mobilisation from non-NBR sources, NBR will need to continue with the current robust growth trend to compensate for the likely shortfall in the non-NBR component.

Table 3.2

NBR Revenue Growth

(in Per cent)

Indicator	Target FY2011	Growth FY2011 (Jul-Dec)	Achieved FY2010 (Jul-Dec)	Required FY2011 (Jan-Jun)
Customs Duty	14.2	13.4	4.3	14.9
VAT	12.9	28.6	19.8	0.3
Income Tax	22.9	34.0	21.6	17.0
Others	20.5	5.7	22.8	33.5
Grand Total	17.1	22.7	17.8	12.9

Source: Authors' estimation from the National Board of Revenue (NBR) data.

Note: VAT: Value added tax.

The size of the budget deficit itself should not be a matter of serious concern in FY2010-11. Rather it will be argued here that the composition of deficit financing could become a matter of debate and judicious choice. The overall budget deficit (excluding foreign grants) was 1.5 per cent of the gross domestic product (GDP) at the end of first quarter of FY2010-11 and remained well within the programmed limit (5 per cent of GDP) (Table 3.3). It appears that during the early months of FY2010-11, the government has mostly relied on domestic sources rather than foreign

Table 3.3

Financing of Budget Deficit in FY2009-10 and FY2010-11 (as Per cent of Total Deficit)

Source	FY2010	FY2011 (B)	FY2010 (Q1)	FY2011 (Q1)
Net Foreign Financing	47.5	39.8	92.6	31.8
Grant	19.0	12.2	80.8	27.0
Loan	49.8	40.6	73.5	40.5
Amortisation	21.3	13.1	61.7	35.7
Domestic Financing	52.5	60.2	7.4	68.2
Non-Bank Borrowing (net)	61.8	20.3	173.5	41.4
Bank Borrowing (net)	-9.3	39.9	-166.1	26.8
Total Financing as % GDP	3.3	5.0	0.9	1.5

Source: Authors' estimation from the Ministry of Finance (MoF) data.

Note: B denotes Budget; Q1 refers to the first quarter (July-September period) of the corresponding fiscal year.

financing and will likely continue to do so in near future. In making use of domestic resources for financing of the fiscal deficit, bank borrowing is expected to play a leading role when compared with the last fiscal.

In all likelihood the budget deficit is going to rise in the coming months as a result of the anticipated higher public expenditure requirements, including ADP implementation requirements, and more importantly, due to inflation resulting from food price hike. High level of oil prices[2] in the international market may call for more subsidy demand during the rest period of the fiscal year.[3] Thus the monetary policy may be required to play, over the remaining part of FY2010-11, a more proactive role to accommodate the envisaged public expenditure.

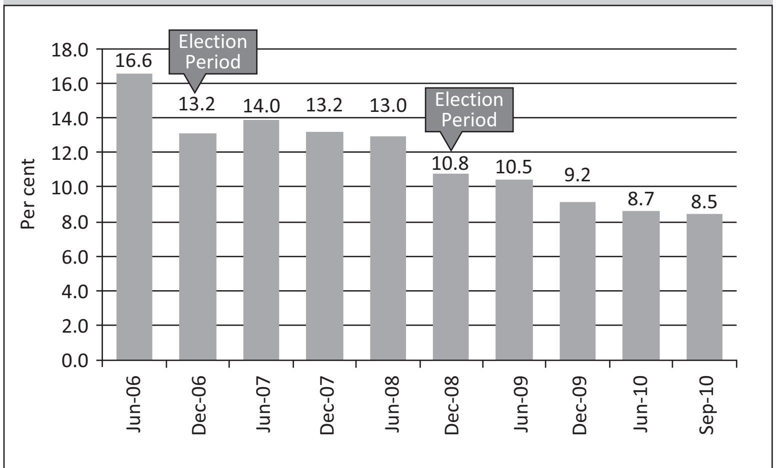
3.2.2 Financial Institutions

Financial sector in Bangladesh has been growing in tandem with the growth of the economy. 2010 has been a year of good profit for private commercial banks (PCBs), thanks to growing international trading activities and gains reaped from capital market. However, governance of financial sector came under scrutiny during the noted period. Evidence tends to suggest that credit in the form of industrial term loan, working capital and over-draft against workers' salary were diverted to the capital market.

Failure to address the issue of non-performing loans (NPLs) also led the financial sector under close scrutiny in recent times. The main reasons include higher flow of loans to unproductive sectors and risky exposure to capital market. Total classified loan at the end of first quarter of FY2010-11 (September 2010) stood at Tk. 8,978.2 crore (8.5 per cent of the total outstanding loan). This figure is 5.7 per cent lower than the corresponding figure of June end 2010. PCBs were able to limit their classified loan both in terms of total amount and with respect to the corresponding quarter of the previous fiscal. However, the overall recovery of default loans remained poor in case of the state-owned commercial banks (SCBs). A recent media report[4] informs that SCBs were able to recover only 12 per cent of the targeted Tk. 388 crore of bad debt from top 20 of their listed defaulters in 2010. More over, another media report quoted[5] an official from the Finance Division that two SCBs bought 25 bad loan cases from PCBs. Interestingly, it was found that only during the election period the recovery of NPL had been successful (Figure 3.1).

Figure 3.1

Percentage Share of Non-Performing Loan to Total Outstanding



Source: Authors' estimation from the Bangladesh Bank data.

[2] International oil price, which is currently hovering around USD 100 per barrel, is expected to remain at a high level in the near future.

[3] The Finance Division has already estimated a higher demand for subsidy (an additional Tk. 3,200 crore) for energy, power and agriculture in view of the escalating global commodity prices.

[4] http://www.thedailystar.net/newDesign/news-details.php?nid=167412

[5] http://www.thedailystar.net/newDesign/news-details.php?nid=171651

3.2.3 Inflation and Price Trend

Successive monetary policies in Bangladesh in general were designed with a view to facilitate growth acceleration without losing the focus on containing inflationary expectations. No wonder, the ongoing inflationary pressure[6] has drawn considerable attention from the monetary authority when the recent monetary policy stance was formulated. *World Economic Outlook 2010 (October)* forecasted that commodity prices in advanced countries will remain at a high level in 2011. However, inflation in developing countries may ease to some extent, from 6.2 per cent in 2010 to 5.2 per cent in 2011 (IMF 2010). In spite of this, current global and national trends indicate that Bangladesh is not expected to experience any respite from the inflationary pressure at least in the short-run.

Evidence found in the academic literature concerning inflation in Bangladesh appears to be divided as far as determinants of inflation were concerned. Structuralists would argue that bottlenecks in the agriculture sector and the continuing BOP deficits were able to explain the rise in the price level. On the other hand, monetarists would claim that the persistence of inflation is the result of an exogenous expansionary monetary policy. Taslim (1982) found that neither the monetarist theory nor the structuralist theory alone is able to adequately explain the inflationary phenomenon in Bangladesh.

A number of studies concerning identification of the determinants of inflation in Bangladesh indicate that monetary aggregates have significant impact on inflation (Mortaza 2006; Majumdar 2006). Hossain (2007) also found that money supply tends to have a significant positive impact on inflationary trend, while devaluation of currency was found to have insignificant influence on inflation in Bangladesh. Osmani (2007), on the other hand, argued that exchange rate can have an influence on the inflation rate. Besides, inward remittances, government debt, inflation inertia, and food and oil prices are also found to be important determining factors driving inflation in the Bangladesh context (Ahmed n.d.). CPD (2011) found clear evidence of a positive relationship between inflation and foreign exchange reserve and domestic petroleum price. The study also found that inflation is negatively related to domestic rice production, while the relationship between money supply and inflation was found to be positive, but insignificant.

It can be argued that the current developments in the inflationary front in Bangladesh is not similar to the historical trend, and that econometric analysis using long-term time series data may not be adequate to explain current inflationary developments. In fact, the nature of current inflation is very similar to the one experienced by Bangladesh in 2007 and 2008, when inflationary trend was led by the food inflation. One can readily observe that the ongoing inflationary trend is also informed by some of these characteristics. Price hike in the global market has caught up with most of the countries in the world including Bangladesh. Bangladesh, being a small open economy, has experienced the influence of world prices for most of her daily essential commodities, even when particular commodities have not been predominantly dependent on imports. It has been seen that international oil price often dictates the overall inflation scenario to a large extent. The international price of oil has increased by 22.3 per cent in January 2011. Global Commodity Price Index maintained by the IMF also indicates a steady rise in global prices. The year-on-year growth in IMF's Commodity Price Index and Food Commodity Price Index in December 2010 stood at 23.4 per cent and 26.8 per cent respectively. One will need to consider that the level of inflation in Bangladesh has been lower compared to her other neighbours except for Sri Lanka. It is often stated that the inflation of Indian economy has a more pronounced and direct influence on commodity prices in Bangladesh. India has experienced a higher growth of inflation in recent years. However, this was the case in the

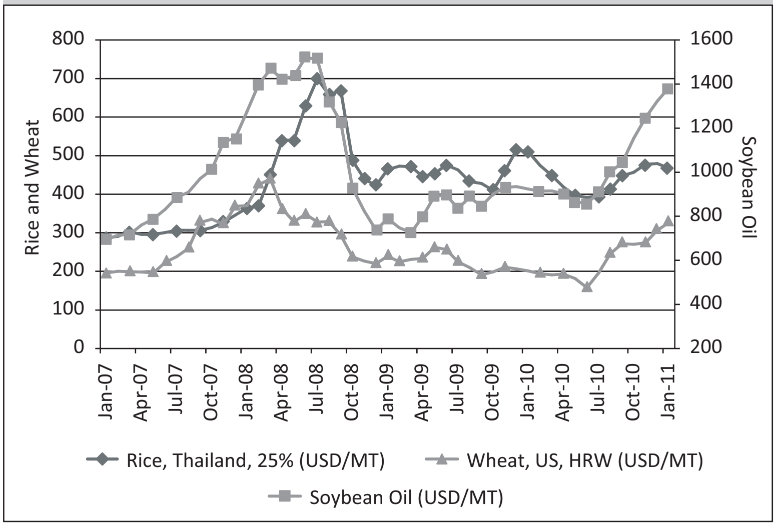
[6]In December 2010, average inflation was 8.1 per cent.

backdrop of higher pace of growth. On the other hand, Sri Lanka, with a lower growth rate of 3.5 per cent in 2010, had experienced a lower inflation rate. Pakistan has been a typical case of a conflict economy that had a higher inflation rate but a lower growth rate.

One may also argue that the overall inflation at present is driven by food inflation. In December 2010, the food inflation was 11 per cent whereas the non-food inflation was only 3.3 per cent. In fact the present non-food inflation is the lowest in last nine years! Given this, demand-side management can hardly work in view of the inelastic nature of demand for food items. Food inflation around the world is also on the rise. FAO Food Price Index has been increasing for the seventh consecutive month. The World Bank data suggests that international prices of rice, wheat and soybean oil increased in January 2011 by 16.2 per cent, 51.7 per cent and 37.9 per cent respectively, and heading towards the historical peaks of mid-2008 (Figure 3.2).

Figure 3.2

International Commodity Prices



Source: Authors' compilation from the Pink Sheet, World Bank.

At that point (mid-2008), Rahman *et al*. (2008) explained that the inflation was driven by significant rise in the international commodity prices besides supply-side constraints, as well as distortions in the domestic supply chain. Role of non-competitive market (syndication) behaviour is a much-discussed topic which is perceived to have aggravated the inflationary situation in Bangladesh (Rahman *et al*. 2008). Ahmed (n.d.) and Majumdar (2006) identified this as a major determining factor behind the high inflation in Bangladesh. However, Osmani (2007) did not observe any significant evidence of this variable in his study. There is no denying the fact that information asymmetry, lack of infrastructure and weak institutional capacity are key factors that limit the growth prospects of the Bangladesh economy. There is no short-cut solution to these issues. These will need to be addressed head on by facilitating information flows, through strategic market interventions and instituting effective market (global and domestic) monitoring mechanisms.

In recent times doubts have been raised with regard to supply and demand situation of foodgrains in the country. There is also a debate with regard to the figure of population in Bangladesh. CPD (2011) found that during the last few years domestic food production exceeded the demand for food in the country. It is thus surprising to find that even after a comfortable level of per capita food availability, rice prices have been constantly on the rise even during the paddy-harvesting season. The lower public stock of foodgrain is also not transmitting the right signal to the market. As is known, government was not able to meet its procurement target during the last Boro season. The government has decided not to procure Aman rice in the current season, instead plans to procure foodgrains from the international market. Rice imported from the global market will have to be procured at higher prices, and hence, government may have to continue to sell the foodgrains in the open market at a subsidised rate.

3.2.4 Balance of Payments

Decelerated remittance receipts and swelling import payments had put pressure on the BOP situation in FY2010-11 despite a relatively broad-based export growth. In the

Table 3.4

Export Growth

(in Per cent)

Product	Target FY2011	Growth FY2011 (Jul-Jan)	Growth FY2010 (Jul-Jan)	Required Growth FY2011 (Feb-Jun)
RMG	10.0	41.3	-6.9	-26.1
Knitwear	*10.0*	*43.2*	*-6.9*	*-30.0*
Woven wear	*10.0*	*39.1*	*-7.0*	*-22.1*
Non-RMG	28.2	35.1	4.1	19.9
Raw jute	*30.0*	*91.8*	*39.6*	*-52.5*
Leather	*30.0*	*29.9*	*-0.8*	*30.1*
Total	14.2	39.8	-4.6	-15.7

Source: Estimated from the Export Promotion Bureau (EPB) data.

Table 3.5

Balance of Payments

(Million USD)

Items	FY2010 (July-November)	FY2011 (July-November)
Trade Balance	-1976	-2752
Export FOB (including EPZ)	6107	8299
Import FOB (including EPZ)	-8083	-11051
Services	-653	-978
Receipts	777	1024
Payments	-1430	-2002
Income	-601	-547
Receipts	16	44
Payments	-617	-591
Of which: Official interest payments	*-81*	*-87*
Current Transfers	4904	4840
Official transfers	9	44
Private transfers	4695	4796
Of which: Workers' remittances	*4659*	*4581*
Current Account Balance	1674	563
Capital Account	114	125
Financial Account	890	-873
FDI (net)	285	320
Portfolio investment	-34	56
Other investments	639	-1249
Errors and Omissions	-522	-399
Overall Balance	2156	-584

Source: Bangladesh Bank data.

Note: FOB: Free on board; EPZ: Export processing zone.

backdrop of the low export growth in FY2009-10, export was able to turn back during the early months of FY2010-11 and registered a robust 39.8 per cent growth in the first seven months. Readymade garments (RMG) export growth during this period was an impressive 41.3 per cent, while non-RMG exports posted a 35.1 per cent growth (Table 3.4).[7]

However, increased demand of import in the first five months of FY2010-11 (with a growth of 36.7 per cent) underwritten by the augmented demand for raw materials for export, industrial investment, and food price hike were the reasons that made trade balance situation uncomfortable during this period. A sluggish remittance inflow[8] could not help maintain the current account surplus that Bangladesh had enjoyed over the last five fiscal years. Current account surplus came down to USD 563 million during the first five months of FY2010-11 while the overall balance turned negative in the concerned period of FY2010-11 (Table 3.5). Stagnating net FDI[9] and low inflow of foreign aid[10] have also put further strains on the BOP position of Bangladesh. A further widening deficit may become evident by the end of the fiscal year if the current trends continue.

The relatively high foreign exchange reserves could provide some cushion against any sudden fall in foreign exchange earnings or rise in foreign exchange demand. Foreign exchange reserves stood at USD 10.4 billion at the end of January 2011, which was equivalent to payment of 4.2 months of import. This level of foreign exchange reserve does allow Bangladesh to maintain stability of the exchange rate and to cope with larger BOP deficit in the short-run.

The stability of exchange rate is also important from the perspective of balancing the tension between inflationary targets and export competitiveness. Historic trends indicate that the exchange rate of Bangladeshi Taka (BDT) against the United States Dollar (USD) has been somewhat stable over the last couple of years, but BDT is now showing some tendency to depreciate. Between end of June 2010 and end of January 2011, BDT depreciated against USD and Euro by 2.2 per cent and 11.8 per cent respectively. This has certainly helped export competitiveness of Bangladesh and provided inducement for

[7]However, given the slow pace of global recovery coupled with the lagged impact of the global economic crisis, the targets for RMG (both knit and woven) were set on a conservative mode.
[8]Remittance inflow increased by only 0.4 per cent in July-January, FY2010-11.
[9]Net FDI flow was USD 320 million in July-November, FY2010-11 against USD 285 million in July-November, FY2009-10.
[10]Foreign aid was USD 818.5 million in July-December, FY2010-11 against USD 1,481 million in July-December, FY2009-10.

higher remittance flows. However, BDT has also depreciated against Indian Rupee (INR) and Chinese Yuan (CNY) by 3.9 per cent and 5.7 per cent respectively during this period. This would put some pressure on prices of imported consumer goods as well as intermediate and capital goods. Thus, in view of ongoing global developments, there is a need to remain constantly vigilant regarding the exchange rate movements.

3.3

A DECONSTRUCTION OF THE RECENT MONETARY POLICY STATEMENT

In past, monetary policy was aimed to provide directions to the behaviour of various macroeconomic variables and the policy instruments. These instruments include the volume and direction of credit and the interest rates. At the same time, administrative import allocations were also kept under investigation in order to ration excess demand for foreign exchange. As may be recalled, in mid-2003 the currency peg mechanism was abandoned by introducing the managed floating exchange rate. At present, the monetary policy framework includes the near-term outlook for domestic demand, external trade, inflation and exchange rate stability. Basically Bangladesh Bank formulates MPS by targeting several monetary aggregates in addition to core macroeconomic variables including inflation and economic growth. Bangladesh Bank puts greater reliance on monetary targeting by focusing on the reserve money, and thus via the money multiplier, on the broad money (M2).

The most frequently used instruments to control money supply and credit by Bangladesh Bank include Repurchase (Repo) and Reverse Repo, and outright transactions in government securities (in the form of open market operations). Repo and Reverse Repo instruments were introduced by Bangladesh Bank in 2003 to streamline the liquidity management, and as tools to control money supply more effectively. Other institutional instruments that Bangladesh Bank make use of include directed credit, administered interest rates and policy rates. During the early 1990s, Bangladesh Bank frequently changed the Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR) and the Bank Rate, and used other instruments prior to implementing the financial sector reforms (Bhattacharya and Khan 2010). Later, CRR and SLR were considered as more effective medium-term policy instruments. Recently, the Central Bank changed these policy rates in the backdrop of high level of excess liquidity (Table 3.6).

Table 3.6

Status of Monetary Policy Instruments

Instrument	Current Rate (%)	Last Rate Changed
CRR	6.0	Increased from 5 per cent to 5.5 per cent in May 2010 and again in December 2010
SLR	19.0	Increased from 18 per cent to 18.5 per cent in May 2010 and again in December 2010
Repo	5.5	Increased from 4.5 per cent in August 2010
Reverse Repo	3.5	Increased from 2.5 per cent in August 2010

Source: Compiled by the authors.

3.3.1 Trends in Monetary Aggregates: Targets and Achievements

Bangladesh Bank's targets for monetary aggregates have systematically failed to match the actual outcomes. The targets set for FY2010-11 are also unlikely to be close to reality. For example, the target for money supply growth has been set at 15.2 per cent (Table 3.7). The target can be regarded rather conservative in the context of expanded monetisation in the economy; this was also significantly lower than last year's growth rate of 22.4 per cent. As a matter of fact, the average growth rate of broad money supply during the last five years was 19.1 per cent. Similarly, the targets for the components of money supply

Table 3.7

Targets and Achievements of Monetary Indicators

(in Per cent)

Indicator	FY2009		FY2010		FY2011	
	Target	Actual	Target	Actual	Target	Nov 2010 over Nov 2009
Net Foreign Assets	14.3	27.2	27.9	41.3	4.2	10.8
Net Domestic Assets	18.1	17.8	13.1	18.8	17.6	24.9
Domestic credit	20.4	15.9	15.6	17.9	17.9	24.2
Credit to public sector	27.3	20.3	11.9	-1.7	25.3	9.6
Credit to central government	-	23.2	13.8	-6.5	-	-
Credit to other public sectors	-	4.5	0.0	21.1	-	-
Credit to private sector	18.5	14.6	16.7	24.2	16.0	27.8
Broad Money Supply	17.5	19.2	15.5	22.4	15.2	22.2

Source: Compiled from the Bangladesh Bank data.

were also found to diverge widely when compared to the actual outcomes. This once again puts into question the approach of targeting the monetary aggregates pursued by the Central Bank.

Targeting the monetary aggregates reduces uncertainty and ensures transparency in policy making (Crockett 2004; Lindsey and Wallich 1989). Bhattacharya and Khan (2010) argued that in Bangladesh the Central Bank practices targeting the aggregate money supply while its components are distributed accordingly. However, Ramey and Ramey (1995) argued that it would be more efficient to target the components to achieve objectives and let the aggregate adjust automatically. Taslim (2010) argued that failure of central banks to contain the monetary aggregates within their target bands is not unusual. And hence, many of the central banks in developed countries have abandoned the policy of monetary aggregates targeting.

Rebound of export-oriented industrial production coupled with higher demand for import-oriented trade credit is expected to lead to high level of private sector credit demand in the course of the current fiscal year. A surge of government sector credit (i.e. for subsidy, ADP expenditure acceleration, import bills, etc.) is also already anticipated for the later half of FY2010-11. As a result, other than credit to government sector, all other monetary aggregates are likely to surpass respective targets set for the end of the current fiscal year. A revision of the monetary targets was thus expected from the recent MPS. It was somewhat surprising to observe that Bangladesh Bank did not rationalise the growth target for private sector credit flow in view of the growth record actually attained till December 2011.

3.3.2 Policy Stance for Second Half of FY2010-11

The MPS for the second half of the FY2010-11 (Bangladesh Bank 2011) indicates that Bangladesh Bank has programmed the monetary aggregates to accommodate 6.7 per cent GDP growth with 7 per cent inflation. Reviewing the MPS, one may highlight the following policy stances:

- Bangladesh Bank's monetary policies in the second half of FY2010-11 vowed to support growth and preserve price stability simultaneously.
- The Central Bank conceded that monetary policy had insignificant impact on inflationary trends and domestic food price inflation. Fiscal initiative in the form of subsidised foodgrain sales may be needed in order to ease hardship suffered by low-income earners.

- In view of the apprehension of possible adverse impact of monetary expansion, in line with growth in the real economy, the policy emphasised on keeping the non-food Consumer Price Index (CPI) inflation low and stable. It was, however, surprising to see that the Central Bank did not take cognisance of the fact that non-food inflation is already at its lowest.
- The Central Bank also admitted that the industrial and SME (small and medium enterprise) loans were being diverted to the overheated asset markets. At the same time, the policy expressed its belief that it would be able to bring back the discipline in financial sector by enforcing "*a firmer grip on monetary expansion*."
- The MPS also mentioned that:
  "Supervisory vigil on lending and loan administration discipline in banks will remain stricter, lapses and laxities in lending banks will be dealt with sternly, eschewing forbearance" (Bangladesh Bank 2011).

3.4

CHALLENGES FOR MONETARY POLICY IN FY2010-11

Servicing the Credit Demand

A major task of the central bank is to service and regulate the credit demand of the government and the private sector. In Bangladesh the Central Bank in general tries to accommodate all credit needs of the government as is needed. On the other hand, to stabilise the exchange rate, the growth of net foreign assets in M2 is largely determined by the BOP situation. If we recall the experience of last two fiscal years, one would find that the Central Bank allowed the growth of net foreign assets to surpass beyond the projected level. For FY2010-11, the falling current account balance has kept the growth of net foreign assets in control. However, it is expected that there will be a surge in government credit demand during the second half of the fiscal year. This would mean that restraining the growth of private sector credit remains the only avenue to reduce the monetary growth. The MPS has also stated its intention to have a firm grip on private sector credit. It is evident that industrial loan and SME loan have been diverted to the non-productive sectors (capital market and asset market). However, it will be difficult to stop this ill-practice by constraining the credit flow. As of September 2010, the overall growth in bank advances stood at 25 per cent, whereas growth figure for construction (including real estate activities) and flat purchase were 30.4 per cent and 63.7 per cent respectively. Credit for import financing of food and petroleum products has also increased by around 70 per cent during the reported period. The Central Bank repeatedly indicated its willingness to restrict credit for consumer loans, and direct it towards growth-friendly productive sectors. An active supervision will be required to achieve this goal. The Central Bank also ought to be flexible to service the productive private sector as well as the government.

Limited Role of Monetary Authority in Response to Inflation

In view of the soaring commodity prices the Central Bank has revised its inflation target from 6.5 per cent to 7 per cent for FY2010-11. As is mentioned, the present inflationary phenomenon is largely driven by external and structural forces. The MPS also realised that: *"monetary policy actions will have little leverage on rising food prices. In view of this situation, fiscal measures by way of subsidised foodgrain sales from public stock may need to be expanded to ease the hardships faced by low-income population segments."*

However, in contradiction, the Central Bank also aimed to control monetary expansion to control inflation. The Bank has cited similar moves by the neighbouring countries such as India. However, one should also consider that India revised its policy rates in response to the crisis.

It is also pertinent to mention here that monetary expansion is largely related to the non-food inflation rather than food inflation owing to the inelastic nature of food items. Since the non-food inflation is already at its historical low, the possible contradiction may result in adverse supply-side response to aggravate inflationary pressure. It may also have further adverse implications for growth and employment in the long-term.

Interest Rate is Set to Increase

High lending rate remains one of the major impediments to investment in Bangladesh. The Central Bank, in the face of global crisis, introduced a cap for industrial credit of 13 per cent with a view to revitalise investment. Following IMF conditionality, the Central Bank indicated its intention to phase out the cap on interest in near-term future. One can recall that this provision was introduced at a time when there was a high level of excess liquidity. The commercial banks, at that time, had responded by lowering the interest rate on deposits. The money market situation has changed in recent times – the level of excess liquidity is coming down due to higher demand for credit and subsequent upward revision of policy rates. Commercial banks have been forced to increase the interest rate to attract deposits. Banks are also expecting to increase their interest rates on lending. However, the issue, regrettably, was not mentioned in the most recent MPS.

Exchange Rate Management will be under Scrutiny

In view of growing pressure on BOP, after two years of stability, BDT started to depreciate against USD along with other major currencies. BDT is expected to depreciate further in the coming days. The volatility in the global currency market has started to put pressure on developing economies including Bangladesh. The MPS mentioned that net selling of USD by Bangladesh Bank stood at about USD 84 million during the first half of FY2010-11 to arrest further depreciation of the Taka. In the current context, a prudent exchange rate management will be required to ensure competitiveness of the export-oriented sectors without undermining the interests of consumer's welfare. Bangladesh Bank has to play a more proactive role in managing foreign exchange reserves, and decide as to how far it can use the reserves to maintain a balance between the aforementioned conflicting interests.

Role of Financial Institution in Capital Market

The capital market in Bangladesh has been the centre of attention for some time now given the recent volatility and the consequent developments in the market. Since 2006, capital market related indicators, e.g. price index, trade volume and market capitalisation, have registered significant rise. As a result a large number of small investors entered the market with a view to making lucrative short-term capital gains. CPD (2011) noted that lack of investment opportunities in the productive sector and huge inflow of new investors to participate in the *Keynesian Beauty Contest*, have been the major reasons driving such behaviour. The volatility in the capital market and the possibility of market manipulation is now under the scrutiny of the recently formed Probe Committee.

The role of financial institutions, particularly of the commercial banks, has been criticised in connection with the volatility seen in the capital market in recent times. The Finance Minister has also asked that the commercial banks' involvement in capital market be reduced. According to *Bank Company Act 26(2)*, a commercial bank is not allowed to invest more than 10 per cent of their deposits in the stock market. A total of 12 commercial banks have been identified by Bangladesh Bank which have violated this rule. Credits in the form of industrial term loan, working capital and over-draft against workers' salary are reported to have been diverted to the capital market. Some have suggested that the role of Central Bank should also be examined when capital market scrutiny is carried out. In the latest MPS, the Central Bank has tried to defend itself by arguing that the recent volatility was not a result of monetary contraction pursued by it. However, the role of Central Bank as a supervisory body of all financial institutions needs to be revisited in view of the emergent situation.

Addressing Non-Performing Loans

As is well-known, significantly large amount of NPLs have been afflicting the financial sector of Bangladesh for a long time. Given the debate with regard to the high cost of borrowing, it was expected that the MPS would provide some policy guidelines about dealing with the existing bad debt overhang. This issue is also important for the financial sector from perspective of implementing the Basel II.

Integrating Microfinance

While not being a part of mainstream monetary sector, microfinance has been a major supplier of credit to the private sector, particularly in the rural economy. At the end of FY2009-10, total outstanding microcredit from top five microfinance institutions (MFIs) was about 5 per cent of the total credit to private sector (private sector plus microfinance), and 2.2 per cent of GDP. Even though the MFIs are regulated by a separate authority, it is time that microfinance variables are integrated in monetary aggregates. In fact this would also help the policymakers who have indicated their intention to mainstream and regulate microfinance. Regrettably, the MPS, which demonstrated high level of sensitivity to financing the rural poor, opted not to integrate the issues relating to microfinance within its policy framework.

Impact of IMF's Extended Credit Facility (ECF) of USD 1 Billion

A credit deal, equivalent to about USD 1 billion, for the next three years (FY2012-14) between Bangladesh Bank and IMF is being finalised at the moment. The loan under IMF's Extended Credit Facility (ECF) arrangement is expected to get the nod soon. Since the termination of the Poverty Reduction and Growth Facility (PRGF) arrangement in 2007, this will be the first time that Bangladesh is opting for an IMF programme. According to the IMF factsheet, as in case of its predecessor, the PRGF, the ECF supports a country's economic programmes aimed at *"moving toward a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth."* Bangladesh Bank's decision to go for such another IMF arrangement brought a surprise to many quarters. One may recall the melancholic experience of the IMF-supported structural adjustment programmes (including those under PRGF), and the lessons drawn from the recent global financial and economic crises (CPD 2011).

The last time, Bangladesh Bank received about USD 467 million in six instalments under IMF's PRGF programme. In September 2007, IMF placed 20 conditions under a package of reforms for the government. The then-government decided not to go for further negotiation for the instalment of USD 123 million. Since then, Bangladesh Bank at different times rejected at least four IMF recommendations over a four-year period, including the adoption of Policy Support Instrument (PSI), introduction of a tight monetary policy, raising CRR for the scheduled banks, and opening of the capital account.

The IMF arrangement comes with a set of conditionalities aimed at liberalising economic policies. In order for the loan under ECF to Bangladesh to be disbursed, 11 steps will have to be taken by the country as per agreed conditionalities. They include: raising prices of compressed natural gas (CNG) and furnace oil (to cut back on energy subsidy); establishing a framework to monitor losses of state-owned enterprises (SoEs) such as the Bangladesh Petroleum Corporation (BPC), Bangladesh Chemical Industries Corporation (BCIC) and Bangladesh Power Development Board (BPDB); phasing out of bank lending rate ceilings; placement of the new VAT and income tax laws that will draw on IMF technical assistance; introducing a debt management strategy to reduce budget deficit; further liberalisation of tariff level; and pursuing of demand-side management in the form of contractionary monetary policy to check the inflationary pressure.

The Finance Minister has ruled out any conditionalities from the IMF side for securing the credit, and stated that the reforms agenda has been prepared locally. VAT laws is expected to be finalised in January 2011, while new income tax law will come in June 2011, with a view to strengthen to mobilisation of domestic resources. A rise in CNG prices has also been hinted by the Finance Minister, and adjustment of furnace oil price has already been announced. As is known, the Central Bank has already raised the policy rates (CRR and SLR) twice in six months to have a firmer grip on the monetary expansion.

Conditionalities that inform the IMF loan may give rise to the cost of doing business, limit government's fiscal operation, limit scope for strategic support to domestic industries and push towards a contractionary monetary policy. Thus, on the one hand, this may constrain the policy space of the government in undertaking the supply-side measures for sustained high economic growth, on the other hand, this could further aggravate the inflationary and BOP pressure. Overall, the economic policies may be directed towards a low-level equilibrium rather than moving on to a higher growth trajectory. However, such policies are also contradictory to the suggested policy in post-crisis global economic order (Box 3.1).

Box 3.1: Policy in Post-Crisis Global Economic Order:
Reflection from United Nation's World Economic Situation and Prospects 2011

After two years of recession and uncertainty, the global economy has started to recover albeit at a slow and differentiated manner. The crisis transmits a number of important lessons for the global economic order. While it has signalled the need for rebalancing global economy, it has also called for a reordering the global economic policies. The policy measures taken by various governments during the early stage of the crisis have no doubt helped to stabilise the economy, but their effectiveness has weakened in recent times. In this backdrop, the United Nation's *World Economic Situation and Prospects 2011* report has placed a number of recommendations (UNDESA 2011). The report forecasted that shifting towards fiscal austerity by many developed countries may adversely affect global economic growth in next couple of years while the developing countries will continue to drive the global recovery. The report also concluded that inflation does not pose a 'serious and present danger,' except in parts of South Asia, where increasingly strong inflationary pressures reflect a combination of supply and demand-side factors. It was advised that enough fiscal space was still available in many countries, and that additional fiscal stimulus was required in the short-run to boost the global recovery. However, fiscal policies will need to be redesigned to strengthen their impact on employment and aid in the transition towards promoting structural changes in the economy for more sustainable growth. A prudent policy to target public investments with a view to alleviating infrastructure-related bottlenecks that mitigate growth prospects is also cited a pre-requisite. Social protection policies are mentioned as another crucial element in cushioning the impact of economic shocks, boosting aggregate demand and contributing to the sustainability of economic growth. The report also put emphasis on greater synergy between fiscal and monetary stimulus. In the current context, maintaining an accommodative monetary policy could be supportive of additional fiscal stimuli in the short-run. Counter-acting damaging international spillover effects in the form of increased currency tensions and volatile short-term capital flows have also been highlighted in the report. The exchange rates among a number of major currencies experienced high volatility during 2010, and hence, escalated tension spread rapidly to other currencies. For now global leaders have agreed to avoid any

(Box 3.1 contd.)

(Box 3.1 contd.)

possible currency war. The failure to maintain exchange rate stability among the three major international reserve currencies has also affected currencies of other developing economies. The surge in capital inflows to emerging economies, due to the quantitative easing in developed countries and portfolio reallocation by international investors, in addition to the weakening of the Dollar, has led to an upward pressure on the exchange rates of some emerging economies. Many developing countries responded by intervening in the currency markets. Some of them imposed capital controls to avoid soaring exchange rates, loss of competitiveness and inflating asset bubbles. Overall the report called for a renewal of pledges to intensify and broaden macroeconomic policy coordination among the global leaders. Drawing lessons from the above context, it is thus once again emphasised that Bangladesh will require to maintain an infrastructure and employment-friendly expansionary fiscal policy, while the monetary policy stance will have to be accommodative.

3.5

PROSPECTS FOR ECONOMIC GROWTH IN THE NEAR-TERM

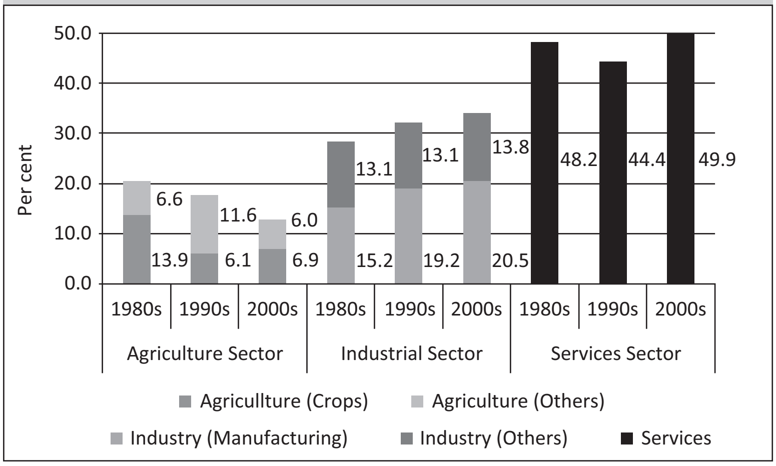
3.5.1 Growth for Structural Change

For a sustainable inclusive development, Bangladesh economy needs to usher in structural changes based on promotion of productive sectors. Growth experience of Bangladesh in the past three decades reveals two broad phases. These are: (a) GDP growth during 1980s and 1990s that had originated from rapid growth of the manufacturing industries; (b) In 2000s, it was the services sectors which had provided a substantial base to augment additional national income, while manufacturing and crops sector held and consolidated their positions (Figure 3.3).

Outline Perspective Plan of Bangladesh 2010-2021: Making 2021 A Reality has rightly emphasised on higher contribution of the manufacturing sector in GDP (Table 3.8). Admittedly, attaining these challenging targets will require considerable acceleration of manufacturing production.

Figure 3.3

Incremental Share of GDP by Broad Sectors



Source: Estimated from the Bangladesh Bureau of Statistics (BBS) data.

3.5.2 Required Sectoral Contributions for Attaining Growth Target

In view of current structure of the GDP in Bangladesh, economic growth beyond 5 per cent is in large part determined by manufacturing sector's level of output. The last time a 'more than six-and-half per cent' growth was achieved in FY2005-06. In that year, the manufacturing sector was able to

Table 3.8

Sectoral Share of GDP

(in Per cent)

Sector	FY2010	FY2015 (Target)	FY2021 (Target)
Agriculture	19.5	16.0	15.0
Industry	28.9	35.0	40.0
Manufacturing	*17.3*	*26.0*	*30.0*
Services (including Import Duty)	51.6	49.0	45.0

Source: Bangladesh Bureau of Statistics (BBS) data and Planning Commission (2010).

Table 3.9

GDP Growth Rate by Sectors

(in Per cent)

Sector	FY2006	FY2007	FY2008	FY2009	FY2010	Required in FY2011 (CPD Projection)
Agriculture	4.9	4.6	3.2	4.1	4.7	4.6
Crops	*5.0*	*4.4*	*2.7*	*4.0*	*5.1*	*5.0*
Industry	9.7	8.4	6.8	6.5	6.0	8.5
Manufacturing	*10.8*	*9.7*	*7.2*	*6.7*	*5.7*	*10.0*
Services	6.4	6.9	6.5	6.3	6.4	6.8
Total	6.6	6.4	6.2	5.7	5.8	6.7

Source: Estimated based on the Bangladesh Bureau of Statistics (BBS) data.

post a growth rate of 10.8 per cent (Table 3.9). An analogous performance will need to be attained by the manufacturing sector in FY2010-11 to achieve the 6.7 per cent overall growth target. The contribution from agriculture sector has to be as good as in FY2009-10. CPD has projected that about 6.8 per cent growth will need to be attained by the services sector in FY2010-11 if the overall growth target was to be reached.

3.5.3 Growth Outlook for FY2010-11

At the halfway mark of FY2010-11, several indicators suggest that the economy was gaining some momentum, particularly thanks to the surge in external demand. Buoyant export growth also indicates the possible upbeat in the manufacturing growth. Greater investment demand is reflected in strong industrial credit flow and growing import demand for capital machinery and other production inputs. The outlook of crops sector is also expected to match the recent past performance. The production of Aus and Aman in the ongoing fiscal year have been satisfactory, while optimistic outcome is being forecasted for the Boro yield by concerned quarters. In general, a steady performance of services sector consistent with the energetic performance of the real sectors is to be expected. Thus, in the final analysis, the ability to generate a broad-based manufacturing growth will define the final growth outcome in FY2010-11.

However a couple of disquieting developments may subdue the GDP growth figure in the current fiscal year. The performance of small manufacturing industries has not been able to match the growth of large and medium manufacturing industries.[11] Moreover, a stagnated implementation of ADP was unable to provide the much needed infrastructure to meet the needs of development, and is consequently holding back private investment plans. The emerging power supply situation may not be adequate to accommodate the potential expansion of agriculture and manufacturing sectors in the coming summer season. The government has already indicated that new connections of power and gas supply will be deferred till next April. Slow progress in the energy and power sector is emerging as a binding constraint for the growth and competitiveness of the processing activities. Unhealthy trend in the domestic capital market is also diverting funds and attention from the development of real sectors. Given the current context, it will be challenging to attain the GDP growth target of 6.7 per cent at the end of the fiscal year if the manufacturing sector does not experience a broad-based boost, promoting the needed structural change in the economy.

[11]Production of small manufacturing industries has declined by 9.2 per cent during the first quarter of FY2010-11. As of now, the data for large and medium manufacturing industries is available for only one month; the production index registered 15.3 per cent growth compared to the matching month of previous fiscal year.

3.6

CONCLUDING REMARKS

The monetary policy for the second half of FY2010-11 has been announced at a time when macroeconomic fundamentals are under considerable stresses and strains. Government's revenue collection is turning out to be inadequate to complement the rising expenditure demands whilst overall BOP has entered into a negative terrain. The plan to control money supply to arrest sustained inflationary pressure appears to be not very successful as yet. Implementation of the announced monetary policy will face enormous challenge in achieving its twin objectives of servicing growth and controlling inflation simultaneously. It appears that, at the margin, attainment of a broad-based growth in manufacturing sector will determine the overall growth outcome for FY2010-11. The present macroeconomic developments may have important implications for attaining the economic growth objective. It is apprehended that the loan arrangement under negotiation with the IMF may limit the growth-supportive policy space that the government would otherwise have. A number of conditionalities of the aforementioned loan may be at variance with the declared development policy framework of the government. If fully executed, the conditionalities may curb necessary fiscal expansionary stance and reduce subsidies to critical sectors. It is extremely important that conditionalities that inform the soon-to-be finalised IMF programme are disclosed which is followed by a broad-based public discussion. The policy framework needs to be designed in a way where fiscal policy takes the lead with monetary policy being accommodative to its need. Given the circumstances, the policymakers should not get overly preoccupied with concerns about stability; rather all possible policy measures should lead to broad-based, inclusive and accelerated growth.

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