

**Monetary Policy Statement (January - June, 2014):  
An Assessment**  
Bangladesh Economic Update  
January 2014



## Bangladesh Economic Update

Volume 5, No.1, January 2014

### Acknowledgement

Bangladesh Economic Update is a monthly publication of the Economic Policy Unit of Unnayan Onneshan, a multidisciplinary research organisation based in Dhaka, Bangladesh. The report is prepared by a team under the guidance of **Rashed Al Mahmud Titumir**. The team comprises **Md. Abdul Latif Mahmud, Mustafa Kamal** and **Ebney Ayaj Rana**. The Update has been copy edited by **Abid Feroz Khan**.



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## 1. INTRODUCTION

*The present issue of the Bangladesh Economic Update focuses on the currently announced half-yearly Monetary Policy Statement (MPS) for the period of January-June of FY 2013-14, by the central Bank, Bangladesh Bank (BB).*

The present issue of the Bangladesh Economic Update focuses on the currently announced half-yearly Monetary Policy Statement (MPS) for the period of January-June of FY 2013-14, by the central Bank, Bangladesh Bank (BB). The Update examines the current MPS in the background of falling growth in private sector credit, which leads to lower investment demand, resulting in lower economic growth in the country for the last three years in a row. In addition, the Update explicates the issue of rising inflationary pressure in the economy as well as implications on the common people.

The rate of growth of actual disbursement of credit to the private sector in July to September, 2013-14 over July to September, 2012-13 were 10.18 percent, representing a 5.32 percentage point gap.

At the same time, the overall inflation increased (7.35 percent) 0.2 percentage point in December 2013 (point to point basis) from 7.15 percent in November 2013, meaning the monetary policy has yet to be proved to be successful in keeping inflation at targeted level which was 6.0-6.5 percent (base year 2005-06).

Moreover, the rate of growth in Gross Domestic Product (GDP) in FY 2013-14 is likely to fall below 6 percent. The rate of growth declined to 6.23 percent in FY 2011-12 from 6.71 percent in FY 2010-11 and to 6.03 percent in FY 2012-13; 0.20 percentage points lower than the decadal average rate of 6.23 percent.

*The present MPS is the continuation of the monetary policy instruments agreed under the three-year reform programme between the government and the International Monetary Fund (IMF).*

The present MPS is the continuation of the monetary policy instruments agreed under the three-year reform programme between the government and the International Monetary Fund (IMF). The government signed a Memorandum of Economic and Financial Policies (MEFP) with the IMF, embodying nothing but orthodox contractionary monetary and fiscal policy instruments.

The current MPS has been taken by the Bangladesh Bank (BB) when the country's economy is facing with major challenges such as continuous declined of rate of growth of GDP, deterioration of private sector credit growth along with high food inflation.

## 2. TARGETS AND ACHIEVEMENTS OF MPS

Monetary policy taken by Bangladesh Bank seems to be a reflection of the IMF conditions. Added to this are non-achievements of targets - a clearly visible distinction between the key targets and outcomes is observable - raising the issue of credibility and realism in the target setting. There is a gap between the target and achievement of credit growth to private sector, inflation as well as growth in GDP (Table 1).

*Monetary policy taken by Bangladesh Bank seems to be a reflection of the IMF conditions. Added to this are non-achievements of targets - a clearly visible distinction between the key targets and outcomes is observable - raising the issue of credibility and realism in the target setting.*

The rate of growth of GDP is likely to fall below decadal average of 6 percent where as the government's budgetary target were 7.2 percent. While talking to the press the Finance Minister is giving a further reduced level of 6.30 percent. In the MPS, the BB concedes the possibility of achievement of 5.8-6.1 percent. In the previous year (FY 2012-13) government achieved the target 6.03 percent against the target of 7 percent.

In the MPS (January-June, 2012) inflation increased to 8.56 percent against the target of down to single digit. The main reason of increased inflation is the food price volatility.

Private sector credit growth declined to 16 percent in June 2012 from the targeted 18.5 percent in the MPS (January-June, 2012). Private sector credit growth declined to 17.4 percent from the targeted 18.3 percent in that MPS (July -December, 2012). Private sector credit growth declined to 11.43 percent in June 2013 from the targeted 18.3 percent in the MPS (January-June, 2013) due to weak physical infrastructure, inconvenient business environment as well as high interest rate on lending. In the light of previous MPSs it can be assumed that the target might not be achieved if the present situation such as lack of physical infrastructure, high interest rate spread exists.

Table 1: Targets and achievements of previous MPSs

Indicators	MPS (January-June 2014)		MPS (July - December, 2013)		MPS (January-June, 2013)		MPS (July - December, 2012)		MPS (January-June, 2012)	
	Target( percent)	Actual	Targets	Actual	Targets	Actual	Targets	Actual	Targets	Actual
<b>Rate of inflation</b>	Below -7	N/A	7.0	7.35	7.5	8.05	7.5	7.14	Down inflation to single digit	8.56
<b>Credit to the Private Sector</b>	16.5	N/A	15.5	11.1	18.3	11.43(May)	18.3	17.4(November)	18.5	16.0
<b>GDP growth</b>	7.2	Might (5.8-6.1) Projection of BB	7.2	N/A	7.2	6.03	7.2(proposed budget) FY 2012-13	6.03	7.0	6.23

Source: Unnayan Onneshan, 2014. The Monetary Policy Statement of January - June, 2014

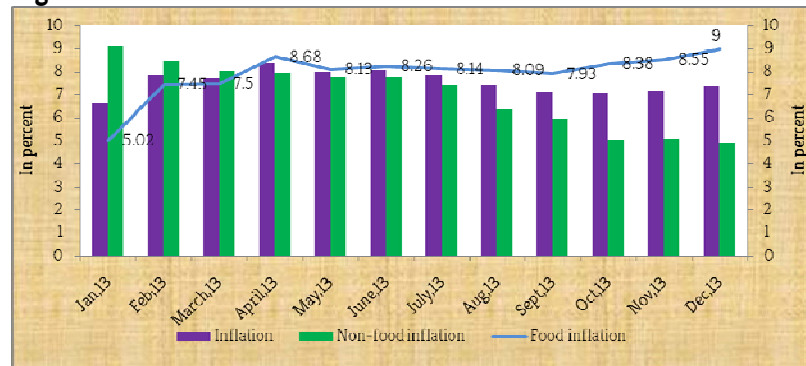
### 3. INVESTMENT AND MPS

Monetary policy influences investment in a number of ways. First, monetary policy is assumed to create better investment opportunity by stabilising the price level. Second, monetary policy ensures a steady flow of funds to private sector for generation of investment. Third, monetary policy instruments channel funds to productive sectors that create positive benefits to other sectors.

*The monetary policies declared by Bangladesh Bank in recent times, however, have been falling to bring the expected results in all the three areas.*

The monetary policies declared by Bangladesh Bank in recent times, however, have been falling to bring the expected results in all the three areas. The inflation rate has been being high as well as persistent. Overall inflation increased by 0.2 percentage point in December 2013 on a point to point basis from 7.15 percent in November 2013 (Base year 2005-06). The food inflation increased by 0.45 percentage point in December 2013 from 8.55 percent in November 2013. On the other hand, non-food inflation has decreased to 4.88 percent in December 2013 from 5.08 percent in November 2013. The increasing trend of food inflation leaves adverse impacts on marginalised people.

**Figure 1: Trend of inflation**



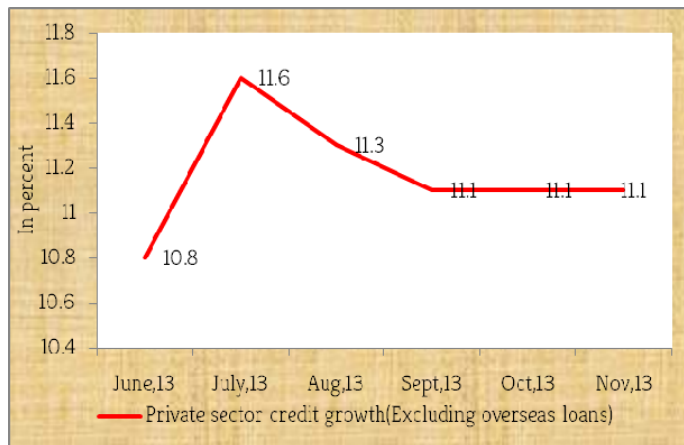
Source: Bangladesh Bureau of Statistics, 2014

*Growth of credit to the private sector slowed in recent time due to consecutive contractionary monetary policy taken by BB and lack of adequate physical infrastructure.*

Growth of credit to the private sector slowed in recent time due to consecutive contractionary monetary policy taken by BB and lack of adequate physical infrastructure. Thus investment demand remains depressed and which in turn would not have been able to expand the economy. The rate of growth of actual disbursement of credit to the private sector in July to September, FY 2013-14 over July to September, FY 2012-13 are 10.18 percent, representing a 5.32 percentage point gap.

Despite repeatedly failing to achieve private sector credit growth, the target of credit in private sector in the current MPS has been set at 16.5 percent in June 2014. This target is 1.0 percentage points higher than the target (15.5 percent) of previous MPS. Private sector credit growth has remained stagnant at 11.1 percent during the months of September, October, and November 2013.

**Figure 2: Private sector credit**



Source: Monthly Economic Indicators, December 2013

Moreover, the government has been struggling to boost up the revenue earning. If the government falls short collecting revenue it has to resort to increasing borrowing from the bank and thus this may crowd out private investment. Total tax revenue collection decreased by Tk. 528.82 crore in November

2013 and stood Tk. 8291.7 crore against Tk. 8820.42 crore in October 2013. National Board of Revenue collected Tk. 5,331 crore less in the first five months of the FY 2013-14, and stood Tk. 41,593.68 crore in July-November against the target Tk.46924.68 crore.

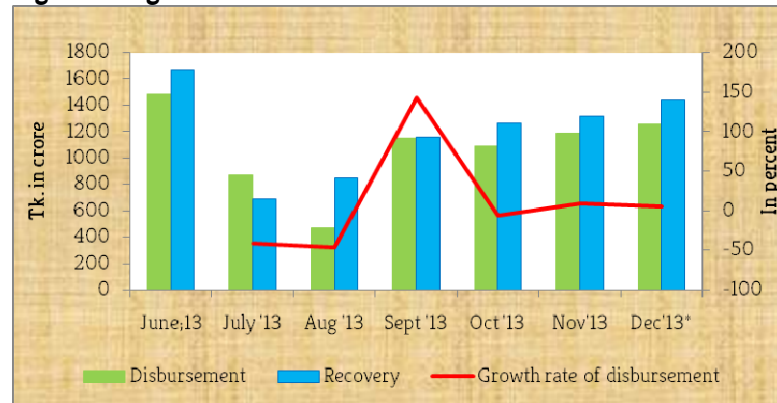
*The rate of growth of agricultural credit disbursement and recovery of credit has been experiencing lower trend as well as negative rate of growth after September, 2013.*

Finally, lower disbursement of credit as well as lower recovery in agricultural, industrial, and SME loans not only increase the default loans but also may impact on growth prospects of the economy in the medium term, resulting in farther contraction of the economy.

### Agricultural Credit

The rate of growth of agricultural credit disbursement and recovery of credit has been experiencing lower trend as well as negative rate of growth after September, 2013. The disbursement of agricultural credit stood at Tk. 1086.56 crore in October, 2013, whereas it was Tk. 1149.04 crore in September, 2013. In August, 2013, the disbursement of agricultural credit also decreased by Tk. 399.08 crore. The rate of growth of the disbursement of the agricultural credit stood negative 5.4 percent in October 2013, where as it was positive 143.2 percent in the September 2013. Recovery of the agricultural credit disbursement has been increasing at an insignificant amount. If the trend remains as usual, the disbursement, recovery, and rate of growth of the agricultural credit disbursement might decline.

**Figure 3: Agricultural credit**



Source: Monthly Economic Indicators, December 2013



## Industrial Term Loan

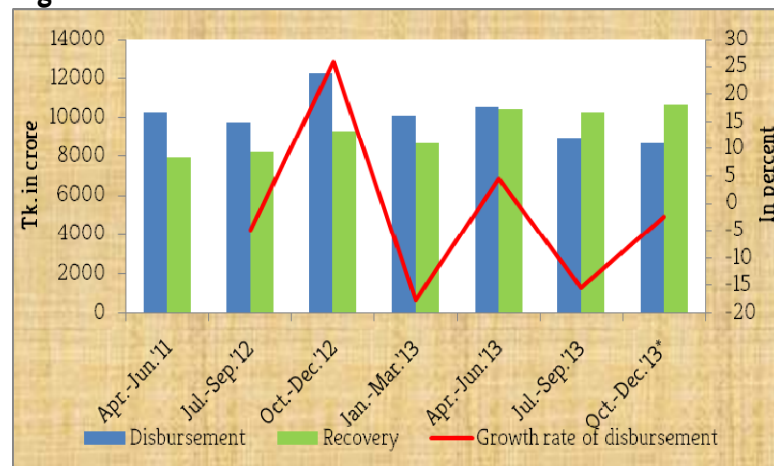
*The disbursement of industrial term loan stood at Tk. 8880.79 crore in the first quarter of the current FY 2013-14, which is the lowest among the last five quarters, whereas it was Tk. 9720.3 crore in the first quarter of the previous FY 2012-13.*

The rate of growth in the industrial term loan has been experiencing an irregular movement with negative rate of growth since April-June, 2011. Adequate capital is needed for industrialisation of a country. Loan is one of the most important factors of capital formation, mainly for developing country like Bangladesh.

The disbursement of industrial term loan stood at Tk. 8880.79 crore in the first quarter of the current FY 2013-14, which is the lowest among the last five quarters, whereas it was Tk. 9720.3 crore in the first quarter of the previous FY 2012-13. In the first quarter of the current FY 2013-14, disbursement of the industrial term loan decreased by Tk. 1632.48 crore compared to the last quarter of the previous FY 2012-13. The rate of growth of the disbursement of the industrial term loan stood negative at 15.53 percent in the first quarter of the FY 2013-14, compared to the positive rate of growth of 4.49 percent in the last quarter of the FY 2012-13. If the trend remains as usual, the disbursement might decline.

The condition of the recovery of the industrial term loan has been improved by insignificant amount since the last quarter of the previous FY 2012-13.

**Figure 4: Industrial term loan**



Source: Monthly Economic Indicators, December 2013

## SME Loans

Although the total loan given by state owned commercial banks, foreign banks, and non-bank financial institutions, except the specialised banks, increased to Tk. 473242.7 crore at the end of September, 2013 from Tk. 466162.3 crore at the end of June 2013, the SME loan as a percentage of total loans has been increasing by an insignificant amount. The total SME loan decreased by Tk. 9451.91 crore at the end of September 2013 compared to Tk. 24398.34 crore at the end of September 2012. The rate of growth of SME loan was negative at 5.25 percent in March, 2013. Especially, state owned banks observed a negative growth of 38.47 percent at the end of September 2013 compared to September 2012.

**Table 2: SME loan**

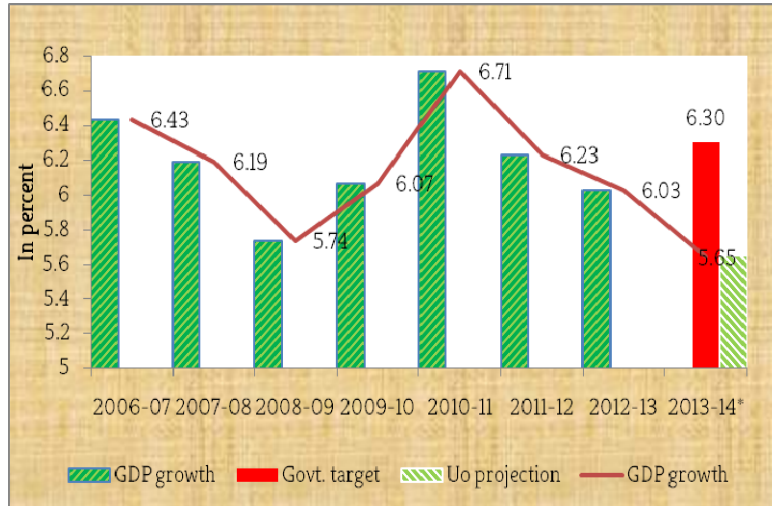
Month	Total Loans	SME Loans	Rate of growth of SME loan
Sept, 12	437744.3	100001.9	
Dec, 12	451096.7	100813.2	0.81
March, 13	454500	95523.06	-5.25
June, 13	466162.3	100863.7	5.59
Sept, 2013	473242.7	108599.5	7.67
Dec, 13*	480342.4	110319	1.58

Source: Monthly Economic Indicators, December 2013

## 4. GROWTH AND MPS

The country has been facing a decelerating rate of growth which can partly be attributed to its monetary policy. Under the five year MTMF-2014-18, the annual GDP growth was projected at 7.6 percent in FY 2013-14. But the projection has been revised and set at 7.2 percent in the current fiscal year instead of 7.6 percent projected by MTMF. BB is consecutively taking contractionary monetary policy which restrained the credit growth in the country, which depresses investment demand and contracts the possibilities of expansion of the economy. Therefore, it might not be possible to achieve the targeted GDP growth of 7.2 percent in FY 2013-14.

**Figure 5: Rate of growth in GDP (real, targeted and projected)**

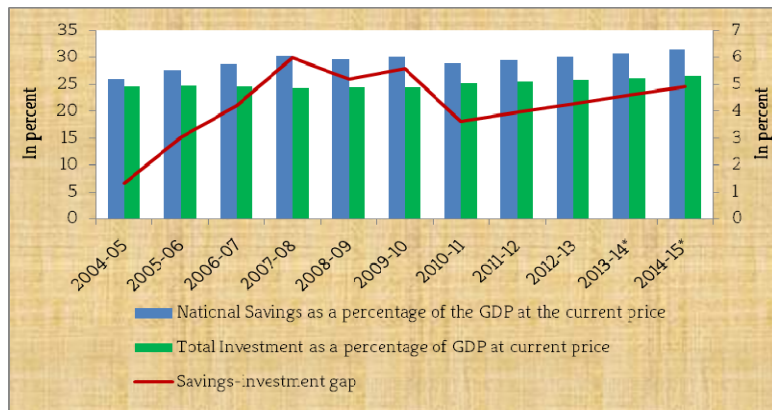


Source: Various issues of Bangladesh Bureau of Statistics (BBS) 2013 and the Unnayan Onneshan Projection

Further, the gap between savings and investment has increased over time, which is also a problem for the expansion of the economy. An increase in savings and investment ratio increases the growth rate of the country. On the other hand, the government fails to create the investment demand due to lack of infrastructure development. The savings-investment gap has been increased sharply and considering the same business scenario it will continue further if the existing policies prevail in future. The savings –investment gap might be 5.47 and 5.81 percent of the nominal GDP in FY 2013-14 and FY 2014-15 respectively.

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**Figure 6: Savings –Investment gap**



Source: Authors' calculation based on various issues of BBS

The growth of the economy is often contingent upon adequate supply of credit to the real economy such as agriculture and industry. For example, about 47.30 percent of labour force is involved in agricultural production in Bangladesh. The agricultural production system is mainly small-farmers dominated, with high labour intensity. The small farmers usually cannot accumulate enough capital to invest in production to become more productive. Thus low agricultural productivity is a problem for the economy, which can be tackled through expansion of availability of credit to the farmers. However, despite all tall talks regarding the financial inclusion, all banks in the country do not have an equal distribution of branches in rural areas.

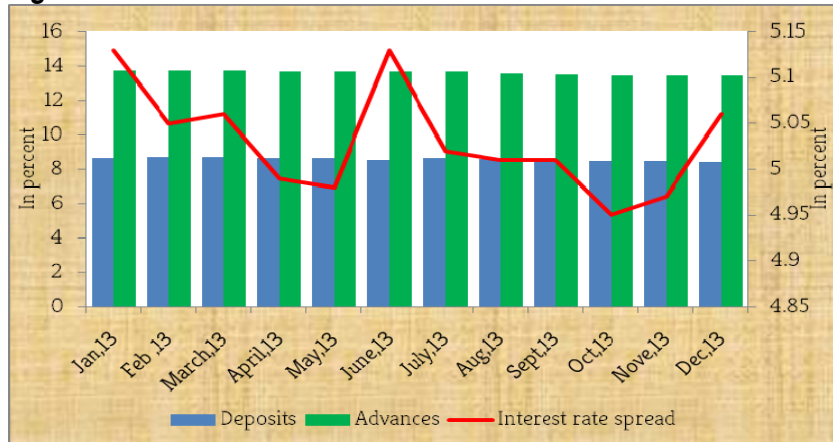
The industry sector is more in need of credit than the agriculture sector. Unlike the agriculture sector, the industry sector is capital intensive. Moreover, Bangladesh mostly export labour intensive products which the country urgently needs to transform into more capital intensive ones. If the country fails to do so, whether because of contractionary monetary policy, poor investment environment or because of other reasons, the growth of the country would suffer severely.

Finally, despite promoting financial sector liberalisation, interest rate spread (IRS) has not decreased and lending rate has been remaining high, increasing the cost of capital. Rate of interest on advances is still too high and interest on deposit has been decreasing after July 2013. The IRS in Bangladesh is indicative of interactions of the factors such as high costs of intermediation as a consequence of large non-performing loan (NPLs) and practice of setting higher than competitive deposit interest rates.

The spread of lending and deposit rate increased to 5.06 percent in December 2013 from 4.97 percent in November 2013. The rate of interest on depositor and lender was 8.39 and 13.45 percent respectively in December 2013 while these were 8.45 and 13.42 percent respectively in November 2013. It is noticeable that rate of interest on lending increased to 13.45 in December 2013 from 13.42 percent in November 2013 which indicates that business community might suffer due to high interest rate and this will further reduce the investment.

*As a result of high lending rate, the slow demand for loan has been observed from the banking sector. The overall credit-deposit ratio in the banking sector decreased to 70.80 percent as of December 19, 2013 from 71.91 percent as of November 14, 2013.*

**Figure 7: Interest rate**



Source: Bangladesh Bank, 2014

As a result of high lending rate, the slow demand for loan has been observed from the banking sector. The overall credit-deposit ratio in the banking sector decreased to 70.80 percent as of December 19, 2013 from 71.91 percent as of November 14, 2013. The credit-deposit ratio in the banking sector along with its credit growth might decline further in the upcoming year if the present situation exist (high interest rate on lending, infrastructure etc.) Similarly, the current MPS seems to be lacking in promoting financial inclusion, thus bringing more people under the coverage of financial services.

## 5. A LOOK AT THEORETICAL UNDERPINNING

The monetary policy formulation in Bangladesh does not encompass the theoretical underpinnings of neither of the two major theoretical approaches to monetary policy formulation – the “Impossible Trinity” and the “Taylor Rule”. The following paragraphs briefly analyse the two theoretical approaches as regards the monetary policy formulation in Bangladesh.

Of late, the global debate on monetary policy making has focused on whether policy formulation should target financial stability in addition to the domestic business cycle in an economy. In this regard, there has emanated a question of reconciliation between two widely held macroeconomic policy formulation, namely, Mundell-Fleming “Impossible Trinity” and “Taylor rule” of monetary policy.

*In particular, the recent consecutive contractionary monetary policy formulations by Bangladesh Bank which were assumed to address the rising inflationary pressure in the economy factually did not succeed to check the inflationary pressure.*

*In a nutshell, according to the "Impossible Trinity", a central bank cannot exercise monetary control and fix the exchange rate simultaneously with an open capital account.*

In particular, the recent consecutive contractionary monetary policy formulations by Bangladesh Bank which were assumed to address the rising inflationary pressure in the economy factually did not succeed to check the inflationary pressure. Rather, these policy formulations have proved to be merely at the behest of International Monetary Fund (IMF) to satisfy the conditions articulated in the Memorandum of Economic and Financial Policies (MEFP), since the trend of average inflation in 2013 remained upward (6.06 percent in January 2013, 6.78 percent in June 2013, and 7.53 percent in December 2013). However, prior to considering "Impossible Trinity" and "Taylor Rule" of monetary policy as regards the monetary policy formulations in Bangladesh, a brief sketch of both approaches needs to be presented.

The "Impossible Trinity" states that a country can have only two of the following three at the same time: a fixed exchange rate, free capital flow, and an independent monetary policy (a monetary policy that is free to respond to the domestic business cycle). In a nutshell, according to the "Impossible Trinity", a central bank cannot exercise monetary control and fix the exchange rate simultaneously with an open capital account. However, it has been argued that the best way to resolve the "Impossible Trinity" is to maintain an open capital account, then letting the exchange rate float so as to exercise domestic monetary control through an independent monetary policy formulation. This way of resolving the "Impossible Trinity" is often undertaken in an inflation targeting monetary policy framework.

On the other hand, the "Taylor Rule" implies that how much the central bank should change the nominal interest rate in response to changes in inflation and output. The "Taylor Rule" is a rule-bound monetary policy which requires the adjustment of short-term policy interest rate by the central bank based on a mathematical formula using differentials between a country's potential GDP and actual GDP and between the inflation target and actual inflation. The mathematical formula is as follows -

$$i = \hat{r} + \pi + 1.5 (\pi - \pi^*) + 0.5 y$$

Where  $i$  is the short-term policy interest rate,  $\hat{r}$  is the long-run or equilibrium real interest rate,  $\pi^*$  is central bank's inflation target,  $\pi$  is the actual inflation rate, and  $y$  is the current period



output gap. According to the “Taylor Rule”, the central bank aims at attaining inflation around its target level and output around its potential level. The formula, therefore, stipulates that the positive (negative) deviations of the two variables from their target or potential level will be associated with tightening (loosening) of monetary policy. However, in essence, the “Taylor Rule” postulates that for each one-percent increase in inflation, the nominal interest rate should be raised by more than one percentage point.

Now, in seeking the relevance of both the “Impossible Trinity” and the “Taylor Rule” of monetary policy to the monetary policy formulations in Bangladesh, it has been ironically found that neither of the approaches can be applicable in this regard. As regards the “Impossible Trinity”, with an open capital account, Bangladesh Bank still intervenes in foreign exchange market in order to avoid excessive exchange rate volatility and promote export competitiveness while the monetary policy is formulated with a view to satisfying IMF conditions, not making it free to respond according to domestic business cycle. On the other hand, the “Taylor Rule” does also not apply to the formulation of monetary policy in Bangladesh. Since the application of “Taylor Rule” implies that the central bank takes contractionary (expansionary) monetary policy in accordance with positive (negative) deviations of inflation and output from their target and potential levels respectively. The mathematical formula indicates, as regards the formulation of monetary policy in Bangladesh, that Bangladesh Bank should not tighten the monetary policy as it is now. According to the “Taylor Rule” equation, the policy interest rate should be 9.81 percent (calculated through taking into account Bangladesh Bank’s GDP projection of 6 percent and inflation projection of 7 percent), while it remained nearly 13.51 percent on average during the first six months of FY13-14.

## **SUMMARY AND CONCLUSIONS**

Recent decelerating growth of Bangladesh economy has been posing the foremost challenges for the central bank in articulating appropriate monetary policy stances. The decreasing growth in private sector credit does not meet the investment demand; rather the government has been expending the money in different unproductive sectors. As a

result, both the private investment and the implementation of ADP remain far away from the target which in turn do not create fiscal multiplier effect in the economy and thus decelerate the rate of growth of the economy.

The slow demand for investment has been reflected in the credit deposit ratio. The overall credit-deposit ratio in the banking sector decreased to 70.80 percent in December 2013 from 71.91 percent in November 2013. The credit-deposit ratio was 76.59 percent in December 2012 and 80.33 percent June 2012.

*In addition, increasing trend of inflation, especially food inflation, poses challenges for the central bank. Moreover, higher food inflation compared to non-food inflation has put the marginalized people into a dire situation.*

In addition, increasing trend of inflation, especially food inflation, poses challenges for the central bank. Moreover, higher food inflation compared to non-food inflation has put the marginalized people into a dire situation.

On the other hand, Bangladesh Bank has currently been pursuing contractionary monetary policy which has virtually been failing to address the inflationary pressure in economy. Therefore, it seems paradoxical for the central bank of the country to pursue consecutive contractionary monetary policies merely to satisfy the IMF conditions without considering its adverse impact on the economy.

The current tightening of monetary policy by the Bangladesh Bank seems to be ineffective and therefore requires a new policy approach. Recent declining trend in private sector credit growth, which has factually been causing the growth of Bangladesh economy to decline in the last three years in a row, can be restrained through a harmonisation of fiscal and monetary policy. The central bank may demonstrate its prudence while harmonising monetary and fiscal policy through undertaking an expansionary monetary policy that will ensure private sector credit growth and a fiscal management that will increase government expenditure in productive sectors. Such a harmonisation of monetary and fiscal policy may foster both the investment and employment creation in the economy.



Besides, the current inflationary pressure can be checked by the policy harmonization since increased private investment and employment creation will ensure the use of money in productive sectors and cause both the money and fiscal multiplier effects to work in the economy. As a result, the vicious causality (declined private sector credit growth decreases investment which, in turn, causes growth of the economy to turn down) can be neutralised through channeling adequate resources to productive sectors that will eventually restrain the inflationary pressure and ensure an increasing trend in economic growth in the country.

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