Bangladesh Economic Update

Monetary Policy Statement of July - December 2012: An Assessment

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Executive Summary

Bangladesh Bank has just recently announced the six-monthly Monetary Policy Statement (MPS) for the period of July-December of FY 2012-13. The current issue of the Bangladesh Economic Update focuses on this Monetary Policy Statement.

The Bangladesh Economic Update sees the recently announced Monetary Policy Statement as a missed opportunity on behalf of Bangladesh Bank to safeguard the economy by correctly addressing the issue of fiscal mismanagement in the first place and then placing a monetary policy which would have been appropriate in the current context. The Monetary Policy Statement has taken a contractionary monetary policy stance which is en masse in nature, whereas the appropriate approach should have been a differential one-- to try to encourage sectors which are conducive to growth of the economy as well as discourage unproductive expenditures related to imports of items which do not contribute to growth, or which encourages rent-seeking behavior of some sections of the society. With this Monetary Policy Statement, the economy has been directed towards a vicious cycle of mismanagement-- first there was a case of fiscal mismanagement, and then rather than addressing this mismanagement, Bangladesh Bank has moved towards a contractionary monetary policy, and this policy would lead towards contraction of the growth of the economy, and this would further lead to even greater fiscal mismanagement and possibly more rounds of misplaced monetary policy statements.

The recently announced Monetary Policy Statement keeps the target for inflation rate at 7.5 percent, the same as the Budgetary Statement. In order to achieve this, the MPS aims to increase the supply of production besides the demand. The MPS also emphasizes on composition of the private sector credit to be more focused on productive sectors instead of consumer credit. In order to promote financial inclusion, the MPS has targeted to keep a larger share of loan portfolios of the banking sector in SME and agricultural credit. The contractionary monetary policy has set a target for the Broad Money growth rate at 16 percent by December 2012 and aims at ensuring this to be within 16.5 percent by the end of the current financial year. With regards to the reserve money, target has been set at 14.5 percent by December 2012 and it might be at 13.8 percent by June 2013. The MPS has emphasized on private sector credit growth. The growth rate of credit to the private sector is envisaged to remain at a healthy 18.3 percent by December 2012 and around 18 percent by the end of the current fiscal year. With regards to government borrowing, the MPS has set a target of around 230 billion Taka by the end of the fiscal year. The MPS has also emphasized on easing pressure on the Primary Dealer Banks. With regards to call money rates, the MPS mentions that this has been decreasing since June 2012 which implies an ease of the liquidity pressures. With regards to interest rate spreads, Bangladesh Bank actually limited the interest rate spreads in the banking sector in the previous Monetary Policy Statement, and due to this, the spread has been decreasing to some extent and this is expected to decrease further in the upcoming months. The MPS aims at preserving the country's external sector stability-- for this, a modest export sector growth rate of 8.0 percent, import sector growth of 8.0 percent and a remittance sector growth rate of 12 percent has been targeted. With regards to foreign exchange reserve and exchange rate, the MPS seeks to preserve a market based exchange rate while seeking to avoid excessive foreign exchange volatility.

With regards to target setting and achieving the set targets, we find that Bangladesh Bank has repeatedly failed with unfailing regularity. The apparent divergence between the key targets and outcomes actually raises the issue of credibility and realism in target setting. The inflation rate in FY 2011-12 was 8.80 percent against the target of 7.5 percent, similarly the actual inflation rate was 8.85 in 2010-11 whereas the target was 6.5 percent and in 2009-10 the actual inflation rate stood at 7.31 as against the target of 6.5

percent. Under the business as usual scenario it is likely that Bangladesh Bank will again fail to obtain the targets with substantial gaps to remain between the target and the actual.

The incremental growth rate of broad money has been following a downward trend since June 2011 due to the tight monetary policy, the main reason behind the decrease in broad money is the decrease in currency outside the bank. The ratio of demand and time deposits is declining gradually over the recent months, plausibly due to interest rate increases in the time deposits. There has been an increase in the net foreign assets which may help to ease the pressure on external sectors as well as on liquidity position.

With regards to domestic credit, the domestic credits are increasing day by day due to the expansion of the credits to the private sectors. However, the growth rate of domestic credit and net other items are lower than that of the previous fiscal year because of the tight monetary policy. In July-April 2012, the credit to the public sector increased by 17.30 percent against the increase of 18.41 percent in the same period of the previous fiscal year. Out of the public sector credit, net credit to the government increased by 22.47 percent during the same period of 2011-12. Due to the finance of the quick rental power plant and debt management, credit to the net government sector has increased over the months of FY 2010-11. In April 2012, net government credit from the banking system reached up to Tk. 899.34 billion which increased by 41.10 percent than that of April 2011.

With regards to the reserve money, the amount of reserve money stood at Tk. 923.86 billion in May 2012 which was an increase of 8.25 percent than that of the same month of 2011. The reserve money increased by only 2.96 percent during July-May of FY 2011-12 as compared to the increase of 15.11 percent in the same period during the previous fiscal year. Components of the reserve money are exhibiting a declining trend over the second half of FY 2011-12. By April 2012, currency outside banks increased by 9.38 percent than that of April 2011-- matching with the tight monetary policy pursued by the Bangladesh Bank.

The MPS has targeted an inflation rate of 7.5 percent. The inflation rates have exhibited a tendency to decrease in the recent months. In June 2012, food and non-food inflation was 7.08 and 11.72 percent respectively whereas it was 7.46 and 12.72 percent respectively in May 2012. Non-food inflation increased at an alarming rate in the last ten months of the previous fiscal year due to high bank borrowing by the government, on the other hand, food inflation has eased to some extent as prices of rice, spices and other food items have fallen. Food inflation has decreased not because of any monetary policy intervention by Bangladesh Bank, but because of satisfactory harvest productions of Aman and Aus, and this was helped by declining trend of food grain prices in the international market.

The MPS taken a policy of a market based exchange rate system in order to preserve the external stability. The Bangladeshi currency has depreciated against dollar from the starting month of the last fiscal year. In FY 2011-12, exchange rate was at the peak of 84.44 Taka per dollar in January 2012 whereas it was 71.15 in January 2011. In June 2012, exchange rate was at 81.83 Taka per dollar which was 74.23 in the same month of the previous fiscal year. During the July-June of FY 2011-12, export receipts were USD 24.29 billion which was 5.93 percent higher than that of the same period of the previous fiscal year. However, during the eleven months of the last fiscal year, import payments was USD 32.95 billion which was 7.16 percent higher than that of the same month of the previous fiscal year. The export and import payments are increasing over the years, causing a continuous trade deficit and imbalance in balance of payments. During July-May of FY 2011-12, trade deficit stood at USD 10.97 billion which increased by 24.66 percent against USD 8.80 billion in the same month of the previous fiscal year.

The monthly data trend exhibits that imports of crude petroleum have increased by 7 percent in May 2012 than that of the previous month of the last fiscal year and imports of petroleum products has increased by 42.00 percent in May 2012 than that of April 2012. Under the business-as-usual scenario, the import of petroleum products might increase even further in the upcoming fiscal years to meet its increasing demand for irrigation and oil-based power plants. The overall import might be at stake in the upcoming months due to Bangladesh Bank's maintaining restrained monetary policy.
During the last two fiscal years, government domestic borrowing has been rising. During July-April of FY 2011-12, total domestic borrowing of the government stood at Tk. 18.42 billion which increased by 39.10 percent than that of the same period of the previous fiscal year. Continuation of current trend might result into an increasing movement in domestic debt. Excessive borrowing from banking sectors indicates a sharp crowding out effect which may dampen private investments.

In spite of the global financial crisis, economic slowdown and higher rate of inflation, the foreign exchange reserve increased over the years but at a decreasing rate. It is a general notion that a country requires to have at least three months' import bills but the International Monetary Fund (IMF) suggests that reserve of four months' import bill is a prerequisite. The existing reserve is only USD 386.46 million over that of the total cost of the import bill for the next three months.

For the last two fiscal years, the central bank has been following contractionary monetary policy to rein in higher rate of inflation by adjusting with the IMF-MEFP policies. Under the ECF loan arranged with Bangladesh Bank, the IMF-MEFP has asserted to increase the rate of interest and to limit bank borrowing and set a ceiling on the reserve money held by Bangladesh Bank. Ultimately this would increase the investment cost and monetary squeeze would decline the domestic investment. This slower rate of investment would not only result in decline of generation of employment but also reduce aggregate demand. Thus this contractionary monetary policy as pursued by the Bangladesh Bank may result in a reduced GDP growth in the upcoming fiscal years. In FY 2011-12, the GDP growth rate target was 7.00 percent whereas the actual rate achieved was 6.32 percent. Similarly, in the current fiscal year, GDP growth rate is targeted to 7.2 percent but this might not be achieved.

During the last fiscal year, domestic savings slightly increased for the increases in remittance inflow, which were 19.4 as percent of GDP. This reflected an increase in both private and public saving rates. Private savings rate increased from 17.91 percent of GDP in FY 2010-11 to 18.01 percent in FY 2011-12 but still it is lower than that of FY 2009-10. Under the business as usual scenario, the domestic and national savings as percent of GDP might attain at 19.28 and 29.65 percent in FY 2012-13 (the domestic private and public savings as percent of GDP might attain at 17.89 and 1.35 respectively).

The target of monetary policy is to boost up supporting funds for agriculture sector. However, the growth rate of agriculture and forestry up to April 2012 decreased to 1.72 percent. Although during the period of FY 2011-12, aman production had positive growth due to good rainfall nationwide, but aus production and the boro (largest rice crop) production was comparatively lower than that of the previous fiscal year due to slightly lower land. Business as usual scenario shows that agriculture growth rate and share of GDP might decrease in the next fiscal years.

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1. INTRODUCTION

The current issue of the Bangladesh Economic Update focuses on the recently announced six-monthly Monetary Policy Statement (MPS) for the period of July-December of FY 2012-13. The report suggests that the proposed instruments in the recent policy statement such as limits in the domestic private sector growth rate and increases in the interest rate may dampen investment by increasing the cost of capital, as the banks will keep advancing at higher rates. The recent monetary policy targets that government borrowing from the banking sector will remain around Tk. 230 billion, same as the budgetary target of FY 2012-13. This implies that there will be associated risk factors in terms of targeting the productive sector for further investment. And at the same time, the expectation of reduction of pressure on liquidity by the Bangladesh Bank may not be materialised as high inflationary pressure may crowd out the attempt to increase the savings rate. The issue also diagnoses the effects of IMF-MEFP on instruments of monetary policy taken under the ECF. The prescription of shrinking import in the upcoming fiscal years would not only reduce the import of capital machineries and intermediate goods which is the prerequisite for the expansion of productive sector, but also result into contraction in export which would widen trade deficit further. This report also shows that the credit to public sector may crowd out the private sector investments because there is no such targeted level for the public sector credit growth.

Recently, inflation rate is slightly easing due to the bumper harvest of Aman and Aus but not for the instruments of monetary policy. This shows that the envisaged instruments of MPS may not rein in inflation as there has been inadequate diagnosis of the causes of continuous increase in prices. This inflation has occurred for two reasons; due to the liberalisation of trade and administered prices are adjusted to global prices, domestic prices are increasing and less emphasis on public distribution system has encouraged soaring in prices. Furthermore, the dampening of investment and unabated rise in the price levels would hurt different sections of society differently. Any failure to contain inflation is bound to increase economic inequality within the society as the latter has been exhibiting an upward trend in recent times.

2. MATRIX OF THE RECENTLY ANNOUNCED MONETARY POLICY STATEMENT (JULY-DECEMBER, 2012

Indicators of Monetary policy	Focus
Inflation Rate	The Monetary Policy Statement (MPS) aims to keep the inflation rate at 7.5 percent, the same as the Budgetary Statement. In order to achieve this, MPS aims to increase the supply of production besides the demand. The MPS also emphasizes on composition of the private sector credit to be more focused on productive sectors instead of consumer credit. SME and agricultural credit are expected to take a larger share of the loan portfolios of the banking sector in order to promote financial inclusion.
Broad Money	The current MPS is adopted with a stated objective of decreasing the inflation rate by stimulating inclusive growth. This contractionary monetary policy has set the broad money growth rate at 16 percent by December 2012 and aims at ensuring this to be within 16.5 percent by the end of this current fiscal year.
Reserve Money	In this MPS, target for the reserve money growth rate has been set at 14.5 percent by December 2012 and it might be at 13.8 percent by June 2013.
Credit to the Private Sector	The MPS has emphasized on private sector credit growth. The growth rate of credit to the private sector is envisaged to remain at a healthy 18.3 percent in December 2012. Moreover, it is expected that it might be at 18 percent by the end of this current fiscal year.
Government Borrowing	A key focus of Bangladesh Bank would be that government borrowing from the banking system does not crowd out available liquidity for the commercial banks. The MPS has focused on easing the pressure on Primary Dealer Banks. This also assumes that government borrowing will remain around the budgetary figure of 230 billion taka.
Call Money Rates	Call money rates have declined steadily since June 2012 which implies an ease of liquidity pressures.
Interest Rate Spreads	Bangladesh Bank limited the interest rate spreads for the banking sector in the last monetary policy stance. Due to this restriction, average interest rate spreads for the banking sectors have come down slightly and this might decrease further in FY 2012-13 especially for the foreign Commercial Banks which has the highest current spreads in the industry. In order to strengthen the financial system, new loan classification and provisioning guidelines are being introduced by the FY 2012-13.
External Sector Stability	This monetary policy stance also aims to preserve the country's prevailing external sector stability. In this stance, balance of payments assumes a modest export growth rate at 8.0 percent, import growth rate might attain at 8.0 percent and the growth rate of remittance might reach at 12 percent. Ultimately, this might increase the current account surplus and foreign exchange reserve to 620 USD and 150 USD million respectively.
Foreign Exchange Reserve and Exchange Rate	In order to preserve the external sector stability, Bangladesh bank will continue a market based exchange rate while seeking to avoid excessive foreign exchange volatility.

3. MONETARY POLICY (TARGETS AND ACHIEVEMENTS)

Through monetary policies, Bangladesh Bank regulates the supply of money, interest rates, and exchange rates; and maintains a reasonable price level in order to achieve the targeted growth rate of the economy. It regulates the cost and availability of domestic credits to the priority sector. The monetary policy by the Bangladesh Bank is tailored to maintaining a reasonable price level. Monetary policy can be both expansionary and contractionary. It is contingent upon the expansion/contraction of the total supply of money. In the context of high unemployment rate, expansionary policy is applied to increase production. On the other hand, contractionary monetary policy, conventionally, is applied, if prices are destabilised. In a continuously high inflation regime, people need more money for consumption. Increases in domestic credit, import payment and trade deficit result in rising demand of both domestic and foreign currencies. So the currency outside the banks and currency in bills are increasing simultaneously.

In order to meet the objectives of the MPS, instruments such as Repo, reverse Repo, limiting the domestic credit to the private sector and increasing the interest rate are mainly used. Due to the increase in the world prices of food grain and oil, the pressure of inflation is increasing in Bangladesh. There has been an increased pressure of demand in both domestic Taka and the foreign exchange markets. While workers' remittance inflows have slowed down and trade deficit have increased due to higher import growth; reduction in the capital account inflows has created the stress on Taka and foreign exchange markets. Domestic borrowing from the banking sectors has increased at an alarming rate. As a result, the recent monetary policy discourages the credit to the private sector and the unnecessary demand of loans.

Under the business as usual scenario, it is evident that the targets set in the Monetary Policy Statement (July-December of FY 2012-13) may not be achieved and even there may be large gaps as compared to the actual outcomes.

Yet the central bank has not been able to maintain its target. The apparent divergence between key targets and outcomes seems to occur with unfailing regularity raising the issue of credibility and realism in target setting. The inflation rate in FY 2010-11 was 8.80 against the target of 7.5 percent. The growth rate of Board Money was 16.63 percent up to May 2012 as compared to the target of 17.0 percent by the end of FY 2011-12 and similar difference prevailed for domestic credit, credit to public and private sector. Under the business as usual scenario, it is evident that the targets set in the Monetary Policy Statement (July-December of FY 2012-13) may not be achieved and even there may be large gaps as compared to the actual outcomes.

Table 1: Monetary Policy Statements (Target & Actual)

	FY 10		FY 11		FY 12		FY 13	
	Target	Actual	Target	Actual	Target	Actual	Target Dec.12	Target Jun.13
Domestic Credit	18.7	17.91	17.9	27.8	19.1	19.96	17.2	18.6
Credit to Public Sector	25.3	-1.65	25.3	38.0	31.0	31.8	13.5	20.8
Credit to Private Sector	16.7	24.24	16.0	25.5	16.0	18.5	18.3	18.0
Broad Money	15.5	22.44	15.2	21.4	17.0	16.73*	16	16.5
Reserve Money	7.00	18.1	13.0	21.0	12.2	8.25*	14.5	13.8
Inflation (12Month Moving Avg.)	6.5	7.31	6.5	8.85	7.5	8.80	-	7.5

Source: Bangladesh Bank
*These statistics are collected based on May, 2012

4. BROAD MONEY

Broad money is the intermediate targets in the monetary policy which consists of currency plus demand deposits, travelers' checks, other checkable deposits, retail money markets, mutual fund balances, saving deposits and small time deposits. It is a fundamental theoretical relationship that the growth of the monetary aggregates such as the money supply (M2) has a direct impact on the domestic price levels in the economy. The central bank tries to control the price level by controlling M2 on an emergency basis. As Bangladesh is passing through a difficult stage with higher inflation rate, lower growth rate (incremental) and some major changes in the macroeconomic scenario since the last fiscal year, the central bank has adopted the tight monetary policy for controlling the money supply and maintaining the overall sustainable growth of the economy as per prescribed by the IMF.

The incremental growth rate of broad money is following downward trend since June 2011 due to the tight monetary policy.

Broad money has increased by 1.47 percent in May 2012 at Tk. 5010.89 billion than that of Tk. 4938.07 billion in April 2012.

The incremental growth rate of broad money is following downward trend since June 2011 (Table: 2) due to the tight monetary policy. The main reason behind the decrease in broad money is the decrease in currency outside the banks. The incremental growth rate of broad money in June 2011 was 21.34 percent against 19.17 and 22.44 percent in June 2009 and 2010 respectively. However, broad money has increased by 1.47 percent in May 2012 at Tk. 5010.89 billion than that of Tk. 4938.07 billion in April 2012. The amount of broad money is also 16.73 percent higher than that of the same period of the previous fiscal year. However, government targeted the broad money growth at 17.00 percent in the second half of FY 2011-12. During July-May of FY 2011-12, broad money increased by Tk. 718.13 billion or 13.75 percent against the increase of 18.25 percent in July-May of FY 2010-11.

During July-April of FY 2012-13, out of the components of broad money, currency in circulation has increased by 4.51 percent than that of the same period of the previous fiscal year.

However, during July-April of FY 2012-13, out of the components of broad money, currency in circulation has increased by 4.51 percent than that of the same period of the previous fiscal year but this percentage increase was lower than that of in FY 2010-11 which attained at 13.43 percent. Due to the tight monetary policy, currency outside the bank was Tk. 572.64 billion in April 2012 which was 1.22 and 1.07 percent respectively lower than that of March, 2012 (Tk. 579.73 billion) and January, 2012 (Tk. 578.83 billion) respectively.

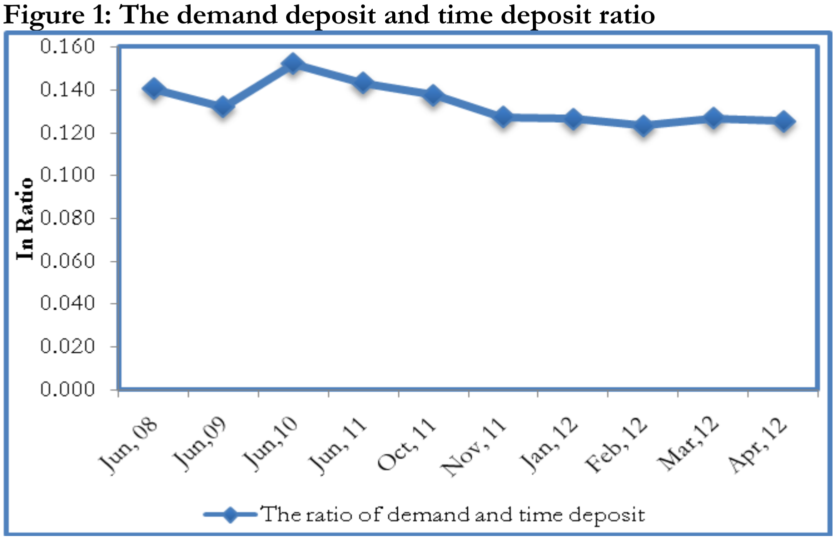
Due to the tight monetary policy, currency outside the bank was Tk. 572.64 billion in April 2012.

Table 2: Sources and components of Broad money supply (In Billion Tk.)

Indicators	Jun,08	Jun,09	Jun,10	Jun,11	Nov,11	Mar,12	Apr,12
Net Foreign assets of Bangladesh Bank	373.18	474.59	670.74	706.2	624.19	720.53	751.22
Net Domestic assets of Bangladesh Bank	2114.77	2490.4	2959.58	3698.99	4024.04.8	4182.75	4186.85
Broad Money	2487.95	2964.99	3630.31	4405.2	4648.24	4903.28	4938.07
a. Currency outside Banks	326.89	360.49	461.57	547.95	595.69	579.73	572.64
b. Deposits	2161.05	2604.51	3168.74	3857.25	4062.55	4323.56	4365.43
Demand deposits	266.25	303.78	418.31	483.06	458.24	485.91	486.02
Time deposits	1894.81	2300.73	2750.43	3374.19	3604.31	3837.65	3879.41
Domestic Credit	2486.77	2885.52	3402.14	4335.26	4724.95	4960.53	4995.36

Source: Statistics department, Bangladesh Bank, 2012

Figure 1: The demand deposit and time deposit ratio



Source: Authors' calculation based on Statistical Department, Bangladesh, 2012

In April 2012, deposits, demand deposits and time deposits increased by 18.27, 5.22 and 20.14 percent respectively than that of the same month of the previous fiscal year.

During the ten months of the last fiscal year, total deposit was 13.17 percent higher than that of the corresponding period of FY 2010-11. Out of which, demand deposits and time deposits witnessed an increase by 0.61 percent and 14.97 percent respectively during the period of July-April in FY 2011-12. In April 2012, deposits, demand deposits and time deposits increased by 18.27, 5.22 and 20.14 percent respectively than that of the same month of the previous fiscal year. The main reason behind decrease in demand deposit and increase in time deposits was the increase in interest rate which was adopted in the last monetary policy statement-- relative attractiveness of time deposits has increased as compared to that of the demand deposits.

The ratio of demand and time deposits is declining gradually over the months of different fiscal years.

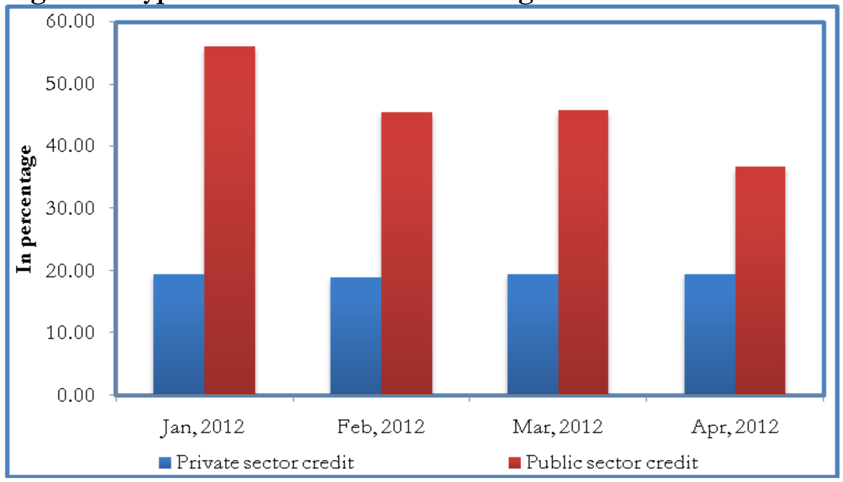
The ratio of demand and time deposits is declining gradually over the months of different fiscal years. In June 2010, the ratio was 0.152 which was only 0.132 in the same month of the previous fiscal year. Then the ratio continued to decline from January 2012 except March 2012. The ratio of demand and time deposit was 0.126 in January 2012 then it declined to 0.125 in April 2012. The monthly data trend indicates that the time deposit is increasing more than the demand deposit. Time deposits sometimes provide attractive returns which partly reflect the higher opportunity cost of holding money. Declining trend of demand deposits matches with the intended policy of the Bangladesh Bank to decrease the cost of borrowing and thus to stimulate the economy.

Out of the sources of broad money, net foreign assets and net domestic assets of banking system increased by 6.38 and 13.19 percent respectively during July-April of FY 2011-12. The increase in the net foreign assets may help to ease the pressure on external sectors as well as on liquidity position.

Domestic credits are increasing day by day due to the expansion of the credits of the private sectors.

One of the components of net domestic assets of Bangladesh bank is the domestic credit. Domestic credits are increasing day by day due to the expansion of the credits of the private sectors. During July-April of FY 2011-12, domestic credit and net other items has increased by 15.23 and 27.07 percent respectively than that of the same period of FY 2010-11. This growth rate of domestic credit and net other items of FY 2011-12 are lowered than that of the previous fiscal year because of the tight monetary policy. In the monetary stance for second half of FY 2011-12, the domestic credit was targeted to keep in 19.1 percent. Bangladesh Bank increased the repo rate and lifted the lending cap to contain the credit growth in the monetary policy of January-June, 2011-12.

Figure 2: Types of domestic credit sector growth over the months



Source: Authors' calculation based on Statistical department, Bangladesh Bank, 2012

To maintain the growth rate and rein in the rate of inflation, some effective measures were taken by the Bangladesh Bank over the years. In the last monetary policy, it discouraged the banks to lend credits to the unproductive sectors and unnecessary consumer loans as gorgeous marriage ceremony, travel to foreign countries and consumer credits by using credit cards, etc. Moreover, the sufficient credit availability for agriculture, small and medium enterprises; renewable energy and other productive sectors were emphasized on the last monetary policy. One of the components of domestic credits, private sector credit is increasing in volume but the growth rate has decreased from the starting month of 2012. In April 2012, private sector credit recorded an increase of Tk. 602.03 billion or 18.22 percent than that of April 2011. However, the growth of private sector credit was 18.94 percent in January 2012 than that of the same period of the previous year.

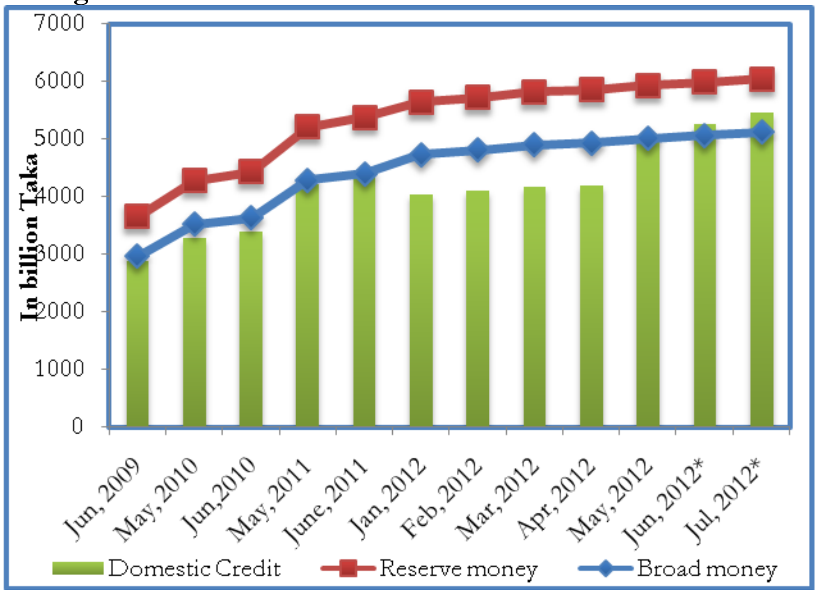
In April 2012, private sector credit recorded an increase of Tk. 602.03 billion or 18.22 percent than that of April 2011.

During July-April of FY 2011-12, the growth of private sector credit rate was 14.66 percent which was 22.06 percent during the same period of the previous fiscal year. The growth of private sector credit and public sector credit were 19.40 and 56.02 percent in December, 2011 than that of the same month of the previous fiscal year. However, the growth of private sector credit decreased to 18.22 percent in April 2012 than that of April 2011.

In April 2012, credit to the other public sector increased by 2.45 percent than that of April 2011.

On the other hand, the credit to the public sector is increasing in volume but the growth rate has decreased to 33.92 percent in April 2012 than that of the same month of the previous fiscal year due to the decrease in other public sector credit growth. In April 2012, credit to the other public sector increased by 2.45 percent than that

Figure 3: Status of Broad money, Reserve money and Domestic credit growth over the months



Source: Authors' calculation based on Statistics department, Bangladesh Bank, 2012

Due to the finance of the quick rental power plant and debt management, credit to the net government sector has increased over the months of FY 2011-12.

In April 2012, net government credit from the banking system reached up to Tk. 899.34 billion.

In July-April 2012, the credit to the public sector increased by 17.30 percent against the increase of 18.41 percent in the same period of the previous fiscal year. Out of public sector credit, net credit to the government increased by 22.47 percent during the same period of 2011-12. Moreover, due to the finance of the quick rental power plant and debt management, credit to the net government sector has increased over the months of FY 2011-12. In April 2012, net government credit from the banking system reached up to Tk. 899.34 billion which increased by 41.10 percent than that of April 2011.

5. RESERVE MONEY

In May 2012, the amount of reserve money stood at Tk. 923.86 billion which was an increase of Tk. 70.82 billion or 8.25 percent than that of the same month of May 2011.

The Reserve Money (RM) consists of currency with the public cash in tills and balances of scheduled banks and other financial institutions with the central bank. This is the operating target in the annual monetary programme. In May 2012, the amount of reserve money stood at Tk. 923.86 billion which was an increase of Tk. 70.82 billion or 8.25 percent than that of the same month of May 2011. Moreover, reserve money increased by only 2.96 percent during July-May of FY 2011-12 compared to the increase of 15.11 percent in the same period during the previous fiscal year. The main reason of this decreasing growth rate is the contraction of monetary policy during January-June of FY 2011-12. In addition, reserve money was targeted at 12.21 percent in the last monetary policy.

Growth rate of reserve money is decreasing mainly due to the decrease in net domestic assets of central bank between the first four months of 2012.

During July-April of FY 2011-12, there was shortfall of Tk. 18.81 billion in net domestic assets of Bangladesh Bank which was 6.63 percent lower than that of the corresponding period of the previous fiscal year.

Growth rate of reserve money is decreasing mainly due to the decrease in net domestic assets of central bank between the first four months of 2012. During July-April of FY 2011-12, there was shortfall of Tk. 18.81 billion in net domestic assets of Bangladesh Bank which was 6.63 percent lower than that of the corresponding period of the previous fiscal year. However, it increased by 68.71 percent during July-April of FY 2010-11 than that of the same month of the previous fiscal year. During the first four months of 2012, claims on government and other public increased by 6.90 and 33.57 percent respectively. In addition, claims on other public increased only by 13.80 percent during the first four months of FY 2010-11. However, the monthly data appears that net domestic assets of Bangladesh Bank witnessed an increase of 21.25 percent in April, 2012 over April, 2011 as compared to the increase of 91.49 percent in April, 2011 over April, 2010.

During July-April of FY 2011-12, net foreign assets of Bangladesh Bank increased by 6.25 percent than that of the same months of the previous fiscal year. However, the growth rate of net foreign assets increased by only 0.32 percent during the same period of FY 2010-11. It appeared a growth rate of 6.23 percent in April, 2012 than that of the same month of 2011. The reserve money multiplier increased to 5.39 at the end of April, 2012 from 4.83 of January, 2012.

Table 3: Particulars of Reserve Money

Items of reserve money	Jun,10	Jun,11	Jul,11	Jan,12	Mar,12	April, 12
Net Foreign assets of Bangladesh Bank	612.05	613.9	62144.7	617.4	632.8	264.65
Net Domestic assets of Bangladesh Bank	129.38	283.5	34765.5	362.87	286.9	283.46
Reserve Money	741.43	897.34	969.1	980.3	919.67	916.92
a. Currency Issued	504.65	605.27	614.38	636.92	579.73	637.97
b. Deposits held with BB	236.77	292.08	354.72	343.34	282.75	278.95
Reserve Money Multiplier	4.9	4.91	4.57	4.83	5.33	5.39

Source: Statistic Department, Bangladesh bank, 2012

Components of reserve money are indicating a declining trend over the second half of FY 2011-12. In April 2012, currency outside banks increased by 9.38 percent than that of April 2011 against the increase of 23.68 percent in April 2011 than that of the same month of the previous fiscal year. This reduction was required for the decline in rate of inflation that was adopted in the last monetary policy. However, cash in tills increased by 42.33 percent in April 2012 than that of April 2011 whereas the growth rate of cash in tills was only 14.80 percent in April 2011 than that of April 2010.

6. LIQUIDITY RATIO

The central bank also increased the special repo rate from 9.25 percent to 10.25 percent in late December 2011 and the reverse-repo rate from 5.25 percent to 5.75 percent in January 2012.

By controlling the repo rate, reverse repo rate, Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR), the central bank tries to control the liquidity situation in the economy. Central bank has already taken several steps to contain credit growth, tame the inflationary situation and specially decrease in excessive investments in the unproductive sectors such as consumer products and luxurious goods, real estate, and the capital markets etc. which creates the stress on liquidity. In the recent monetary policy of 1st half of FY 2012-13, central bank does not take any targets of repo; reverse repo, CLR or SLR. Moreover, the targets of these instruments remain the same as the previous monetary stance. In the last Monetary Policy Statement, the repo rates raised by 100 basis points for the second half of FY 2011-12. The central bank also increased the special repo rate from 9.25 percent to 10.25 percent in late December 2011 and the reverse-repo rate from 5.25 percent to 5.75 percent in January 2012.

6.1 Repo and Reverse Repo

The weighted average call money rate in the inter-bank money market increased to 15.03 percent in June 2012 as compared to 19.66 percent in January 2012.

The stress on liquidity assets of the economy occurred for the increase in excessive investments in the unproductive sectors such as consumer products and luxurious goods, real estate, and the capital markets etc. In this situation, central bank is supplying liquidity help by Repo. In June 2012, Repo rate (1-3 Day tenure) and reverse repo rate (1-3 Day tenure) was 7.75 and 5.75 percent respectively which was 6.75 and 4.75 percent respectively in the first month of FY 2011-12. However, Repo rate (1-3 Day tenure) and reverse repo rate (1-3 Day tenure) increased by 50 basis point at 7.75 percent and 5.75 percent in 8 January 2012 whereas it was 7.25 percent and 5.25 percent respectively in 5 January 2012. The weighted average call money rate in the inter-bank money market increased to 15.03 percent in June 2012 as compared to 19.66 percent in January 2012. Increase in the call money rates occurred due to the tightening liquidity in the market as an appropriate measure by Bangladesh Bank to curb the inflationary situation and maintaining the imbalances in balance of payments.

Increase in the call money rates occurred due to the tightening liquidity in the market as an appropriate measure by Bangladesh Bank to curb the inflationary situation and maintaining the imbalances in balance of payments.

In November 2011, growth of reserve money and broad money rate have gone to a satisfactory level through open market operation and raising the repo rate by 100 basis points for the second half of FY 2011-12. For the high rate of inflation, Bangladesh Bank increased its repo and reserve repo rates by 25 basis point upto 6.25 and 4.25 percent respectively in 27 April, 2011. Moreover, the central bank resumed reverse repo auction since October 2009 due to excess liquidity in the banking system during the last quarter of FY 2008-09 and the first quarter of FY 2009-10. In November 2009, the repo rate (1-2 Day tenure) plunged into 4.5 percent from 8.5 percent in September, 2009 and remained unchanged at 4.5 percent up to June, 2010. On the other hand, the rate on reverse repo (1-2 Day tenure) declined to 2.5 percent in October, 2009 from 6.5 percent in March, 2009 and also remained unchanged at 2.5 percent up to June 2010.

6.2 Cash Reserve Ratio

One of the regulations of central bank is the reserve requirement (or cash reserve ratio) which sets the minimum reserves each commercial bank must hold (rather than lend out) of customer deposits and notes. The reserve ratio influences the country's borrowing and interest rates by changing the amount of loans available. It is normally in the form of cash stored physically in a bank vault (vault cash) or deposits made with a central bank. Central bank generally prefers to use open market operations (buying and selling government-issued bonds) to implement their monetary policy rather to use the reserve requirements because it would cause immediate liquidity problems for banks with low excess reserves. However, in the Monetary Policy of December 2010, CLR and SLR determined at 6 and 19 percent respectively. But in the recent monetary policy, CRR and SLR have not been stated specifically.

The total liquid assets of the schedule banks were Tk. 1151.47 billion at the end of May 2012 which was 0.59 percent higher than that of April 2012.

The total liquid assets of the schedule banks were Tk. 1151.47 billion at the end of May 2012 which was 0.59 percent higher than that of April 2012. By the end of June 2011, this went up by Tk. 1005.65 billion whereas it was Tk. 871.97 billion at the end of June 2010. Moreover, the total liquid assets of the foreign banks was Tk. 99.31 billion at the end of May 2012 which was three percent lower than that of the previous month of FY 2011-12.

At the end of May 2012, the required liquidity of the scheduled banks (SLR) stands at Tk. 787.74 billion which is 18.86 percent higher than that of June 2011. In the mean time, the required SLR for the private Banks (Islamic) is increased by 41.01 percent than that of June 2011. The Scheduled Banks holds the liquid assets in

At the end of May 2012, the required liquidity of the scheduled banks (SLR) stands at Tk. 787.74 billion which is 18.86 percent higher than that of June 2011.

the form of cash in till with Sonali Bank to meet immediate cash withdrawal needs of customers which is 5.93 percent of the total liquid assets. Moreover, it holds the liquid assets in the form of balances with Bangladesh Bank and unencumbered approved securities which are 30.18 and 63.89 percent respectively of the total liquid assets.

7. INFLATION

In the national budget and monetary policy of FY 2011-12, the rate of inflation was targeted at 7.5 percent whereas in fact it stood at 10.6 percent (12-month average) and point to point inflation stood at 8.56 percent in June 2012.

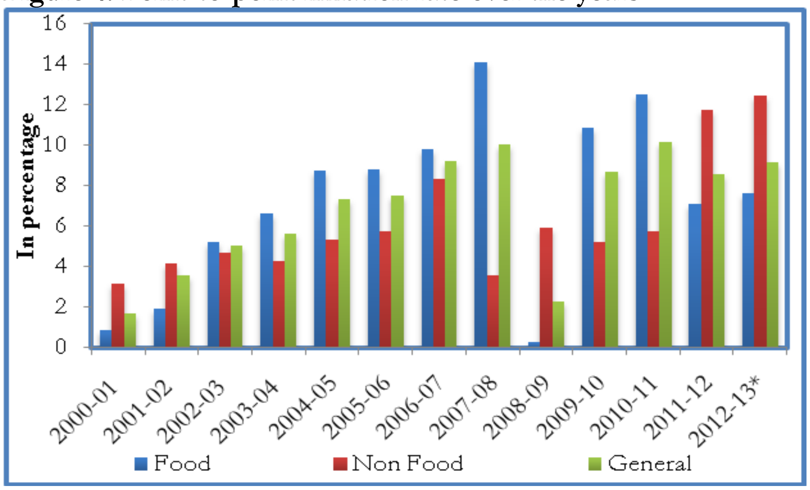
In the national budget and monetary policy of FY 2011-12, the rate of inflation was targeted at 7.5 percent whereas in fact it stood at 10.6 percent (12-month average) and point to point inflation stood at 8.56 percent in June 2012. Due to the high inflation rate in FY 2011-12, Bangladesh Bank once again has adopted the contractionary monetary policy for reining in the rate of inflation, increase the rate of employment and sustain economic growth. Inflation rate increased from the last four fiscal years but over the past few months of FY 2011-12 it is showing a declining trend.

The inflation rate (twelve months average) was highest during the world recession in FY 2007-08 at 9.94 percent because of the price hike of food-grains, fertilisers and fuel.

The persuasion of prescribed mechanisms to contain inflationary pressures in subsequent MPS' has a little bit success. In FY 2009-10, the point-to-point inflation rate (General) was 8.70 percent whereas in FY 2010-11 it reached at 10.17 percent and 8.56 percent in 2011-12 but this is well above the targeted level of 7.50 percent. The inflation rate (twelve months average) was highest during the world recession in FY 2007-08 at 9.94 percent because of the price hike of food-grains, fertilisers and fuel. Moreover, two consecutive cyclones hitting in November 2007 and 2009 respectively, badly affected the economy. Gradual price rises in the international market following global recovery, oil and food supply shocks and monetary expansion in the domestic economy have exerted upward pressure on the CPI inflation rate during the last fiscal year. Food and fuel prices together with external factors have contributed to the increase in domestic inflation. However, In case of the point-to-point inflation, food and non-food stood at 7.08 and 11.072 percent respectively in FY 2011-12 which was 12.51 and 5.73 percent respectively in the previous fiscal year. The twelve average inflation rates increased due to the depreciation in exchange rate and upward trend of energy and petroleum prices and lagged effects of high domestic credit in FY 2010-11.

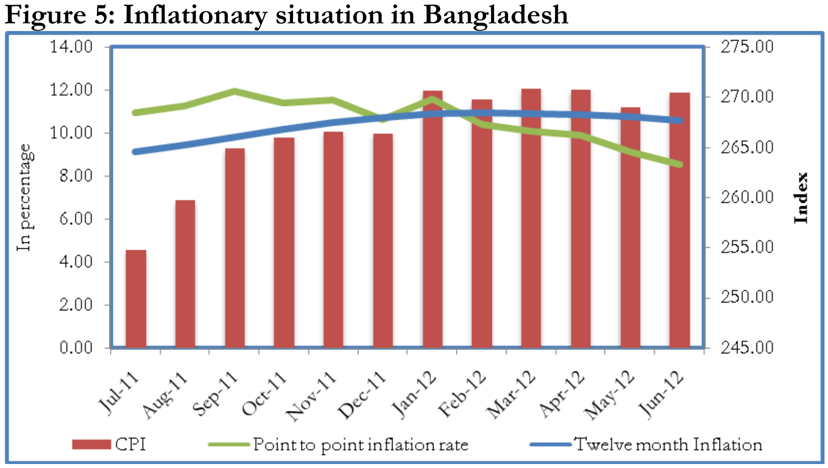
From the last several months of FY 2011-12, moderate inflation pressures is observed as point-to-point inflation has declined from the highest position of 11.97 percent in September 2011 to 10.63 percent in December 2011. Due to the contractionary monetary policy in the 2nd half of FY 2011-12, the inflation rate declined further in 8.56 percent in June 2012. In June 2012, General inflation (12-month average) was 10.60 which were 10.76 percent in the previous month of FY 2011-12. Moreover, general inflation in case of point-to-point also decreased to 8.56 percent in the same period which was 9.15 percent in May 2012 because of the decreasing trend of food inflation and non-food inflation. This is observed that the overall inflation is reducing but if not hold then the government projection of inflation will remains in the oblivion.

Figure 4: Point-to-point inflation rate over the years



Source: Authors' calculation based on Statistics department, Bangladesh Bank, 2012

Figure 5: Inflationary situation in Bangladesh



Source: Statistic Department, Bangladesh Bank

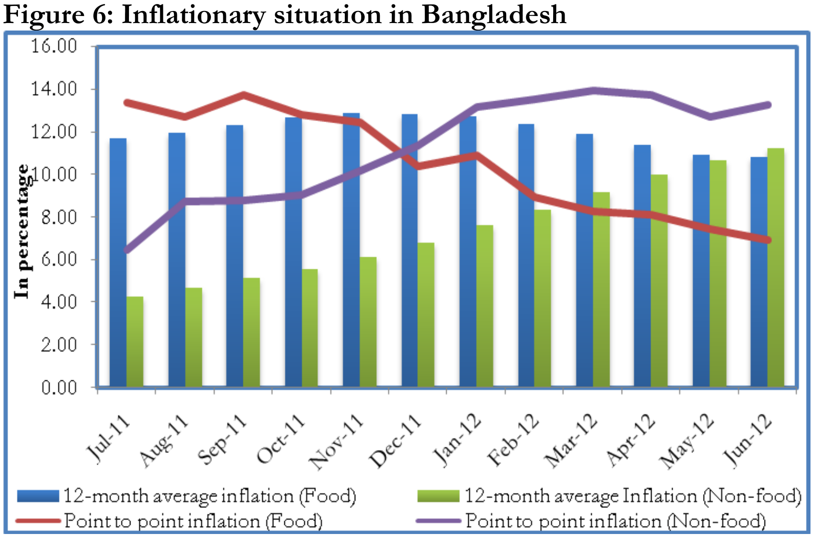
The annual average rate of food inflation is increasing over the successive three years but eased up in the several few months of FY 2011-12. On the contrary, non-food inflation was lower over the years but started to increase in the last fiscal year due to electricity and fuel price hikes. Point-to-point food inflation is declining from January 2012 and twelve month average from December 2012 mainly due to bumper harvest of food grain.

However, prices of non-food commodities such as garments, medical services, transport, furniture and those of household and laundry increased, causing the spike in inflation in non-food sector.

The restrained monetary stance of the Bangladesh Bank continues until inflation falls to single digits, because inflation is determined by multiple factors and the growth rate of money supply is an important determinant in increasing the inflation rate and as a result. As a result the money supply rate is declining which ultimately helps the inflation rate to decline. For the second time, in this last fiscal year, the Energy Regulatory Commission of Bangladesh raised power tariff for bulk users and retail consumers after several hikes in 2011, the fourth times increase of fuel prices soared in non-food inflation.

In June 2012, Food and non-food inflation (point-to-point) was 7.08 and 11.72 percent respectively while it was 7.46 and 12.72 percent respectively in May 2012. However, food and non-food inflation (twelve month average) in May 2012 was 10.92 and 10.66 percent respectively against 11.20 and 4.11 percent respectively in the same period of the previous fiscal year. Non-food inflation increased at an alarming rate in the last ten months of the previous fiscal year due to high bank borrowing by the government. In addition, rate of Inflation starts to decline as prices of rice, spices and other food items fell.

Figure 6: Inflationary situation in Bangladesh



Source: Statistic Department, Bangladesh Bank, 2012

Food inflation decreased due to the satisfactory production of Aman, along with the bumper harvest of rice during November-December of FY 2011-12, which placed a downward pressure on the retail price level of rice. Moreover, the declining trend of food prices in the international market specially in India have helped bring food price growth down in Bangladesh.

7.1 Impacts of inflation

From the last two fiscal years, Inflation is the most shattering phenomenon. Inflation affects the poor the most and there is considerable global, and local, evidence that high inflation can contribute to social unrest. It has a direct impact on unemployment, the output and income levels. Increase in the global food and oil prices often leads to higher domestic retail prices due to increase in cost of production and overall prices. It mainly upsurges the level of poverty and inequality.

Inflation does not only worsen poverty but can also exacerbate inequality in the economy such as the wealthy persons find their assets more valuable and the condition of the poor deteriorates further. As the food inflation rises, the poorer are compelled to spend more on it that reduces the consumption in basic needs such as health, education. As real income falls due to the increased price level, conditions of the middle-income families become vulnerable.

According to the textbook Phillips law, increases in inflation rate may reduce the unemployment rate in the economy. But such was not the case in FY 2010-11 even if not in FY 2011-12. In FY 2011-12, inflation rate increased to 8.80 percent from 8.68 percent in FY 2009-10 whereas the unemployment rate also increased from 4.9 percent in FY 2009-10 to 5.2 percent in FY 2010-11. Inflation reduces the value of money and people's purchasing power. Though unemployment rate increases, the output level has also reduced and it affects the fixed income earners.

8. EFFECT ON EXCHANGE RATE

Bangladesh Bank has taken the contractionary monetary policy to decrease the depreciation of Tk. against dollars which further increases the trade deficits in the last fiscal year. In the recent monetary policy, Bangladesh bank has taken a market based exchange rate in order to preserve the external sector stability. Though the competitiveness of a country's goods depends on the REER,[1] irregular movement in the exchange rate has a direct effect

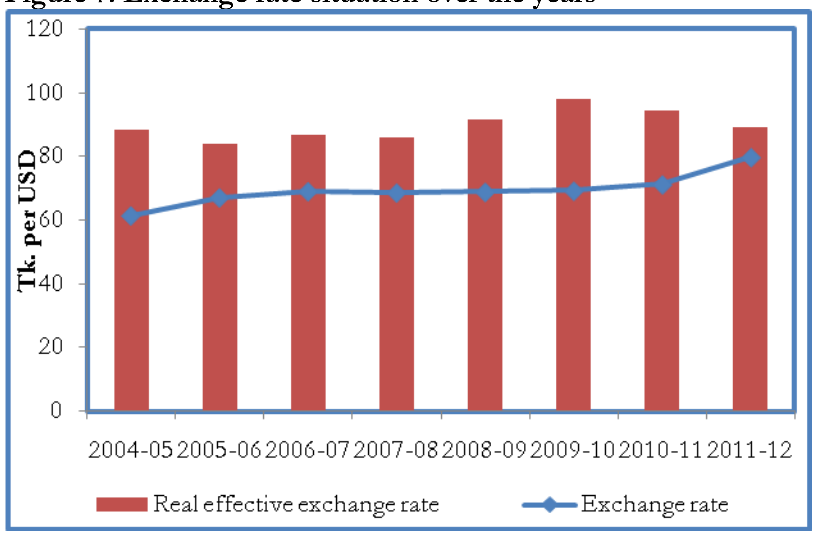
[1] The real effective exchange rate (REER), which measures the development of the real value of a country's currency against the basket of the trading partners of the country, is a frequently used variable in both theoretical and applied economic research and policy analysis.

on GDP and employment outlook especially through the export channel.

Depreciation in the REER resulted in lower levels of imported goods and services and higher export earnings.

During July-March of FY 2011-12, the real effective exchange rate declined to 89.05 which were 94.14 in FY 2010-11. However, the real effective exchange rate (8 currency basket) in FY 2008-09 was 91.50 then it appreciated to 97.78 in FY 2009-10. In the other hand, exchange rate was 79.74 in FY 2011-12 which was 71.17 in the previous fiscal year. Taka depreciated by 23.01 percent in FY 2011-12 than that of FY 2004-15. Depreciation in the REER resulted in lower levels of imported goods and services and higher export earnings. Depreciation increases the dollar cost of a given volume of imports, but the volume may decline to the extent that domestic goods and services are substituted for imports in response to the increase in the relative cost of purchases from abroad.

Figure 7: Exchange rate situation over the years



Source: Bangladesh Bureau of Statistics, Statistics Department, Bangladesh Bank, 2012

To avoid excessive foreign exchange rate volatility, the recent monetary policy has allowed increasing the interest rate and flexibility in exchange rate which might improve the availability of Tk. and adjusted retail petroleum and electricity prices to contain the losses of the BPC and BPDB.

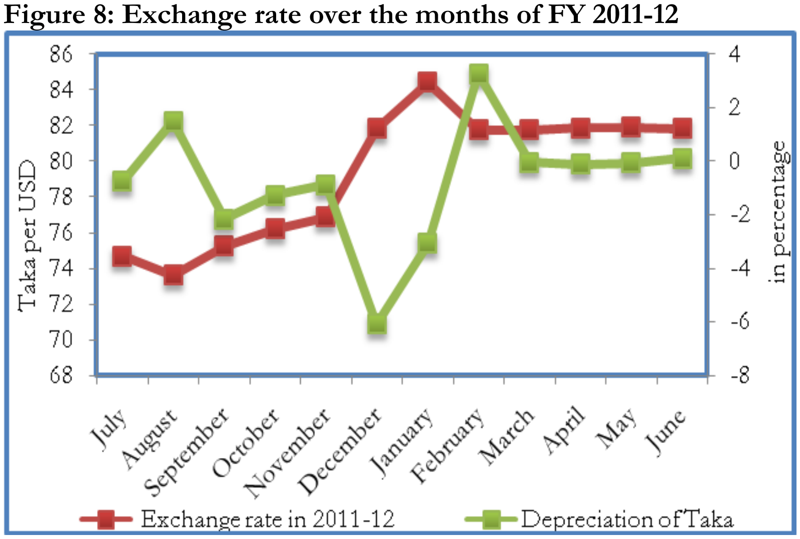
In FY 2011-12, the exchange rate was in peak at 84.44 in January 2012 whereas it was 71.15 in January, 2011.

Bangladeshi currency has depreciated against dollars from the starting month of the last fiscal year with a faster speed. In FY 2011-12, the exchange rate was in peak at 84.44 in January 2012 whereas it was 71.15 in January, 2011. However, it appreciated by 3.28 percent in the next month of FY 2011-12 and again it showed a depreciation of taka against dollars. In June 2012, exchange was

In June 2012, exchange was 81.83 which were 74.23 in the same month of the previous fiscal year.

81.83 which were 74.23 in the same month of the previous fiscal year. Depreciation of Tk. against dollars was higher in December 2011 at 6.09 and depreciation of Tk. has improved by taking some effective measures in the second half of FY 2011-12. Under the business as usual scenario, exchange rate might increase to 82.43 in the first month of this current fiscal year. In the recent of FY 2011-12, the overall increase in commodity, food prices and increases import in crude petroleum, petroleum products has increased the cost of import, while the flows of remittance have relatively declined. As a result Bangladeshi Taka against dollars has depreciated and this pressure might continue in the upcoming fiscal years, despite the competitiveness of exports improves due to the decline in real effective exchange rate. The pressure might relieve slightly if remittances continue to increase for the recent depreciation of Tk.

Figure 8: Exchange rate over the months of FY 2011-12



Source: Statistics Department, Bangladesh Bank, 2012

During July-June of FY 2011-12, export receipts were USD 24.29 billion which was 5.93 percent higher than that of the same period of the previous fiscal year.

Depreciation of Taka against USD increases the export earnings and decreases the import bills.

During July-June of FY 2011-12, export receipts were USD 24.29 billion which was 5.93 percent higher than that of the same period of the previous fiscal year. Moreover, in the same period of FY 2010-11, the growth rate of export receipt were increased by 41.61 percent than that of the previous fiscal year. Export rose in FY 2010-11 to USD 22.93 billion which was USD 16.21 billion in FY 2009-10 due to various measures of attracting the export sectors and export diversifications especially in readymade garments. Depreciation of Taka against USD increases the export earnings and decreases the import bills. However, During the eleven months of the last fiscal year, import payments was USD 32.95 billion which was 7.16 percent higher than that of the same month of the previous fiscal year. In May 2012, import decreased by 6.02 percent than that of the same month of the previous fiscal year and this is increased by 6.43 percent than that of April 2012. For the depreciation in exchange rate, theoretically import should have decreased but this did not happen due to increase in cost of commodities and food and rise in import of fuel oil for quick rental power plant. Bangladesh is an import-dependent country and depreciation of taka increases the import bill, causing trade deficit to go larger. The devaluation of taka may temporarily induce an increase in the value of export, but the country being an import dependent one, overall this may put further pressure on the prices to go up, resulting in higher inflation. In addition, the increase in import bill may increase the domestic price in the economy. The export and import payments are increasing over the years, causing a continuous trade deficit and imbalance in balance of payment. Thus the dual reasons may seriously dampen the economic situation by increasing inflation.

The devaluation of taka may temporarily induce an increase in the value of export, but the country being an import dependent one, overall this may put further pressure on the prices to go up, resulting in higher inflation.

During July-May of FY 2011-12, trade deficit was USD 10.97 billion which increased by 24.66 percent against USD 8.80 billion in the same month of the previous fiscal year. Exports are facing a negative growth rate during the last few months of FY 2011-12 because of the EU debt crisis which has cast a shadow on the expectations of export. Moreover, the financial crisis in the western world is hampering exports from Bangladesh. EU Zone covers 51 percent of total export earnings of the country while 22 percent comes from the U.S.A. Recently the EU debt crisis and global recession especially in U.S.A has decreased the price of commodities and discouraged the export earnings.

During July-May of FY 2011-12, trade deficit was USD 10.97 billion which increased by 24.66 percent against USD 8.80 billion in the same month of the previous fiscal year.

In December 2011, depreciation was 6.09 percent and 3.07 percent was found in January 2012. Depreciation of Tk. is expected to make the importable goods expensive and the exportable goods cheaper as well. In the mean time, import and export were valued at USD 2.91 billion and USD 2.06 billion respectively which indicates that export earnings increased by 29.76 percent and import decreased by 8.00 percent than that of the previous fiscal year. Import bills increased by 15.78 percent in January than that of the previous month of this current fiscal year. The main reason of this increase in import payments was the import of petroleum products and crude petroleum for the quick rental power plants.

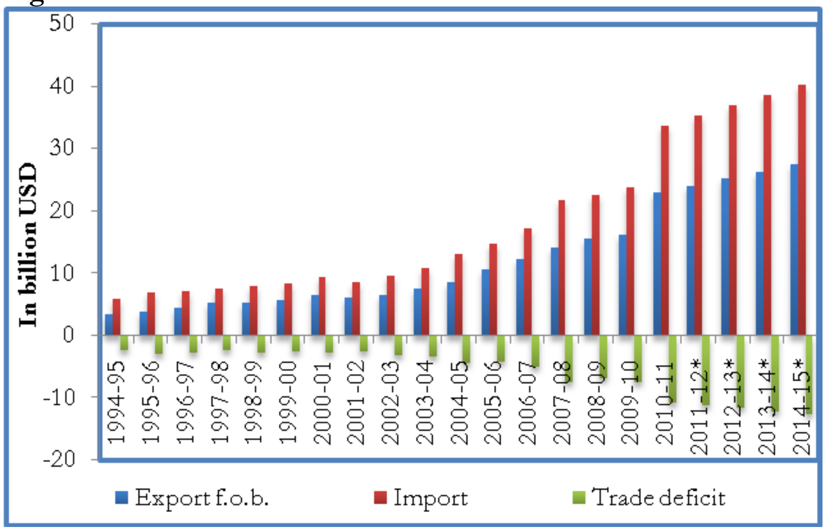
The depreciation slowed down the import growth of capital machinery and intermediate goods which is very alarming for the industrialization of the country.

However, the local currency started to gain strength by February 2012 which also saw decreases in both of imports bills and export earnings. The main concern is that soaring import bills decreased the reserve and increased the borrowing from different sources. The depreciation slowed down the import growth of capital machinery and intermediate goods which is very alarming for the industrialization of the country. Decline in imports also decreased

Decline in imports also decreased the export earnings as most of the export products of the country are secondary.

the export earnings as most of the export products of the country are secondary. In the same way, the increase in import payments has created a pressure on the foreign exchange reserve. The demand for dollars exceeds the supply which is depreciating the local currency against USD.

Figure 9: Trade Balance



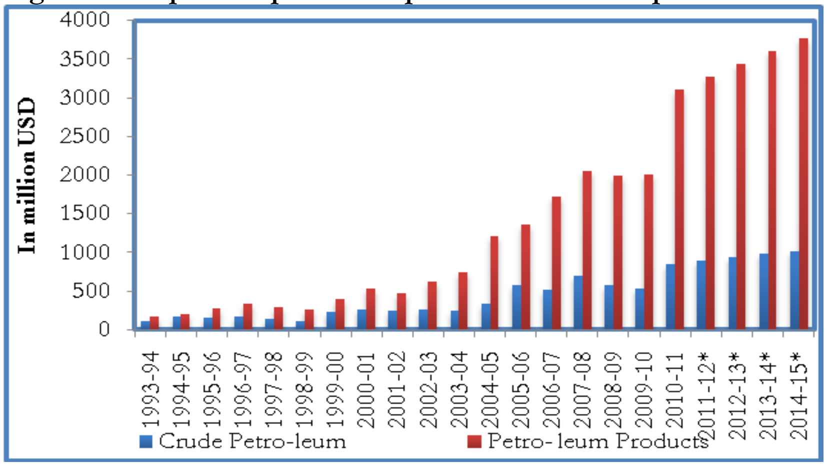
Source: Bangladesh Bureau of Statistics, Statistics Department, Bangladesh Bank, Export Promotion Bureau, 2012

9. IMPORTS OF CRUDE PETROLEUM AND PETROLEUM PRODUCTS

During July-April of FY 2011-12, import of petroleum products and import of crude petroleum was USD 3607 and USD 969 million which increased by 15.98 and 13.20 percent respectively than that of the same period of the previous fiscal year.

Food grain, intermediate raw materials, capital goods, machineries, petroleum products, fuel and lubricants, chemicals etc. are the principal imports of Bangladesh. Now-a-days the relative shares of different categories in total imports are changing whereas food import payments are higher which may have spillover effects on the domestic prices of commodities. As a result inflation may go upward. Again, increases in oil prices and the political instability of different countries have increased total import bills. Imports of crude petroleum and petroleum products are increasing over the years. During July-April of FY 2011-12, import of petroleum products and import of crude petroleum was USD 3607 and USD 969 million which increased by 15.98 and 13.20 percent respectively than that of the same period of the previous fiscal year. Eventually, the growth rate of petroleum products and crude petroleum were 54.45 and 60.74 percent higher in FY 2010-11 than that of the corresponding previous fiscal year due to demand in the quick rental power plants.

Figure 10: Imports of petroleum products and crude petroleum



Source: Authors' calculations based on Bangladesh Bank, 2012

Petroleum demand of the country is uprising as the government has moved to widen its range of energy generation by installing dozens of high-cost diesel and furnace oil power plants in both the private and public sectors.

Under the business as usual scenario, the import of petroleum products might increase further in the upcoming fiscal years to meet its increasing demand for irrigation and oil-based power plants.

The monthly data trend shows that imports of crude petroleum have increased by seven percent in May 2012 than that of the previous month of the last fiscal year and imports of petroleum products has increased by 42.00 percent in May 2012 than that of April 2012. Under the business as usual scenario, the import of petroleum products might increase further in the upcoming fiscal years to meet its increasing demand for irrigation and oil-based power plants. This concludes that imports of crude petroleum and petroleum products might increase to USD 898 million and USD 3273 million respectively by the end of FY 2011-12.

Table 4: Monthly trend of imports of petroleum (in million USD)

FY 2011-12	Crude Petroleum	Petroleum Products
July	86	368
August	0	274
September	208	341
October	15	321
November	0	386
December	127	174
January	177	239
February	89	343
March	88.88	342.67
April	86.09	338.75
May	92.52	480.53
June*	93.12	490.78

Source: Authors' calculation based on statistics department, Bangladesh Bank, 2012

Import payment as percentage of GDP is higher than the contribution of export as percentage of GDP, causing the deficit in the balance of payment.

Import payment as percentage of GDP is higher than the contribution of export as percentage of GDP, causing the deficit in the balance of payment. A number of national and internal factors are responsible for this situation. The service accounts also show the deficit situation. But increased deficit in B.O.P, higher amount of debt repayment and payment to IMF, foreign exchange reserves are bound to shrink.

The overall import might be at a stake in the upcoming months due to maintaining restrained monetary policy by the central bank to rein in the rate of inflation and bring down to a single digit by discouraging further investment in unproductive sectors.

10. GOVERNMENT BORROWING

The recent monetary policy of the first half of FY 2012-13 asserts that government borrowing from the banking sector would be around at Tk. 230 billion same as the budgetary target of FY 2012-13.

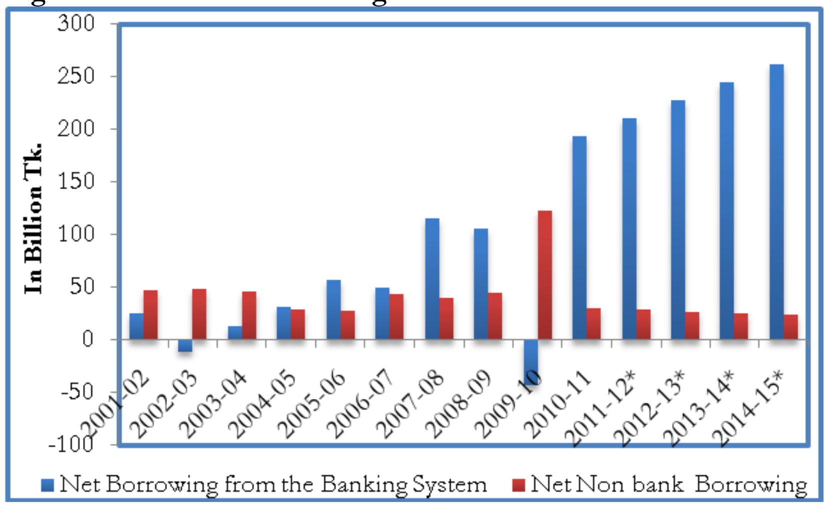
During July-April of FY 2011-12, total domestic borrowing of the government was Tk. 18.42 billion which increased by 39.10 percent than of the same period of the previous fiscal year.

Central bank, scheduled banks, non-bank financial institutions and individuals are the main sources of the domestic borrowings in the higher debt-facing country. The government depends on the sources of internal and external borrowings to meet its fiscal deficit and becoming over burden of debt and budget deficits. During the last two fiscal years, government domestic borrowing has been uprising. During the first half of FY 2011-12, pressures in balance of payment was observed due to the high global oil prices, increase in government borrowing, huge depreciation of Tk. against dollars, high rates of inflation and depletion in the foreign exchange reserve. Moreover, external pressure slightly relieved due to the monetary tightening and lower import demand. During July-April of FY 2011-12, total domestic borrowing of the government was Tk. 18.42 billion which increased by 39.10 percent than of the same period of the previous fiscal year. The recent monetary policy of the first half of FY 2012-13 asserts that government borrowing from the banking sector would be around at Tk. 230 billion same as the budgetary target of FY 2012-13.

Continuation of current trend might result into an increasing movement in domestic debt. Excessive borrowing from banking sectors indicates a sharp crowding out effect which may dampen private investments. Net Government borrowing from banking sector in FY 2011-12 (July to April) is Tk. 16.42 billion which is 154.94 percent more than that of the same time of the previous fiscal year. On the other hand, net government borrowing from non-banking sector in FY 2011-12 (July to April) is Tk. 2.004 billion which is 40.11 percent less than the FY 2010-11 (July to April).

Net government borrowing from banking sector in FY 2011-12 (July to April) is Tk. 16.42 billion which is 154.94 percent more than that of the same time of the previous fiscal year. On the other hand, net government borrowing from non-banking sector in FY 2011-12 (July to April) is Tk. 2.004 billion which is 40.11 percent less than the FY 2010-11 (July to April).

Figure 11: Domestic borrowing from banks and other non-bank



Source: Authors' calculation based on National Accounts Statistics, Bangladesh Bureau of Statistics, 2012.

Over the last few months of FY 2011-12, government borrowing from the banking system increased markedly. On the other hand borrowing from the non-bank sources declined with the same period of the previous fiscal year. Net foreign financing was Tk. 7.387 billion during the period of July-April of FY 2011-12 which was 24.15 percent higher than that of the same period of the previous fiscal year and this is 28.62 percent of the total financing due to the shortage of foreign fund which was targeted in the budget for FY 2011-12.

Increase in domestic borrowing from the banking sectors crowds out private investment and could increases inflation. It is better to find out effective options to increase the internal resources other than borrowing from banking system.

11. FOREIGN EXCHANGE RESERVE

Foreign exchange reserve has increased to USD 10.45 billion in the first 27 days of FY 2012-13 due to the fact that expatriates sent more money for the Eid-Ul-Fitr.

In spite of the global financial crisis, economic slowdown and higher rate of inflation, reserve increased over the years but at a decreasing rate. Moreover, Increase in debt and deficit, inflation and devaluation of currency have reduced the foreign exchange reserves. Foreign exchange reserve has increased to USD 10.45 billion in the first 27 days of FY 2012-13 due to the fact that expatriates sent more money for the Eid-Ul-Fitr. In FY 2010-11, foreign exchange reserve was USD 10911.6 million which was 1.51 percent higher than that of the previous year and it is only 0.14 percent of the total GDP which was 0.15 percent in FY 2009-10. .

In June 2012, reserve was USD 10.36 billion which is 8.82 percent lower than that of May 2012 and it is decreased by 5.13 percent than that of the same period of FY 2011.

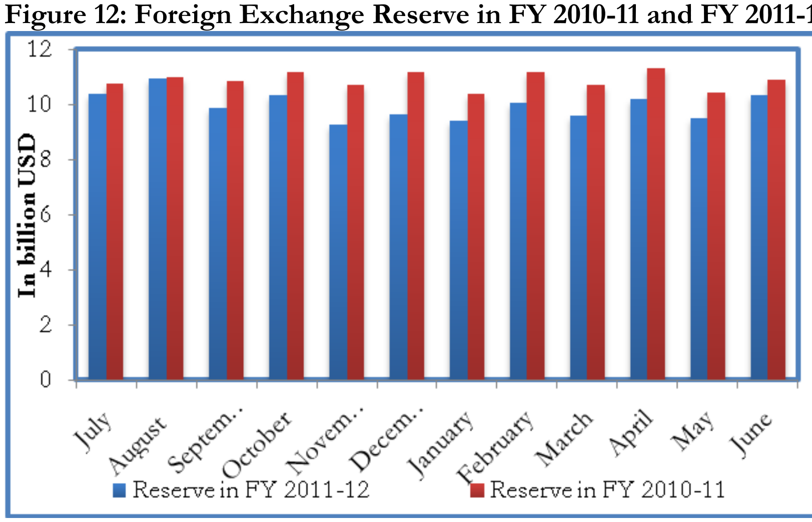
In June 2012, reserve was USD 10.36 billion which is 8.82 percent lower than that of May 2012 and it is decreased by 5.13 percent than that of the same period of FY 2011. Reserve was the highest at USD 10931.9 million in August 2012 in this last fiscal year because of the increasing in remittance and export earnings. It decreased by 10.19 percent in November 2012 than that of October where depreciation of Tk. against dollars increased as well as import bills. Reserve decreased during the period of May 2011 and July 2011 because of higher inflation and increased import bills. In January 2012, foreign exchange reserve reached at USD 9.39 billion which was USD 10.38 billion in January, 2011.

Continuation of trend from July 2011 to June 2012 suggests that reserve might reach at USD 10.35 billion in July 2013, if remittance and export earnings do not attain at a satisfactory level.

In April 2012, reserve continued to slide down than that of the previous fiscal year due to the steady depreciation of taka, decrease in export earnings, remittance and the upward trend of import bills. After clearing the monthly payments of ACU (Asian Clearing Union), foreign exchange reserve dropped by 6.59 percent in May 2012 than that of the previous month of this current fiscal year. Moreover, reserve increased in April 2012 as the first installment (USD 141 million) of USD 987 million has already disbursed by International Monetary Fund. However, the continuation of trend from July 2011 to May 2012 suggests that reserve might slide down by the end of this current fiscal year unless receipt of remittance and export earnings gives a positive vibe.

However, the continuation of trend from July 2011 to June 2012 suggests that reserve might reach at USD 10.35 billion in July 2013, if remittance and export earnings do not attain at a satisfactory level.

Figure 12: Foreign Exchange Reserve in FY 2010-11 and FY 2011-12



Source: Finance Division, Ministry of Finance; Accounts & Budgeting Department and Bangladesh Bank, 2012

Moreover, a general concept is that it is required to have a total of three months import bills as reserve which is USD 9000 million but International Monetary Fund (IMF) suggests that reserve of four months import bills is a prerequisite. The existing reserve is only USD 386.46 million over than that of the total cost of the import bill for the next three months.

12. IMF'S VIEW

The International Monetary Fund approved a three-year loan of USD 0.987 billion to overcome the imbalances of balance of payments and to restore macroeconomic stability under the Extended Credit Facility (ECF) by the IMF-MEFP (International Monetary Fund–Memorandum on Economic and Financial Policies). About USD 0.141 billion was handed over and the rest paid over six equal installments. Bangladesh will repay the cash after 10 years. A different conditionality's with four reforms are asserted in the loan.

From the last two fiscal years, the central bank has been following contractionary monetary policy to rein in higher rate of inflation by adjusting with the IMF-MEFP policies. Under the ECF loan, the IMF-MEFP has also asserted to increase the rate of interest and to limit bank borrowing and set a ceiling on the reserve money held by Bangladesh Bank (BB). Ultimately this would increase the investment cost and monetary squeeze would decline the domestic investment. This slower rate of investment would not only decline in generation of employment but also reduce aggregate demand. Thus this contractionary monetary policy as pursued by the Bangladesh Bank may result in a reduced GDP growth rate in the upcoming fiscal years. In FY 2011-12, the GDP growth rate was targeted to 7.00 percent but actually it was 6.32 percent. However, in the current fiscal year, GDP growth rate is targeted to 7.2 percent but this might not achieved if necessary measures and steps are not taken.

One of the conditionality's is the flexibility in exchange rates using demand-supply mechanism and to tighten further the monetary policy stance in order to boost up the social and development-related spending and improve the trade balance. According to the IMF-MEFP, further depreciation of Tk. against dollars is necessary to increase the export earnings, remittances and discourage the import. Furthermore, depreciation of Tk. against dollars is observed during the months of FY 2011-12 which ultimately increases the trade deficits. The flexibility of exchange rate by the requirement of IMF-MEFP might decelerate the foreign exchange reserve.

In January-June of FY 2011-12, government followed the contractionary monetary policy based on the conditions of IMF-MEFP to ease the balance of payment imbalances. But this loan did not provide any fruitful result despite the increased debt crisis and imbalances in balance of payment. Again the same restrained monetary policy might further hamper the imbalances in balance of payment rather improve the economic condition of the country.

13. POSSIBLE EFFECTS OF MONETARY POLICY

13.1 Impact on Savings

National Savings as percent of GDP was increased by 2.08 percent in FY 2011-12 than that of the previous fiscal year due to the increase deposit rates.

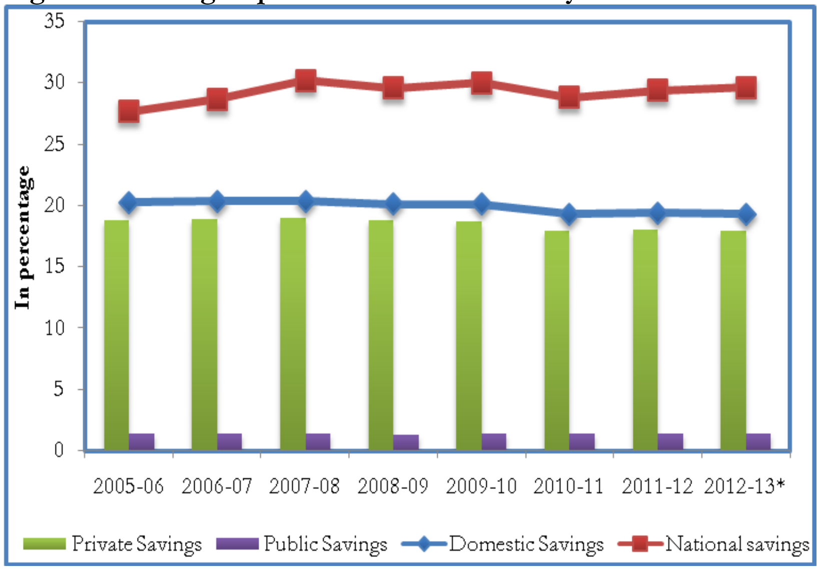
Private savings rate increased from 17.91 percent of GDP in FY 2010-11 to 18.01 percent in FY 2011-12 but still it is lower than that of FY 2009-10.

Under the business as usual scenario, the domestic and national savings as percent of GDP might attain at 19.28 and 29.65 percent in FY 2012-13.

Bangladesh Bank has taken the contractionary monetary policy by keeping the Repo and reverse Repo as same as the last monetary policy which ultimately increases the interest rates. The monetary authority can contract the money supply by raising the interest rate under its control because higher interest rates encourage savings and discourage lending. In April 2012, the lending rate and the deposit rate of scheduled banks were higher at 13.72 and 8.17 percent respectively as compared to 13.43 and 7.86 percent respectively in January 2012. National Savings as percent of GDP was increased by 2.08 percent in FY 2011-12 than that of the previous fiscal year due to the increase deposit rates but it is lower than that of FY 2010-11 because of the higher inflationary situation in the economy. During the last fiscal year, domestic savings slightly increased for the increases in remittance inflow, which were 19.4 as percent of GDP. This reflected an increase in both private and public saving rates. Private savings rate increased from 17.91 percent of GDP in FY 2010-11 to 18.01 percent in FY 2011-12 but still it is lower than that of FY 2009-10. The slower rate of private savings occurred due to the slower growth in real disposable income and the stock market catastrophe which hurt small investors generally. On the other hand, public savings declined from 1.38 percent of GDP to 1.36 percent because of the slower revenue growth and large increases in subsidies in quick rental power plant. However, savings rate did not increase at a satisfactory level due to the increase in the rate of inflation and though the interest rate on deposit is still low compared to the lending interest rate.

Under the business as usual scenario, the domestic and national savings as percent of GDP might attain at 19.28 and 29.65 percent in FY 2012-13 (the domestic private and public savings as percent of GDP might attain at 17.89 and 1.35 respectively).

Figure 13: Saving as percent of GDP over the years



Source: Authors' calculation based on Bangladesh Bureau of Statistics, 2012

13.2 Impact on Investment

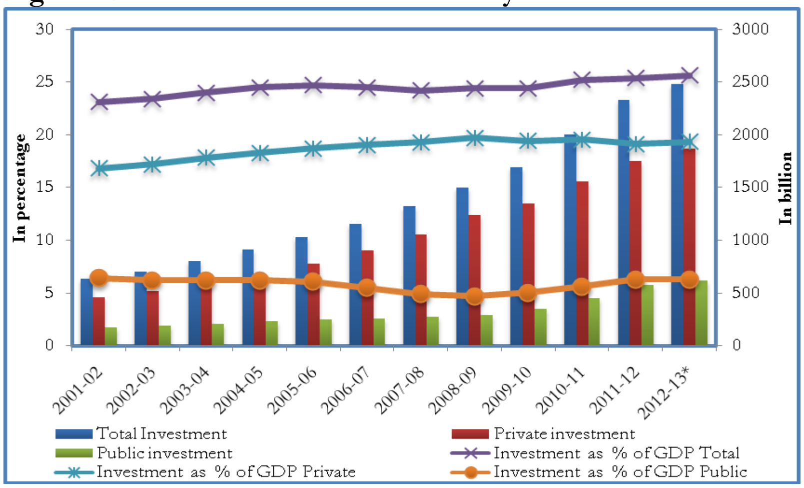
Total investment is increasing in volume over the years but the percentage share on GDP is still unsatisfactory.

The lending interest rate rose to 13.74 upto March 2012 whereas the private investment as percent of GDP declined to 19.1 percent in FY 2011-12.

Total investment is increasing in volume over the years but the percentage share on GDP is still unsatisfactory. Investment is interrelated with the levels of inflation and interest rate. Increase in interest rate may pose an adverse effect on investment. In FY 2010-11, lending interest rate was 10.72 with a private investment ratio in GDP was 19.5 percent. However, the lending interest rate rose to 13.74 upto March 2012 whereas the private investment as percent of GDP declined to 19.1 percent in FY 2011-12. However, in the last monetary policy statement in July-December of FY 2011-12, all the lending interest rates caps are lifted other than for agricultural and pre-shipment export credit. This increases the cost of business in the productive sector. The declining rate of private investment as percent GDP occurred because of the higher interest rate on deposits.

In addition, this would lead the small investors less interested to invest in the capital market which will definitely hamper the industrialization of the country hence put further pressure on production. Moreover, increase in the higher deposit rate and lending rates may narrow down the profit margin of the investors and this discourage the investors to borrow money from the bank. Ultimately, this can hamper the production of the country. In the last fiscal years, private investment as percent of GDP followed a slower trend because of the high variation of inflation, tightening credit conditions in the financial sector as reflected in the reduction of growth in industrial term loan disbursement, energy shortage and policy uncertainties in the run up to elections in early 2014 which creates the insecurity to the investors.

Figure 14: Investment situation over the years



Source: Authors' calculation based on Bangladesh Bureau of Statistics, 2012

In FY 2011-12, public investment as percent of GDP increased slightly to 6.3 percent from 5.6 percent in FY 2010-11. The government's Annual Development Program is the single largest source of public investment. Though the investment in the quick rental power plant is increasing, the public investment appears an increasing trend over the years.

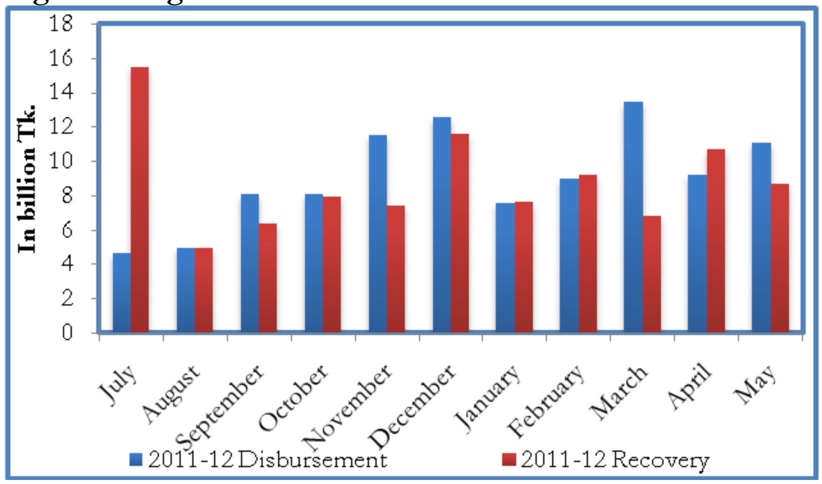
13.3 Agriculture

To maintain the sufficiency of the demand of food, it is necessary to develop the agricultural sector of Bangladesh. In order to this purpose, Tk. 89.18 billion is targeted to allocate to the development and non-development budgets combined for the Ministry of Agriculture in the budget for FY2012-13 which was Tk. 74.11 billion in the budget of the previous fiscal year in order to ensure increase in agricultural output, poverty reduction and food security.

During July-May of FY 2011-12, disbursement of agricultural credit is Tk. 100.31 billion which was 15.82 percent lower than that of the same period of FY 2010-11

During July-May of FY 2011-12, disbursement of agricultural credit is Tk. 100.31 billion which was 15.82 percent lower than that of the same period of FY 2010-11 due to the fact that government has given the highest priority to the credit of productive sectors such agriculture, industry and SME and discourages the credit to the unproductive sector and luxurious goods. In the same time, recovery of agricultural credit was Tk. 96.77 billion which was 11.49 percent higher than that of FY 2010-11. In May 2012, disbursement of agricultural credit was Tk. 11.04 billion which was 48.09 percent higher than that of the same month of FY 2010-11.

Figure 15: Agricultural disbursement over the months



Source: Authors' calculation based on Agricultural Credit & Financial Inclusion Department, Bangladesh Bank, 2012

the share of agriculture and forestry in GDP was 14.90 in FY 2011-12.

The business as usual scenario shows that agriculture growth rate and share of GDP might decrease in the next fiscal years.

The target of monetary policy is to boost up supporting funds for agriculture sector. However, the growth rate of agriculture and forestry up to April 2012 decreased to 1.72 percent. Although during the period of FY 2011-12, aman production had positive growth due to good rainfall nationwide, but aus production and the *boro* (largest rice crop) production was comparatively lower than that of the previous fiscal year due to slightly lower land. (World Bank, 2012) It decreased to 5.09 percent in FY 2010-11 from 5.56 percent in FY 2009-10. Besides of these, the share in GDP of agriculture sector in FY 2010-11 decreased to 15.58 percent from 15.81 percent in FY 2009-10. In addition, the share of agriculture and forestry in GDP was 14.90 in FY 2011-12. As business as usual scenario shows that agriculture growth rate and share of GDP might decrease in the next fiscal years.

Table 5: Components of agriculture sectors

	Sectorial/sub-sectorial growth rate						Sectorial/sub-sectorial share in GDP					
	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	FY 2011-12*	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11	FY 2011-12*
Agriculture and forestry	4.69	2.93	4.10	5.56	5.09	1.72	16.64	16.18	15.91	15.81	15.58	14.90
Crop and horticulture	4.43	2.67	4.02	6.13	5.65	0.94	12.00	11.64	11.43	11.42	11.32	10.74
Animal farming	5.49	2.44	3.48	3.38	3.48	3.39	2.88	2.79	2.73	2.65	2.58	2.50
Forest and related service	5.24	5.47	5.69	5.23	3.90	4.42	1.76	1.75	1.75	1.73	1.69	1.66
Fishing	4.07	4.18	4.16	4.15	5.25	5.38	4.73	4.65	4.58	4.49	4.43	4.39

Source: Bangladesh Bureau of Statistics (BBS), 2012
* This statistics are based on April 2012

14. CONCLUDING REMARKS

The recently announced monetary policy statement reveals the revision of government's previous targets without having a realistic check. Although the past monetary stance showed success in some areas of the target, yet these are not sufficient. The inflation rate starts to decline but still now it appears in a double-digit rate at 10.62 percent in June 2012. The main challenges of the recent monetary policy are to curb the inflation, to ease the imbalances of balance of payment and to keep the economic growth of the economy. On the basis of this growth-inflation dynamics, it is apparent that the current monetary policy stance should focus on a balanced approach which may ensure the investment in the productive sector and controls on public spending. It is necessary to take an effective measure so that huge subsidies on energy sector (quick rental power plant) might not lead to high inflation, in order necessary to maintain the price stability within the remit of people. This also focused that the policy stance related to public borrowing, interest rate and domestic credit are welcome. However, along with this, a clear road map is required on how systematically these instruments will be monitored with a view to keeping the inflation at an acceptable rate and to easing the imbalances of balance of payment.

The Bangladesh Economic Update sees the recently announced Monetary Policy Statement as a missed opportunity on behalf of Bangladesh Bank to safeguard the economy by correctly addressing the issue of fiscal mismanagement in the first place and then placing a monetary policy which would have been appropriate in the current context. The Monetary Policy Statement has taken a contractionary monetary policy stance which is en masse in nature, whereas the appropriate approach should have been a differential one-- to try to encourage sectors which are conducive to growth of the economy as well as discourage unproductive expenditures related to imports of items which do not contribute to growth, or which encourages rent-seeking behavior of some sections of the society. With this Monetary Policy Statement, the economy has been directed towards a vicious cycle of mismanagement-- first there was a case of fiscal mismanagement, and then rather than addressing this mismanagement, Bangladesh Bank has moved towards a contractionary monetary policy, and this policy would lead towards contraction of the growth of the economy, and this would further lead to even greater fiscal mismanagement and possibly more rounds of misplaced monetary policy statements.

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Annex-1

Mathematical Equation

$$P_l = P_b(1 + ry)$$
$$\Longrightarrow r = \frac{1}{y}\left(\frac{P_l}{P_b} - 1\right)$$

Where,
P_l = Value of the launch year;
P_b = Value of the base year;
y = Number of years between launch year and base year;
r = Growth rate.

Then, a projection using this method could be computed as:
$$P_t = P_l(1 + rz)$$

Where,
P_t = Value of the target year;
P_l = Value of the launch year;
z = Number of years between target year and launch year;
r = Growth rate

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