Monetary Policy Statement (January-June, FY2014-15)
A Rapid Assessment
Bangladesh Economic Update
January 2015

উন্নয়ন অন্বেষণ
UNNAYAN ONNESHAN

Bangladesh Economic Update
Volume 6, No.01, January 2015

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 has been prepared by a team comprising of **Nabila Nasrin**, **Ebney Ayaj Rana** and **Md. Al Amin Islam**. The Update has been copy edited by **Abid Feroz Khan**.

For orders and request, please contact:
UNNAYAN ONNESHAN
16/2, Indira Road, Farmgate Dhaka-1215, Bangladesh
Tell: + (880-2) 58150684, 9110636
Fax: + (880-2) 58155804
E-mail: info@unnayan.org
Web: www.unnayan.org

1. INTRODUCTION

The Update examines the current MPS in the background of three major economic issues affecting the growth of the economy – sluggishness in investment due to inflation targeting policy formulation and current political uncertainty, crisis in banking sector due to increase in default loan, and huge capital flight due to slack surveillance and oversight.

The current issue of the Bangladesh Economic Update focuses on the recently announced half-yearly Monetary Policy Statement (MPS) for the period of January-June of FY 2014-15 by the central Bank, Bangladesh Bank (BB). The Update examines the current MPS in the background of three major economic issues affecting the growth of the economy – sluggishness in investment due to inflation targeting policy formulation and current political uncertainty, crisis in banking sector due to increase in default loan, and huge capital flight due to slack surveillance and oversight. Following the scrutiny, the Update reveals that the growth in private sector credit may fall short of target in view of the observed trend of unachieved targets in previous occasions.

It has, however, been cautioned that this trend of shortfall in targets of growth in private sector credit may further worsen the sluggish rate of private investment triggered by current political uncertainty, and cause the rate of growth in gross domestic product (GDP) not to reach the target of 7.3 percent in FY2014-15. Till November of FY2014-15 when the political unrest did not reach the current level, the BB remained far away from its target of 14 percent growth in private sector credit set for the period of July-December of FY2014-15. It is, therefore, argued that the target of 15.5 percent for the January-June period of FY2014-15 seems to be unrealistic amidst the current state of severe political uncertainty since January 2015.

Following the inflation-GDP trade off rule, BB has been adopting monetary policy for several periods to keep the inflation level low in order to fasten growth of GDP. Many argue that consecutive tight monetary policies of BB remain successful in cutting inflation as recently the inflation is on downward trajectory. In Bangladesh, inflation is more related to the cost of production than to monetary variables. In recent time, the inflation is sliding because of decrease in global oil price, falling import price of goods and no supply disruption due to absence of natural hazards. Consecutive tight monetary policy has little impact on inflation but is largely affecting the investment especially the private investment by squeezing the credit growth in private sector. Recent political disturbance and the inadequate supply of gas and electricity have worsened the situation. So, a more accommodative or easier monetary policy is needed for adequate investment instead of the tight one.

A strong financial system is needed for successful implementation of monetary policy (Kholi, 2015).The running crisis in the banking sector mainly due to increase in default loan reflects the institutional weakness in financial system in the country.

A strong financial system is needed for successful implementation of monetary policy (Kholi, 2015).The running crisis in the banking sector mainly due to increase in default loan reflects the institutional weakness in financial system in the country. Banking sector gets caught in trap characterised by increased default loan, low credit growth in private sector, poor risk management, excess liquidity, decrease in government borrowing and slack surveillance over the system. This situation is more upsetting in the State Owned Commercial banks (SCBs) and Development Financial Institutions (DFIs) for which they face huge capital shortfall. Government recapitalises the shortfall with taxpayer's money instead of correcting the faults of the institutions which not only increases the burden on taxpayers but also causes a loss to the economy.

Huge illegal capital flight becomes a concern for the economy. The amount of money flown out of Bangladesh through illicit means is increasing every year riding mainly on trade misinvoicing. Increase in Import of capital machineries vis-a-vis industrial credit growth and increasing savings –investment gap are the signals of illegal capital flight. Besides, hundi, hot money transfer (balance of payment leakage), transfer of illegal money through tax evasion are the facets of capital flight.

Besides the economic factors, some noneconomic factors like– democratic crisis-induced current political uncertainty on the economy together with underdeveloped infrastructure may badly affect production of the economy by creating risky investment climate.

This paper attempts to assess the current monetary policy on the backdrop of these issues. First, a quick look will be given to the overall economy to see the performance of the major macroeconomic indicators. Next, the targets and the achievements of the previous MPSs will be investigated. Then the effectiveness of current MPSs will be discussed against the backdrop of growth and investment, sector wise credit growth, performance of banking sector and capital outflow.

2. MAJOR MACRO ECONOMIC BACKDROP

The current MPS has been taken by the central bank when the country's economy is facing with major challenges such as increasing savings-investment gap, unsatisfactory collection of revenue vis-à-vis target, disarrays in external balance, infrastructural underdevelopments, institutional weaknesses and political uncertainties.

Ambitious fiscal targets, both from income and expenditure sides, set for FY 2013-14, did not materialise at the end of the fiscal year, although the government has been struggling to boost up its revenue earning.

Considering the historical trend of the rate of growth in GDP and assuming the same business scenario, the Unnayan Onneshan projects that the rate of growth in FY 2014-15 might be 6.26 percent where the target was set 7.3 percent in the annual budget, thereby remaining under seven percent for the next fiscal year against the target of a rate of growth of eight percent in FY 2016-17. Stagnant investment together with low rate of ADP implementation and shortfall of revenue is impeding the expected rate of growth in GDP. Besides, large trade deficit, underdeveloped infrastructure and crisis in banking sector have been exerting adverse effect on the economy causing the rate of growth to decelerate.

Ambitious fiscal targets, both from income and expenditure sides, set for FY 2013-14, did not materialise at the end of the fiscal year, although the government has been struggling to boost up its revenue earning. In July-November period of FY 2014-15, National Board of Revenue (NBR) has collected Tk. 47725.70 crore where target was set to collect Tk. 149720 crore ;that is only 31.88 percent of total tax has been collected. The current status of revenue collection therefore implies that the target that was set in annual budget might be not achieved at the end of FY 2014-15. Several issues like narrow tax base, concentrated tax sources and tax evasion as well as tax avoidance are causing the collection of revenue to fall below the target. The allocation of Annual Development Programme (ADP) has been continuously increasing over the last twenty years, whereas implementation has been consistently falling far short of targets. In the FY 2014-15, the ADP allocation was 33.85 percent higher than the previous fiscal year but in July-December period of the fiscal year only 28 percent of total allocation has been spent.

External sector is undergoing an unsatisfactory performance due mainly to recent decrease in the surplus in current account, which may threaten to exert pressure on country's balance of payments.

External sector is undergoing an unsatisfactory performance due mainly to recent decrease in the surplus in current account, which may threaten to exert pressure on country's balance of payments. In the first quarter of FY 2014-15, the economy experienced deficit in current account balance due to increase in import, decrease in export and foreign aid disbursement, although an increase in portfolio investment keeps the overall balance positive. Trade deficit doubled year-on-year in the first five months of the fiscal year on the back of high import and low export growth. Between July and November, trade deficit stood at USD 4.48 billion, which was USD 2.25 billion in the same period last FY 201-14. Imports surged 16.62 percent but exports rose a negligible 0.01 percent. The current account balance also turned negative in the first five months of FY 2014-15: it was USD 1.31 billion in the deficit against the surplus of USD 1.12 billion during the same period last fiscal year.

Country's banking sector being characterised by high rate of interest, excess liquidity and declining growth in disbursement of credit to private sector, intermediating lower investment, coupled with poor risk management, fraudulence, driven by captured governance and lax oversight, resulting in lower profitability to the shareholders is caught in trap. Besides this backdrop, questions are being raised concerning the far-sighted deregulation of the financial sector.

Finally, poor energy infrastructure and underdevelopment in road and transportation system are directly related to below the target performance of the economy and cause the rate of growth to slow down. Large amount of investment and good governance are, however, needed in order to improve the infrastructure to ensure sustainable path of economic growth.

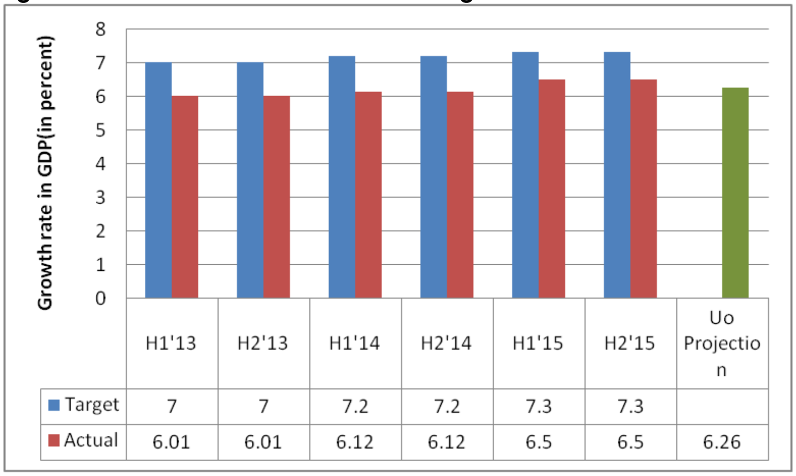
3. TARGETS and ACHIEVEMENTS of PREVIOUS MPSs

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, growth in GDP as well as inflation.

In the current monetary policy for second half of FY 2014-15 BB projects that the rate of growth in GDP might be 6.5-6.8 percent where the budgetary target was set to 7.3 percent.

In the current monetary policy for second half of FY 2014-15 BB projects that the rate of growth in GDP might be 6.5-6.8 percent where the budgetary target was set to 7.3 percent. The sluggishness in investment together with recent political turbulence and inadequate infrastructure cause the rate of growth in GDP not to reach the target of 7.3 percent or 6.5 for the FY 2014-15. Taking account the rate of growth in GDP, UO projects that the rate of growth would be 6.26 percent.

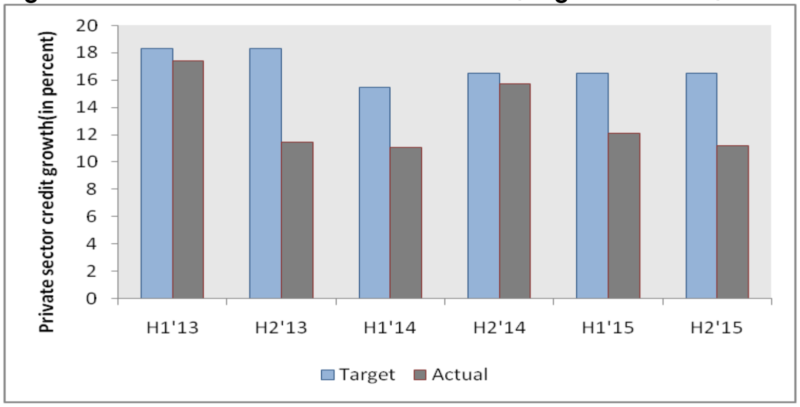
Figure 1: Rate of Growth (Actual and Target)



Source: Bangladesh Bank, 2014; UO, 2014

BB has been missing the target of private sector credit growth on continuous basis. Statistics suggest that the private sector credit growth has declined to 12.7 percent in November,2014 from the targeted 16.5 percent in the MPS (July-December, 2014-15). Private sector credit growth declined to 17.4 percent from the targeted 18.3 percent in that MPS for H1, 2013 (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 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 and political disturbances exist.

Figure 2: Private Sector Credit Growth Rate (target and actual)



Source: Bangladesh Bank, 2014

In the MPS (July- December, 2014), the target for inflation rate was 6.5 percent where the actual rate of inflation was 6.11 percent at the end of December and average inflation reached 6.86 for the first half of the FY 2014-15.

In the MPS (July- December, 2014), the target for inflation rate was 6.5 percent where the actual rate of inflation was 6.11 percent at the end of December and average inflation reached 6.86 for the first half of the FY 2014-15. The average food and non-food inflation for the corresponding period reached 7.1 percent and 5.86 percent respectively. So achieving the inflation target of current MPS of 6.5 percent will be not very difficult if the present situation prevails.

Figure 3: Rate of Inflation (Target and Actual)

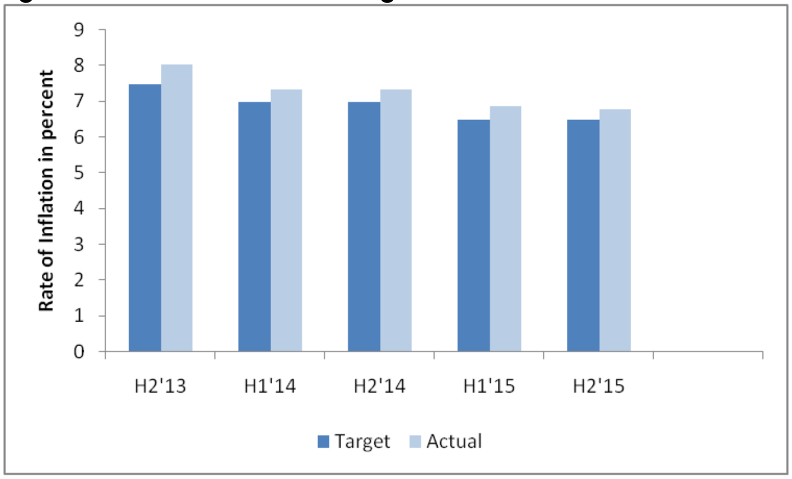


Figure: Bangladesh Bank.2014

UNNAYAN ONNESHAN

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

4. 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.

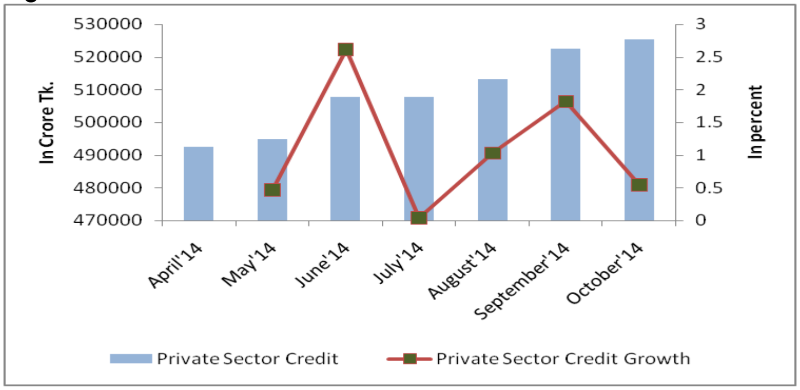
The monetary policies declared by Bangladesh Bank in recent times, however, have been failing to bring the expected results in all the three areas. Monetary policy has little influence in decreasing inflationary pressure. The private sector credit growth has fallen far below the target and channelling of funds is hindered due to institutional weakness; that is weakness in banking sector.

The private investment has been decreasing since FY 2011-12. In 2012-13 private investment decreased to 21.75 percent from 22.50 percent in 2011-12.In the following years there is a continuous decrease in private investment. The private investment stood at 21.39 percent in 2013-14.That private investment decreased by 4.93 percent at an annual rate 2.46 percent from 2011-12. If this trends continues then private investment as share of GDP will be 20.86 percent at the end of the current fiscal year.

4.1 Private sector credit growth

Growth of credit in 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 November of FY 2014-15 over November, in FY 2013-14 is 12.7 percent, representing a 3.8 percentage point gap from the target level of 16.5 percent. If the current trend continues, the gap may further widen in the next half of the FY 2014-15(H2, 2014-15).

Figure 4: Private Sector Credit Growth



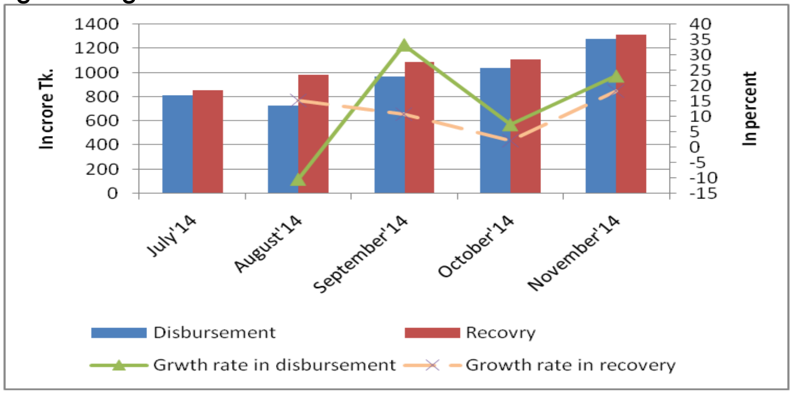
Source: Bangladesh Bank,2014

4.2 Sector wise Credit: Agriculture, Industry and SME credit

Agricultural Credit

The rate of growth of agricultural credit disbursement and recovery of credit have been experiencing lower trend as well as negative rate of growth after July 2014 compared to the previous fiscal year. The disbursement of agricultural credit stood at Tk. 1218.97 crore in January, 2014 whereas it became 811 crore in July 2014; a decrease of 33.46 percent. In October, 2014, the disbursement of agricultural credit also decreased by Tk. 4.29percent compared to the same time period in the previous FY 2013-14. The amount slightly increased to 1280.86 crore in November of FY 2014-15. On the other hand, recovery of the agricultural credit disbursement has been increasing at an insignificant amount. The rate of growth of the recovery of the agricultural credit, therefore, stood at .043 percent in July-November, 2014 period where it was 14.83 percent in the same time period of the FY 2013-14.

Figure 5: Agricultural credit



Source: Bangladesh Bank, 2014

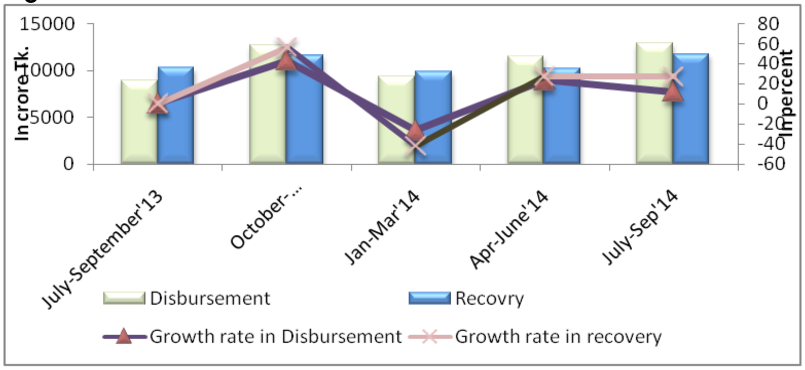
Industrial Credit

The rate of growth in the industrial term loan has been experiencing an irregular movement with frequent negative rate of growth. 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 rate of growth in the industrial term loan has been experiencing an irregular movement with frequent negative rate of growth.

The disbursement of industrial term loan stood at Tk.12809.4 crore in the July-September,2014 whereas it were Tk. 11462.4 crore and Tk. 9283.5 crore(lowest among the last five quarters) in April-June and January-March quarters of the FY 2013-14. As a result, the rate of growth of the disbursement of the industrial term loan stood negative at 27 percent in the January-March quarter of the FY 2013-14. The rate of growth becomes positive to 23.47 percent in the April-June quarter of the same fiscal year which decreased to the 11.75percent in the July-September quarter of the FY 2014-15. The condition of the recovery of the industrial term loan has been improving since the last quarter of the FY 2013-14.

Figure 6: Industrial Term Loan

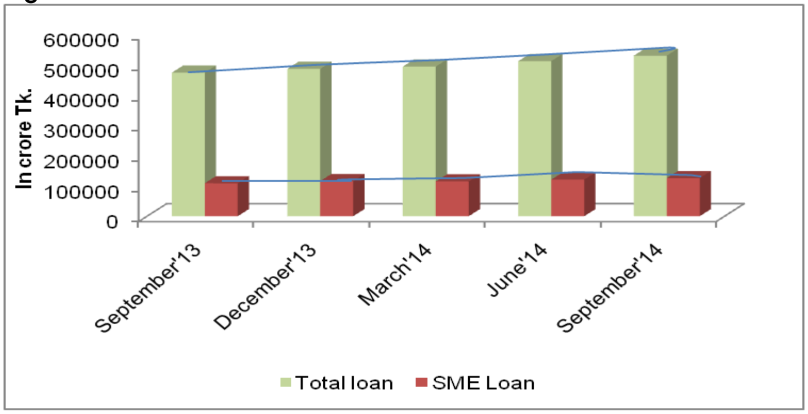


Source: Bangladesh Bank,2014

SME loan

Although the total loan given by state owned commercial banks, foreign banks, and non-bank financial institutions, except the specialised banks, increased to Tk. 529407.68 crore at the end of September 2014 from Tk. 511307 crore at the end of June 2014, the SME loan as a percentage of total loans fluctuated around the 23 to 24 percent during the same period. The total SME loan increased by Tk. 5108 crore between the period of September 2014 and June 2014 and has been calculated at Tk. 125615 crore in September 2014. As a result, the rate of growth of SME loan has increased from negative1.1 percent in March 2014 to positive 5.16 percent in June 2014 but decrease to 4.24 percent in the September 2014.

Figure 7: SME Loan



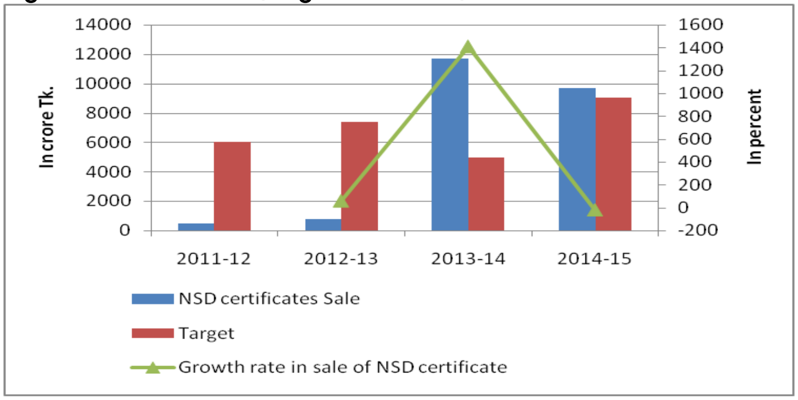
Source:Bangladesh bank,2014

Government borrowing is an important element of monetary policy to control the circulation of money. The mismatch between the revenue and expenditure is fulfilled by borrowing both from domestic and external sources.

4.3 Government Borrowing

Government borrowing is an important element of monetary policy to control the circulation of money. The mismatch between the revenue and expenditure is fulfilled by borrowing both from domestic and external sources. In the first quarter of the current fiscal year (July-October'14), the deficit financing increased by three times than the same time period of the previous year. In July – October period of FY2014-15, the deficit financing is Tk.12060.15 crore where it was Tk.4476 core in July-September of FY2013-14. The borrowing from domestic sources has increased more than that from external sources. In the July –September period of FY2014-15, financing from external sources is Tk.1140.51 crore and from domestic sources is Tk.10919.64 crore. Among the domestic sources, borrowing from the banking system does not increase much, whereas the borrowing from the non banking sources has increased drastically specially from selling the NSD certificates. NSD is most expensive instrument for government for borrowing because of high interest rate. Government borrows 3070.7crore form the banking sector in July-September, 2014 where the borrowing from the non banking sector is Tk.7848.94 crore. Government plans to collect Tk. 9056 crore through NSD certificate in FY 2014-15, but in first five months of this fiscal year, NSD certificates with the value of Tk. 9677 crore have been sold which is 206.31 percent higher than that of same time period of the previous year and Tk. 621 crore higher than the target. The reduction in government borrowing from the banking system is decreasing the profitability of banks and increased selling of the NSD can crowd out the investment as people are more attracted to the NSD than the banks because the NSD offer higher interest than the fixed deposit in the bank.

Figure 8: Sale of NSD (target and actual)



Source: Bangladesh Bank,2014

BB is trying to control the inflation to achieve higher rate of growth tight monetary policy without lowering the interest rate which badly affecting the borrower.

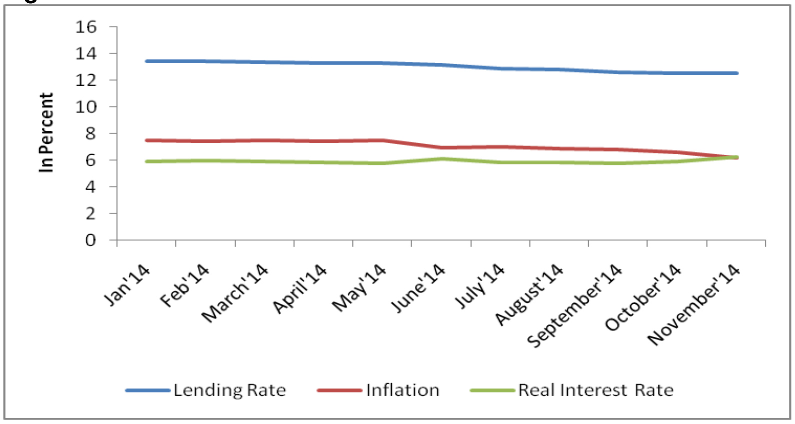
4.4 Interest rate

BB is trying to control the inflation to achieve higher rate of growth tight monetary policy without lowering the interest rate which badly affecting the borrower. First the borrower incurs losses because of falling inflation rate which means the money which he borrowed now worth more. On the other hand the rate at which the inflation is falling greater than that of the nominal interest rate. As a result the real interest rate is too high to encourage the borrowers to borrow thus lowering the demand for credit. Real interest rate is calculated as follows suggested by Irving Fisher:

$$r = i - e$$

Where, r is the real interest rate, i is the nominal interest and e is the inflation rate. Fisher suggests that there exists a one to one relation between inflation and the nominal interest rate. That is if the inflation increases/decreases by one percent the nominal interest rate increases/decreases by one percent. But interest rate is not falling keeping the pace with the falling inflation rate. In November the point to point inflation stood at 6.21 percent from the 7.04 percent in July, 2014 that is .83 percentage point decrease in inflation. Contrarily to this nominal interest rate decreased to 12.49 percent from 12.84 percent in July, 2014 that is a .35 percentage point decrease in nominal interest rate. As the inflation falls but the insignificant fall in nominal interest rate keeps the real interest rate high. In January the real interest rate was 5.89 percent which stand to 5.8 in July, 2014 and 6.28 percent in November, 2014. This high real interest rate has been not only increasing the cost of lending but also suppressing the investment demand.

Figure 9: Nominal Real Interest Rate and Inflation



Source: Bangladesh Bank, 2014

Despite promoting financial sector liberalisation, interest rate spread (IRS) has decreased very slightly and lending rate has been remaining high, increasing the cost of capital.

Despite promoting financial sector liberalisation, interest rate spread (IRS) has decreased very slightly 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 which is discouraging potential savers due to low returns on deposits and thus limiting financing for potential borrowers and only increasing the profit of banks. BB fail to manage the this high inflation manage 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, however, decreased to 5.09 percent in October 2014 from5.31 percent in June, 2014 which was 5.15 percent in March 2014. The rate of interest on depositor and lender was 7.40 and 12.49 percent respectively in October 2014 while these were 7.79 percent and 13.10 percent respectively in June 2014. Although the lending rate is on slight decreased lately, the rate is still too high to attract the small and medium investors and enterprises in the economy.

Figure 10: Interest rate

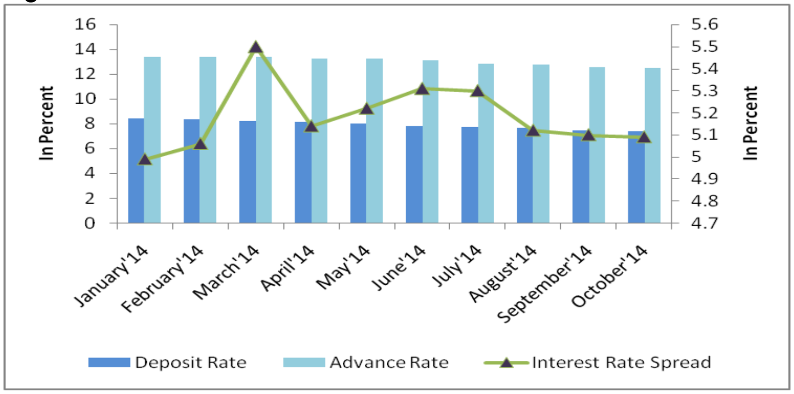


Figure: Major Economic Trends, Bangladesh Bank, 2014

Overall net non performing loan (NPL) increased to 3.9 percent in June 2014 from 3.4 percent in March 2014.

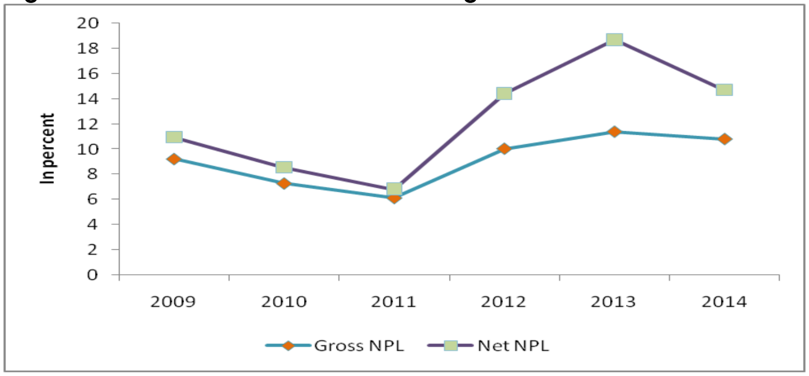
5 Crisis in banking sector: regulation and monetary policy

Country's banking sector has been caught in trap and is characterised by high rate of interest, excess liquidity and declining growth in disbursement of credit to private sector, intermediating lower investment, coupled with poor risk management, fraudulence, driven by captured governance and lax oversight, resulting in lower profitability to the shareholders and institutional weakness in the economy. Besides this backdrop, questions are being raised concerning the far-sighted deregulation of the financial sector.

5.1 Increase in default loan

Non-performing loan both gross and net is increasing. Overall net non performing loan (NPL) increased to 3.9 percent in June 2014 from 3.4 percent in March 2014. At end of March 2014, Net NPL ratios for SCBs and SBs increased from 4.7 percent and 24.2 percent respectively at the end of March 2014 to 7.4 percent and 26.4 percent respectively at the end of June 2014.On the other hand gross non performing loan compared to the total loan increases from 10.5 to 10.8percent in April-June period of the FY 2013-14.

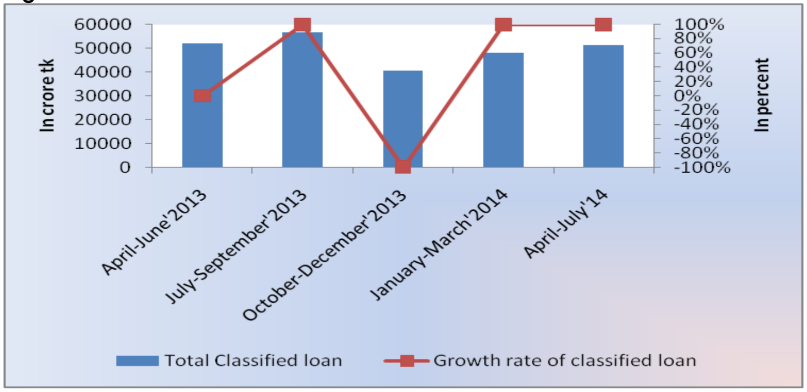
Figure 11: Gross and Net Non Performing Loan



Source: Bangladesh Bank, 2014

Loans that are not paid on time and are nominated as troubled assets by banks are classified loans. Classified loans are usually issued according to terms and regulations of the bank. The extent of default loans increased in the third quarter due to tightening the loan classification guideline, sluggish business activities during the political uncertainty and interruption in energy supplies. The percentage share of classified loan to total outstanding loan has been increasing in every year. At the end of September 2013, the percentage share of classified loan to total outstanding loan was 12.79 percent, whereas it stood 8.9 percent at the end of December, 2013 and then again increased to 10.5 at the end of March2014. The classified loans increased to 51340crore in the April-June quarter of 2014-15 from Tk.40590 crore of the October-December quarter of FY 2013-14 the total classified loan increased by 15.73 percent.

Figure 12: Total Classified Loan



Source: Bangladseh Bank, 2014

Scrap in loan

Embezzlement of Hall-mark, Bismillah Group and BASIC bank etc. has become talk of the country in recent times. This loan scrap is alarming for our banking as well as the financial sector. A brief description of loan scrap is given below:

Table 1: Scrap in Loan

Name of Company	Amount(Taka)	Name of Branch & Bank
Hall Mark	2554 crore	Ruposhi Bangla branch of Sonali Bank
Bismillah Group	1100 crore	Four private banks(Prime Bank, Jamuna Bank, Shahjalal Islami Bank
Basic Bank Limited	1500 crore	By Dilkusha, Gulshan and Shantinagar Branch
Imran Group	101crore	Sholoshahar , Chittagong branch of Bangladesh Krishi Bank
Director of Shahjalal Islami Bank	140 crore	Shahjalal Islami bank
Ideal Cooperative society	1000 crore	Directly from 70000 clients
Destiny Group	3800 crore	Directly from clients
Paragon Group	146.60 crore	Sonali bank
T & Brothers	609.9 crore	Sonali bank

Source: The Daily star, April, September and July 2013, The New age,2012 The Daily Prothom-alo,July,2014

Recapitalisation of government is proved as waste of money where more important sectors like energy and power or heath need the money more which has great positive impact on the economy.

SCBs and DFIs incur a huge loss because of these huge scams such as Hallmark and Bismillah group and experienced a huge capital shortfall. Government, as owner of these banks, come forward to help these public banks in the form of recapitalization with the taxpayer's money. No improvement is seen because of corruption and poor management in these banks. Recapitalisation of government is proved as waste of money where more important sectors like energy and power or heath need the money more which has great positive impact on the economy. This type of recapitalization did not work and probably will not work without fixing the reasons for the deterioration of the public banks. In FY2014-15 government plan to allocate 6000 crore to the four state owned bank which was 4100 crore in Dec'2013 that is a 46.34 percent increase. Among this 6000 crore Sonali bank (SB) has got 710 crore and Basic bank has got 790 crore. As of September 2014, Sonali's capital shortfall was Tk 1,730.30 crore, up from Tk 1,511.31 crore from June, this year. The shortfall of BASIC increased by nearly Tk 600 crore during the given period, suggesting a persistent deterioration in the financial portfolio of the bank, once considered as one of the best-performing public sector banks in the country. (The New Age, 2014)

5.2 Poor risk management

The performance of the banking sector on the basis of risk management deteriorates in the last quarter of the FY 2013-14. Return on asset, returns on asset and capital adequacy ratio are continuously decreasing after 2011. In 2013, overall ROA in the banking sector was 0.90 percent whereas it was 0.60 percent in 2012. At the end of FY 2013-14 the performance of banking sector deteriorates. In June of FY 2013-14, the ROA decreased from 0.9 percent to0 .6 percent and ROE decreased from 11.1 percent to 8.4 percent. Capital adequacy ratio decreased to10.7 in June, 2014 percent from 11.3 percent in March, 2014.

Table 2: Risk Management In Banking Sector

	2009	2010	2011	2012	December' 2013	June'14
Return on assest	1.1	1.8	1.5	.06	.9	.6
Return on equity	21.7	21	17	8.2	11.1	8.4
Capital adequacy ratio	-	-	-	10.46	11.3	10.7

Source: Bangladesh Bank, 2014

5.3 Captured governance and oversight

The present inefficiency in banking sector can partially be attributed to captured governance and oversight. Lack of good management, poor surveillance over the bank, political instability and abuse of political power in this sector are worsening the situation.

High percentage of non-performing loans in the banks generally causes 'credit crunch' i.e. shrinkage in credit flow from the supply side of the bank. At the same time, comparatively poor administration, lack of transparency, weak regulations and monitoring cell, interest rate spread and rent seeking behavior of the politician are also noticeable causes for increasing NPLs. NPLs reduce profitability, as banks cannot take interest income from their classified loans. It also reduces loanable funds by preventing recycling.

The present inefficiency in banking sector can partially be attributed to captured governance and oversight. Lack of good management, poor surveillance over the bank, political instability and abuse of political power in this sector are worsening the situation.

The appointment of Directors of the Board of the SCBs based on the political loyalty and affiliation has traditionally been practiced for a long time. Members of the Board of the SCBs and DFIs are hardly independent, qualified, efficient and socially acceptable persons with integrity. Their political background is more considerable than their qualification and efficiency. Nepotism is not only a problem for public banks but also for the private banks. Although political influence is less the top level officials like chairman or directors are chosen from the family tree. For example, if the present chairman is

Mr. X then next will be his son or daughter or brother even if there is more efficient person in that bank.

Most important of the relevant initiatives was the Bangladesh Bank Amendment bill 2003 through which Bangladesh Bank received the autonomy to operate on its own and also to formulate the monetary policy which increases the power of BB over financial system.

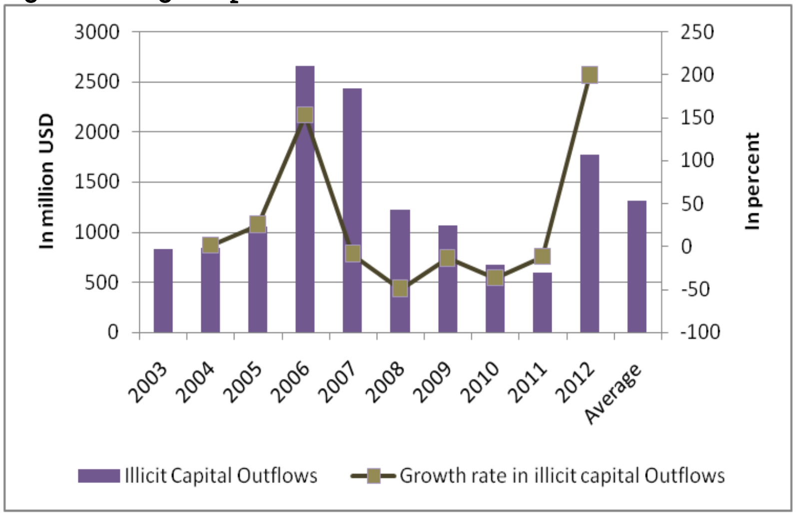
Although BB is the highest monetary authority of the financial system it holds limited control over the economy. A bill was passed in the national parliament in 2003 to bring reforms in the banking sector. Most important of the relevant initiatives was the Bangladesh Bank Amendment bill 2003 through which Bangladesh Bank received the autonomy to operate on its own and also to formulate the monetary policy which increases the power of BB over financial system. The bill gave BB the authority over the scheduled private commercial banks but SCBs and DFIs are under the authority of the Ministry of Finance. As most of the scrap loans are from SCBs and DFIs, BB only can alert the ministry of finance but cannot make any action. Moreover BB is not free from the political allegations.

Feeble legal framework is another reason for increasing nonperforming loans. Anti corruption Commission (ACC) Act-2004, The Bank Companies Act-1991and The Companies Act-1994 is the suitable laws to prevent the bank fraudulence but their implementation is very rare. A functioning financial intelligence is needed to collect information and identify specific cases and trend of committing fraud, money laundering and other financial crime. The investigation agencies are not well trained with adequate knowledge and procedure to investigate financial crimes. Lack of human resource policy, especially in SCBs and DFI motivates the inefficiency of the bank. Department of human resources development is not so strong to take decision on recruitment partly due to lack of capacity and external influence

6. Illicit Capital Flight

Huge illegal capital flight from the country is causing heavy loss to our economy. Bangladesh counts millions of dollars in capital flight every year owing to leakage in the balance of payments and trade misinvoicing by businesses. Over the last decades, the country lost USD 13161million and 1316 a year on average in capital flight driven by balance of payment leakages, trade misinvoicing and unreported remittances by decreasing the revenue.

Figure 13: Illegal Capital Outflow



Source: Global Financial Intrigrity, 2014

The total capital flight from Bangladesh accounts for 30.4 percent of its GDP of over USD 100 billion in 2010,(The daily Star,2014). Illicit outflows were roughly 0.72 times bigger than the USD 1292 million in total FDI, and it was 61 percent of the USD 2126 billion in foreign aid received in 2012.

The main reasons behind capital flight from Bangladesh are economic crimes that generated through huge illegal incomes, whether from the wilful default of bank loans, corruption in tax administration, manipulation in stock exchanges, over-invoicing and under-invoicing in trade settlements, leakage in public development expenditure, or illegal financial deals in the running of state-owned enterprises(Sarkar,2014).Among these means leakages in the balance of payment and trade misinvoicing by business are key conduits of capital flight.(The daily Star,2014). In 2012 the outflow of money through balance of payment leakages (which is also known as hot money outflows) was USD 1026 million where it was USD 593 million in 2011; represents a 73.02 percent increase. During 2003-2012 period total trade misinvoicing was USD 8058 million(61.23 percent of total illicit capital flight) among which export under invoicing was 6844 million and import overinvoicing was 1214 million.

Table 3: Component of Capital Flight (in million USD)

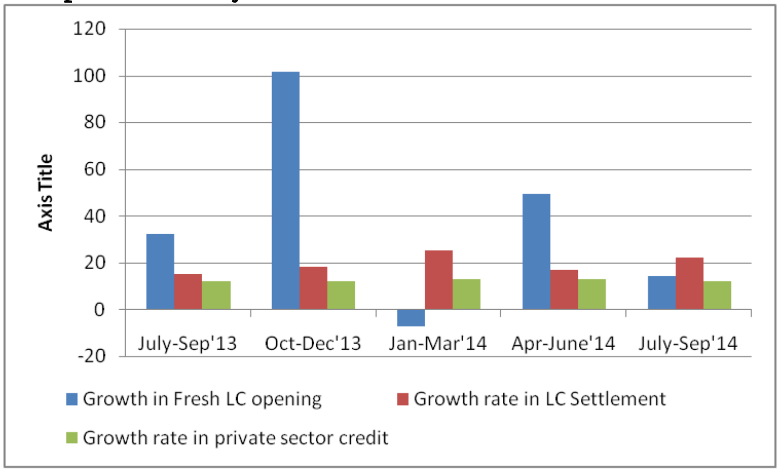
Catagory	2012
BoP Leakages	1026
Export misinvoicing	6844
Import misinvoicing	1214
Total trade invoicing(outflow)	8058

Source: Global Financial Integrity, 2014

The main source of illegal capital flight in Bangladesh is trade misinvoicing. The mismatch between the increased import of capital machineries and sluggish investment situation is a signal of trade misinvoicing.

The main source of illegal capital flight in Bangladesh is trade misinvoicing. The mismatch between the increased import of capital machineries and sluggish investment situation is a signal of trade misinvoicing. Between July and September, some USD691.36 million worth of letters of credit settlement for capital machinery took place which was USD566.54 million, a year-on-year increase of 22.03 percent, according to data from Bangladesh Bank. Letter of credit settlement is the payment made by banks to foreign parties for goods purchased by local businesses. In the first quarter of fiscal 2012-13, when the investment climate was more favourable, total LC settlements for capital machinery stood at $492.61 million, a drop of 17.55 percent from fiscal 2011-12. LC openings, which signify local businesses' intention to import in the near future, too shot up during the period, by 14.27 percent from the previous year. LC accounts worth USD 818$717.68 million meant for capital machinery imports were opened between July and September of FY 2014-15 where it was USD 717.68 million in the same period of the previous year. At the same time, private sector credit growth, a reflection of the financial resources being made available to businesses, has been on a downward trend during the quarter. It stood at 12.15 in July-September of 2014 from 13.04 in April-June of 2014.

Figure 14: Letter Of Credit (LC) Opening and Settlement in Importing of Capital Machinery and the Private Sector Credit Growth



Source:Bangladesh Bank,2014

In developing countries like Bangladesh several reasons encourage people to send their money illegally. High inflation, defective tax system, weak regulatory institutions, high interest differential etc. play key role behind the illicit money transfer. It is very difficult to rescue the transferred money for which proactive role of bb, NBR, ACC and other related institutions is highly required.

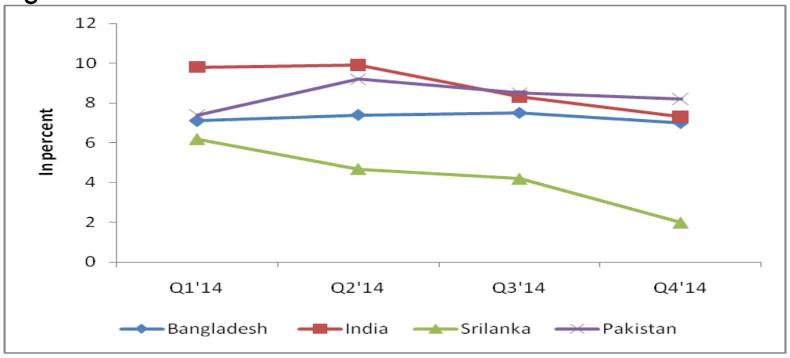
7. INFLATION and EFFECTIVENESS of THE MPS

The pressure of inflation is decreasing from the beginning of the year due to three reasons. First, the oil price all around the world is decreasing. Oil dropped below USD 50 a barrel on January, 2015 from around USD 115 a barrel in June, 2014 and was heading for its biggest annual decline since 2008, pressured by weakening demand and a supply glut prompted by the US shale boom and Organisation of Petroliam Exporting Countries (OPEC's) refusal to cut output.(BBC,2014). Secondly, as in year 2014, there were no big natural hazards for what there was no supply side disruption. Thirdly, due to decrease in oil price the price of the imported goods like imported edible oil, milk decreased. So in Bangladesh inflation is on the downward trajectory with global inflation rate.

Point-to point CPI inflation in our neighboring South Asian countries exhibited a downward trend during the quarter under review. CPI inflation in India declined to 7.31 percent in

June 2014 from 8.59 percent in April 2014. WPI inflation in India also experienced a slight decline to 5.43 percent in June 2014 from 5.55 percent in April 2014. CPI inflation in Pakistan fell to 8.2 percent in June 2014 as compared to 9.2 percent in April 2014. Similarly, CPI inflation in Sri-Lanka declined to 2.8 percent in June 2014 from 4.9 percent in April 2014.

Figure 15: Inflation Rate in South Asian Countries

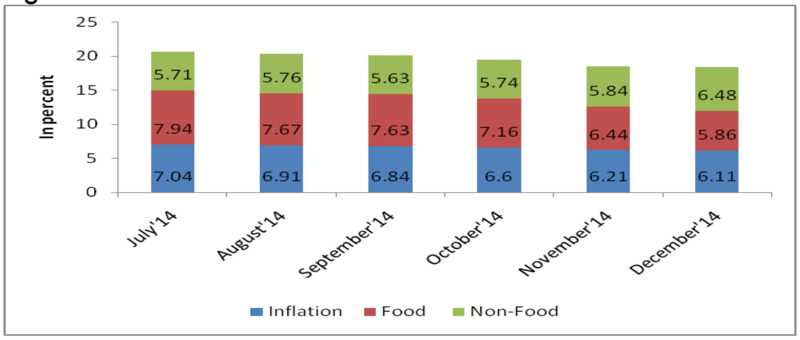


Source: Bangladesh Bank, 2014

During the July- December, 2014 average inflation reached 6.86 percent (point to point basis) against the budgetary target of 7 percent.

During the July- December, 2014 average inflation reached 6.86 percent (point to point basis) against the budgetary target of 7 percent. The rate of inflation decreased to 6.11 percent in December2014 from 7.04 percent June, 2014 that is a decrease.94 percentage point mainly due to decrease in food inflation. The average food and non-food inflation for the corresponding period reached 7.1 percent and 5.86 percent respectively. At the end of the first half of the FY 2014-15 the point to point food inflation decreased to 5.89 from 7.94 percent in June, 2014. On the other hand the non food inflation does not decrease that much. In December, the non food inflation increased to 6.48 percent which was 5.71 percent in June, 2014.

Figure 16: Inflation Rate

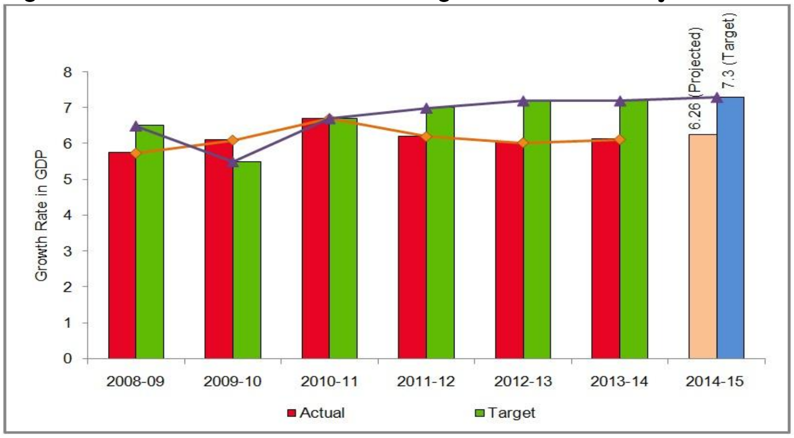


Source: Bangladesh Bureau of Statistics, 2014

8. Growth and MPS

The country has been facing a low rate of growth which can partly be attributed to its monetary policy. Under the five year MTMF 2015-17, the annual rate of growth in GDP was projected at 7.3 percent for the FY2014-15. But the projection has been revised in current MPS and set at 6.5 percent in the current fiscal year 2014-15 instead of 8 percent projected in 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 rate of 7.3 percent or 6.5 percent growth in GDP in FY 2014-15.

Figure 17: Rate of Growth in GDP (Target, Actual And Projection)



Source: Ministry of Finance, 2014

Considering the recent major challenges it seems that an investment friendly monetary policy is needed more than an inflation targeting policy in the present context.

9. CONCLUSIONS

Considering the recent major challenges it seems that an investment friendly monetary policy is needed more than an inflation targeting policy in the present context. Recent hovering growth of Bangladesh economy around six percent 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.

At the time of sluggish investment and falling growth in GDP, it was expected that there would be a signal for quantitative easing in the MPS when inflation is in control. This was the right time for moving towards accommodative monetary policies; however, unfortunately, the current monetary policy has failed to project this. The current tight monetary policy will ultimately take toll on the long-term growth prospects of the economy.

A healthy and sound banking sector is needed for successful implementation of monetary policy which ensure proper channelling of funds thus stimulate the growth. But recent crisis in banking sector is increasing the opacity of the financial system. To get rid of this crisis BB must play a more active role through strong vigilance over banking system.

For preventing the illegal capital flight lower interest rate, stable political environment, and strong law enforcement are essential for preventing the illegal transfer of capital.

For preventing the illegal capital, flight lower interest rate, stable political environment, and strong law enforcement are essential. Although it is very hard to deal with the problem of illegal capital flight the key state entities like Anti Corruption Commission (ACC), National Board of Revenue (NBR) and Anti Money Laundering Unit of the Bangladesh Bank must start the process of bringing back the funds in a coordinated way.

The current tightening of monetary policy by the BB 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.

Major challenges	Trends of the challenges	The way forward
Stagnant Investment	Decline in private investment	Increase credit growth in medium and small industry. Lowering lending rate
Crisis in banking sector	Swelling default loans, unfruitful recapitaslisation in public banks	Active role of BB as a guardian through proper and strong surveillance over the banking system. Keep the banking system away from political pressure.
Capital flight	Hot money transfer, trade misinvoicing, tax evasion	Increase vigilance over the foreign trade. More data efficiency and accuracy about capital transactions.

Besides, the current pressure on economy can be checked by the policy harmonisation 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.

Reference

Ahmed Sadiq,2015. Monetary policy is working,The Daily Star, Friday ,January 18 Available at:http://www.thedailystar.net/business/monetary-policy-is-working-60464
Bangladesh Bank. 2013, Selected indicators, December 2014. Dhaka, Bangladesh: Bangladesh Bank.

Bangladesh Bank. 2014, Major Economic Indicators. December, 2014. Dhaka, Bangladesh: Bangladesh Bank.

Bangladesh Bank. 2014, Monthly Economic Trend, December, 2014. Dhaka, Bangladesh: Bangladesh Bank.

Ministry of Finance (MoF). 2014, Bangladesh Economic Review, 2014. Dhaka, Bangladesh: Finance Division, Ministry of Finance, Government of Bangladesh.

The Financial Express, 2014. Infrastructure and governance deficit Available at:http://www.thefinancialexpressbd.com/old/index.php?ref=MjBfMDRfMjJfMTNfMV82XzE2NzR enu Kohli,2015 . January 17, 2015 vol l no 3 EPW Economic & Political Weekly .Infl ation Targeting as Policy Option for India Evaluating the RisksEyMA

The New Age, 2014. *Recapitalisation fund for scam –hit state-opwned banks* ,29 December,2014. Available at: http://www.hawker.com.bd/news_details.php?news_id=392111

Unnayan Onneshan. 2012, Half Yearly Assessment of Economy of Bangladesh, BangladeshEconomic Update Volume 3, No.12, December 2014. Dhaka: Unnayan Onneshan. Available at:http://www.unnayan.org/index.php/publications/all-publications/recent-articles/86-half-yearlyassessment-of-the-economy-of-bangladesh

Unnayan Onneshan. 2013, Declining Growth: Mismatches in Fiscal and Monetary Management, Half Yearly Assessment of the Economy in Bangladesh, Bangladesh Economic Update Volume 5, No.11, October 2014. Dhaka: Unnayan Onneshan. Available at: http://www.unnayan.org/reports/meu/December%202013/Halfyearly%20assessment_Dec%2020 13. pdf

Unnayan Onneshan. 2014, Banking Sector Caught in Trap, Bangladesh Economic Update Volume 5,No. 7, July 2014. Dhaka: Unnayan Onneshan. Available at: http://www.unnayan.org/reports/meu/MEU_July_2014/MEU_July_2014.pdf

Unnayan Onneshan. 2014, Long On Realities, Short On Targets, Bangladesh Economic Update Volume 5, No.6, June 2014. Dhaka: Unnayan Onneshan. Available at: http://www.unnayan.org/reports/Budget/Budget_FY_2014-15/Budget_FY_2014-15.pdf

Unnayan Onneshan. 2014,Monetary Policy Statement (July-December, 2014): A Rapid Assessment, Bangladesh Economic Update Volume 5, No.8, August 2014. Dhaka: Unnayan Onneshan.Availableat:http://www.unnayan.org/reports/meu/MEU_August_2014/MEU_MPS_August_2014.pdf

UNNAYAN ONNESHAN
16/2 Indira Road, Farmgate
Dhaka-1215, Bangladesh
Tel.: +880 (2) 58150684, +880 (2) 9110636
Fax: +880 (2) 58155804
Email: info@unnayan.org
Web: www.unnayan.org