

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

***Debapriya Bhattacharya***

Distinguished Fellow, CPD

***Towfiqul Islam Khan***

Senior Research Associate, CPD

Released to the media on 23 July 2009



**CENTRE FOR POLICY DIALOGUE (CPD)**

**B A N G L A D E S H**

*a civil society think-tank*

House 40C, Road 11, Dhanmondi R/A, Dhaka 1209, Bangladesh

Tel: +88029141703, 9141734; Fax: +88028130951

E-mail: [info@cpd.org.bd](mailto:info@cpd.org.bd); Website: [www.cpd.org.bd](http://www.cpd.org.bd)

## Acknowledgment

---

The paper is prepared under Centre for Policy Dialogue's (CPD's) programme titled *Independent Review of Bangladesh's Development (IRBD)*.

The authors would like to acknowledge the valuable research support provided by *Mr Tapas Kumar Paul*, Research Associate; *Mr Md Tariqur Rahman*, Research Associate; and *Mr Shouro Dasgupta*, Intern, CPD.

The authors have benefited advice and comments from *Professor Rehman Sobhan*, Chairman, CPD and *Professor Mustafizur Rahman*, Executive Director, CPD.

Support of *Mr A H M Ashrafuzzaman*, Senior System Analyst, CPD is also acknowledged.

The authors are responsible for the analyses and interpretations presented in this report. Comments and feedback may be sent to <debapriya.bh@gmail.com>.

# Contents

<b>1. INTRODUCTION .....</b>	<b>4</b>
<b>2. EVOLUTION OF MONETARY POLICY STANCE: AN OVERVIEW.....</b>	<b>5</b>
Policy Stance in FY2008-09 .....	5
Policy Stance for H1 FY 2009-10 .....	6
<b>3. A REVIEW OF THE MACROECONOMIC OBJECTIVES .....</b>	<b>6</b>
Inflation – Possibility of Kickback? .....	6
Kick Back from Monetary Expansion .....	8
Financing Budget Deficit – The Compositional Issue .....	8
External Sector– Subdued Outlook.....	8
Growth – “Conservatively Positive” Target .....	8
<b>4. DEPLOYMENT OF MONETARY POLICY INSTRUMENTS.....</b>	<b>9</b>
<b>5. TRENDS IN MONETARY AGGREGATES: TARGETS AND ACHIEVEMENTS .....</b>	<b>10</b>
<b>6. ANCHOR(S) OF THE MONETARY POLICY .....</b>	<b>11</b>
<b>7. TWO IMPORTANT ASPECTS .....</b>	<b>12</b>
7.1 Excess liquidity .....	12
7.2 Agricultural Credit Policy .....	12
<b>8. A SELECT SET OF MISSING ISSUES .....</b>	<b>13</b>
8.1 Energising Industrial Term Loan .....	13
8.2 Addressing Non-performing Assets .....	13
8.3 Reducing Interest Rate Spread .....	14
8.4 Integrating Microfinance .....	14
8.5 Institutional Measures (Basel II).....	15
<b>9. CONCLUDING OBSERVATIONS .....</b>	<b>15</b>
<b>REFERENCES .....</b>	<b>16</b>

## *List of Tables*

TABLE 1: STATUS OF MONETARY POLICY INSTRUMENTS .....	9
TABLE 2: TARGETS AND ACHIEVEMENTS OF MONETARY INDICATORS .....	10
TABLE 3: INSTABILITY OF BROAD MONEY AND ITS COMPONENTS .....	12
TABLE 4: TERM LOAN SITUATION IN BANGLADESH .....	13

## *List of Figures*

FIGURE 1: TRENDS IN MOVEMENT OF CONSUMER PRICE INDEX (CPI) AGGREGATE, FOOD AND NON-FOOD (July '06 - May '09) .....	6
FIGURE 2: MOVEMENTS OF GLOBAL COMMODITY PRICES .....	7
FIGURE 3: MOVEMENTS OF INTERNATIONAL OIL PRICE .....	7
FIGURE 4: INTEREST RATE SPREAD .....	14

## 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 organize 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 macro-economic policy in fostering economic development.<sup>1</sup>

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 utilization 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’ interest. 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 (BB) 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 July 19, 2009, the *eighth issue* of half yearly Monetary Policy Statement was announced for July-December FY2009-10 (FY10) 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 select set of critical issues, but missing in the current MPS has been discussed at the penultimate section. The paper rounds up with a few concluding remarks on implementation of the MPS for the first half of the current fiscal year (FY10).

---

<sup>1</sup> On “crisis” of macroeconomic theories in the context of the on-going global economic crisis, see “The Other-Worldly Philosophers” and “What Went Wrong with Economics” in *The Economist*, July 18<sup>th</sup> - 24<sup>th</sup> 2009.

## **2. EVOLUTION OF MONETARY POLICY STANCE: AN OVERVIEW**

### **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 fertilizer. Taking note of the trends in global commodity markets, the Bangladesh Bank in its MPS for the first half of the fiscal year 2008-09 (FY09) 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 GDP growth target of 6.5 per cent (Bangladesh Bank, 2009). Priority was accorded to credit which would support creation and expansion of output capacities, e.g. promoting agricultural and 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 per cent. The central bank also mentioned that any bank that fails to adhere by its CRR guidelines will be penalized at bank rate plus 5 per cent on the difference of the reserves. BB 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.

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 FY09. 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 FY09, the BB introduced a 13 per cent interest cap for on lending (through directive instead of “moral suasion”), except for 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.

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 FY09, 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 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 was able to record this level of performance in FY09 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 (FY10). 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.

### Policy Stance for H1 FY 2009-10

The MPS for the first half (H1) of the FY10 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.

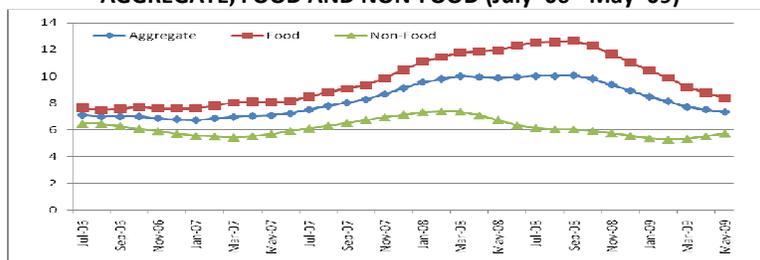
- i. Given the current large liquidity overhang in the system, the central bank believes it can adequately serve demands of both public and private sectors. This is possibly the essence of the declared “accommodative monetary policy”. This is in line with the need for a “moderately expansionary monetary policy” as expressed in the national budget for FY10.
- 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 FY09 and has announced to continue it in the first half of the current fiscal year.
- iii. Emphasis has been given on utilization 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 predominantly 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 market 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.

### 3. A REVIEW OF THE MACROECONOMIC OBJECTIVES

#### Inflation – Possibility of Kickback?

Considerable policy interest of the central bank has been focused on anchoring inflation expectations, if not targetting it. Inflationary pressure in recent times started to ease with good bumper crop harvest and with falling import prices of fuel oil and other commodities. The average inflation (12 month moving average) came down to 7.3 per cent in May 2009 (see Figure 1), a comforting circumstance compared to the earlier projected level of 8.5 per cent for end of the fiscal year.

**FIGURE 1: TRENDS IN MOVEMENT OF CONSUMER PRICE INDEX (CPI) AGGREGATE, FOOD AND NON-FOOD (July '06 - May '09)**

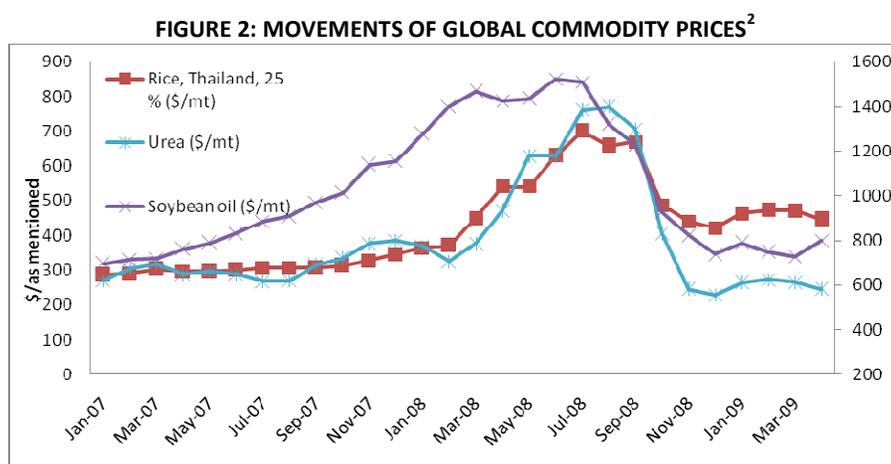


Source: BBS.

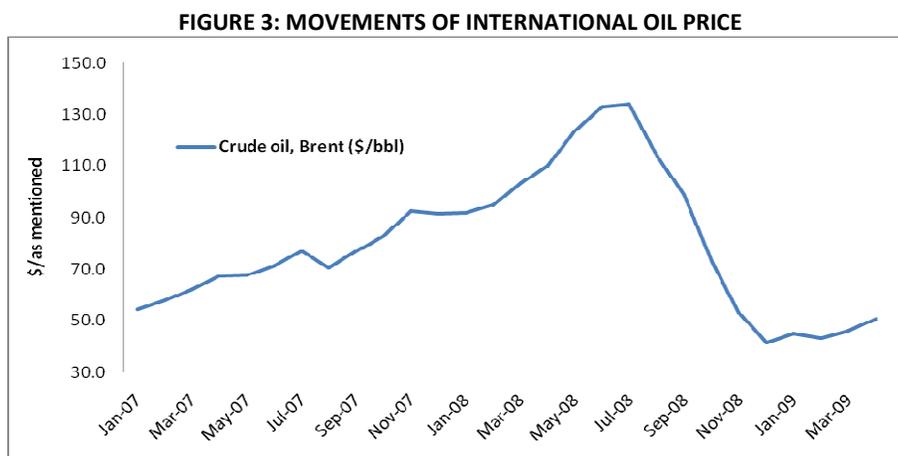
For FY10 the targeted level of inflation at 6.5 per cent appears to be a realistic one given the fall in the global commodity prices and recent bumper foodgrain production at home. Global commodity prices (viz. rice, oil, urea and soybean oil) has been declining since September 2008 (see Figures 2 and 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 (see Figure 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 3 further shows that rice price (Thailand, 25 per cent broken) has stabilised at USD 440 metric ton. 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 (see Figure 2).



Source: Various issues of Pink Sheet, World Bank.



Source: Various issues of Pink Sheet, World Bank.

<sup>2</sup> The right-hand vertical axis shows the price of soybean oil while the left-hand vertical axis shows the price of rice and urea.

### **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 policy-making. While many have argued for an insignificant relationship between the two in 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.

### **Financing Budget Deficit – The Compositional Issue**

Bangladesh Bank is committed to provide necessary resources to underwrite the programmed fiscal deficit of the government for FY10. 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; 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 FY10. 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 FY09 was 87.0 per cent where as 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.

### **External Sector– Subdued Outlook**

The external sector related targets for FY10, 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 FY09. 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 FY10 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.

### **Growth – “Conservatively Positive” Target**

The MPS has “projected conservatively” that real GDP growth in FY10 will “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 CPD, in its reactions to the national budget for FY10, 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 FY09 (CPD, 2009). Such a reassessment of the growth outlook for FY10 is well appreciated.

Although the sectoral GDP growth targets for FY10 are not clearly stated in the recent MPS, the central banks aim 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 FY09) 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, 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.

#### 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 Cash Reserve Ratio (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 informs about the major monetary policy instruments used by the Bangladesh Bank.

**TABLE 1: STATUS OF MONETARY POLICY INSTRUMENTS**

Instrument (in %)	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 March, 2009	Frequently used.
Reverse Repo	6.5	Decreased from 6.75 per cent 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, BB 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 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, BB frequently uses the Repo Rate as lending fund to other commercial banks. In practice, bank rate has become obsolete.

## 5. TRENDS IN MONETARY AGGREGATES: TARGETS AND ACHIEVEMENTS

The Bangladesh Bank through its MPS for the H2 FY09 introduced monitorable indicators by providing projections of monetary aggregates. Indeed, FY09 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 FY09 has been more or less achieved, i.e. 17.2 per cent as against the target of 17.5 per cent (see Table 2). A 15.5 per cent growth target of money supply has been targeted for FY10. However, during the last five years the average growth in broad money supply was 17.6 per cent per annum.

The M2/GDP ratio is expected to increase to 0.49 in FY10 from 0.47 in FY09, 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 monetization in the economy. The central bank has targeted a 3 per cent decline in income velocity of money in FY10, which indicates a lower economic activity. It may be noted that the income velocity of money declined by about 4.0 per cent in FY09.

While the aggregate indicator of money supply was close to target in FY09, 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 BB 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 FY10. This conservative target of money supply has been derived mostly from the squeeze in net foreign asset, which is (-) 4.1 per cent for FY10. 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 FY10.

**TABLE 2: TARGETS AND ACHIEVEMENTS OF MONETARY INDICATORS**

Indicator	FY09 (Target)	FY09 (Estimated)	FY10 (Target)
<b>Broad Money (M2)</b>	<b>17.5</b>	<b>17.2</b>	<b>15.5</b>
<b>Net Foreign Asset</b>	<b>14.3</b>	<b>23.9</b>	<b>-4.1</b>
<b>Net Domestic Assets</b>	<b>18.1</b>	<b>16.0</b>	<b>19.3</b>
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
<b>Inflation (MA)</b>	<b>8.5</b>	<b>7.0</b>	<b>6.5</b>

Source: Compiled from MPS July 2009 and other sources of Bangladesh Bank.

*Domestic credit* has been estimated lower than the projected figure largely due to the slowdown of credit to private sector growth in FY09. Net credit to government has also been lower, perhaps a result of lower deficit financing requirement due to non-implementation of the Annual Development Plan (ADP). The BB has projected 18.7 per cent growth rate in total domestic credit for FY10, which is higher than the estimated growth of last year (17.1 per cent). During the current fiscal year,

incremental domestic credit 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 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 intensions to rejuvenate public enterprises, such target seems implausible.

## 6. ANCHOR(S) OF THE MONETARY POLICY

Intermediate objectives (anchors) are important for monetary policy. They provide guidelines to policy-makers at times when ultimate objective (inflation or growth or both) responds with a lag. It also reduces the uncertainty and ensures transparency in policy making (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 targetting
- ii. Monetary aggregate targetting
- iii. Inflation targetting

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

From an analytical point of view, Broad Money 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 targetting inflation. To examine the stability of money supply (M2) and its different components over the last eight years, we have calculated an *Instability Index* following the methodology developed by the United Nations’ Development Policy and Analysis Division as well as by the Bank of Canada (2007).

The log of broad money (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. We find that, trends in broad money is more stable than that of its components (see Table 3). Among the components of broad money, credit to private sector is the least volatile, followed by credit to the government. Credit to other public sector organizations 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 targets the aggregate money supply and 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, 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.

**TABLE 3: INSTABILITY OF BROAD MONEY AND ITS COMPONENTS**

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

Observations: 95.

Source: Authors' calculation.

## 7. TWO IMPORTANT ASPECTS

### 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. 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. This is evident through the decline of L/C opening for capital machineries. 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 FY10 draw downs the excess liquidity to its usual level in the coming months.

### 7.2 Agricultural Credit Policy

For FY10, 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 FY09. 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, BB has announced a multi-sectoral 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 land-owners, local influential persons and even from neighbors while approving credit to the poor. The policy also kept provision for BKB and RAKUB to disburse a portion of their fund through their NGO 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.

Effective implementation of the abovementioned features will require close monitoring and supervision of the entire lending operation. Bangladesh Bank has already set up a committee titled "Agricultural Credit and Monitoring Cell" 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.

## 8. A SELECT SET OF MISSING ISSUES

### 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 2008-09 compared to similar period of 2007-08 (see Table 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% over the preceding year (previously the growth was limited to 5%). Additionally, the ceiling on single borrower exposure has been raised by another 5% of paid-up capital. Together with the reduced Repo and Reverse 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.

**TABLE 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

### 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 FY09 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 FY08. 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 FY08. 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 (FBs) increased significantly by 26.1 per cent during FY09 (due to application of more stringent standards?).

On July 5 2009, the Finance Minister informed the Parliament that a total of 2,196 loan defaulters who 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% of total classified loan. A similar updated list is expected to be made public in the near future. The Prime Minister, on the other 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

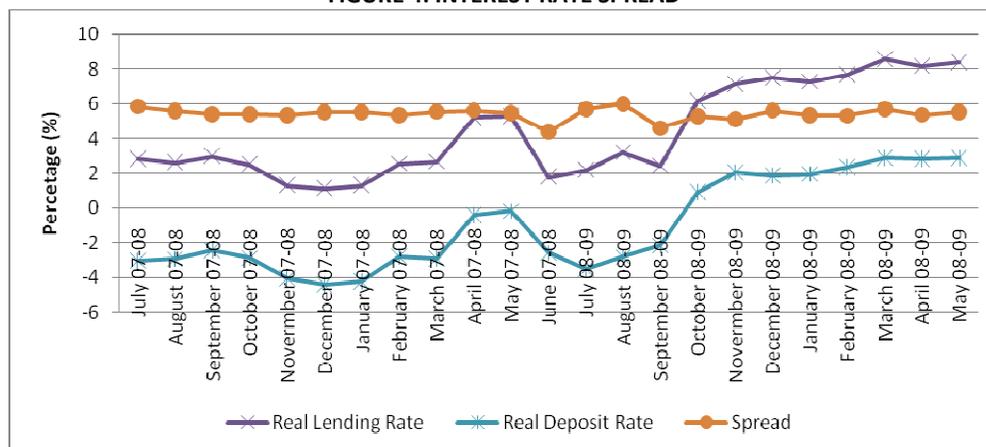
corporations and as demands for funds of the non-performing public enterprises are expected to increase further in view of the government's decision to re-launch them, it would have been prudent for the central bank to lay down a prudential framework for financing the state owned enterprises.

### 8.3 Reducing Interest Rate Spread

Admittedly, high lending rate remains one of the major impediments of investment in Bangladesh. The MPS for H1 FY09 also addressed this issue. High interest spread underpins the problem. 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 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 FY09. The interest rate spread in India generally hovers around 4 to 4.5 per cent. The issue, regrettably, did not get a mention in the MPS of H1 FY10.

FIGURE 4: INTEREST RATE SPREAD



Source: Calculated from Bangladesh Bank data.

### 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 FY08, total outstanding micro-credit 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, MPS of H1 FY10, which demonstrated high level of sensitivity to financing the rural poor, opted not to integrate the issues relating to microfinance within its policy framework.

### 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, BB 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 monetary policy statement.

## 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 monetary policy statement 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 FY10 are the ultimate objective 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.

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. "Monetary Policy Statement (H1)." (FY 2009-10).  
— "Monetary Policy Statement (H1)." (FY 2008-09).  
— "Monetary Policy Statement (H2)." (FY 2008-09).
- Centre for Policy Dialogue. An Analysis of the National Budget for FY 2009-10. Dhaka: CPD, 2009.
- Chatterjee, Partha and Malik Shukayev. "Are Average Growth Rate and." Bank of Canada Working Paper Series (2006).
- Crockett, Andrew. "Central Banking in the New Millenium." Ahluwalia, Montek S., Y.V. Reddy and S.S. Tarapore. Macroeconomics and Monetary Policy. New Delhi: Oxford University Press, 2004. 129-145.
- Lindsey, David E and Henry Wallich. "Monetary Policy." Eatwell, John, Murray Millgate and Peter Newman. Money. New York: The New Palgrave, 1989. 229-247.
- Majumder, Md. Alauddin. "Does Public Borrowing Crowd-out Private Investment? Evidence from Bangladesh." Bangladesh Bank Working Paper Series: WP 0708 (2007).
- Ramey, G and V.A. Ramey. "Cross-Country Evidence on the Link Between Volatility and Growth." American Economic Review (1995): 1138–51.
- "United Nations Development Policy and Analysis Division." 2004. Calculation of Instability Index. 21 July 2009 <<http://www.un.org/esa/policy/devplan/profile/definitions.html>>.