Chapter 6

Monetary Policy Stance Going Forward[115]

6.1 Monetary Policy Stance during FY06

In the 3rd quarter of FY05 Bangladesh Bank shifted from an accommodative to a tightened bias in its monetary policy stance in view of persistent inflationary expectations. Price developments early in FY06 prompted BB to continue with the same bias; in September '05 BB announced upward revision of the SLR and CRR (to 18 and 5 percent, respectively) that took effect from October 1, 2005. The first issue of the half-yearly *Monetary Policy Statement* (BB, 2006a) reiterated the appropriateness of the tighter policy stance, and assured the public that the policy was not intended to slowdown output growth, rather to curb excess demand arising from inflationary expectations, thereby supporting sustained stable output growth over the near and medium term.

In support of the policy stance, the central bank's repo, reverse repo (both 1-2 day and 3-9 day term) rates as well as the 28-day T-bill rate all rose moderately between September '05 and June '06. Further, no repo auction took place either in the first or in the last quarter of FY06. By contrast, Bangladesh Bank used its reverse repo tool more frequently to mop up excess liquidity from the market. Alongside these restraining steps, the realized level of domestic credit in FY06 grew faster than deposit mobilization by DMBs by a margin of nearly two percentage points (20.5 vis-à-vis 18.71 percent, respectively), reflecting excess demand induced by inflationary expectations. Credit to the public sector expanded much faster in FY06 (27 vs. 19.1 percent in FY05) in order to finance both the widening fiscal deficit as well as the import of petroleum products.[116]

Notwithstanding the above measures, the expansion of domestic credit, currency depreciation, and the elevated level of world commodity prices exerted inflationary pressures on both demand and supply side in the domestic market. The 12-month moving average inflation rose modestly in the 4th quarter of FY06 from 7.02 percent in March '06 to 7.16 percent in June '06, staying above the 7-percent mark that has been set as the central bank's ceiling as announced in the first issue of the Monetary Policy Statement of January 2006. Examining the 12-month point-to-point data, it is noted that while non-food prices rose persistently in the first three quarters (especially in rural areas), and moderated in the fourth quarter, food prices started to move up sharply in the fourth quarter in part manifestation of the seasonality factor. Having grown at 6.31 percent during the

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[115] This chapter has been edited by the Resident Advisor based on discussions within PAU and BB.

[116] While the overall budgetary deficit increased modestly from 2.96 to 3.24 percent of GDP between the two fiscal years, in current prices the increase was significant at 22.7 percent over the FY05 level. Moreover, bank financing of budget deficit in FY06 rose to 1.36 percent (vis-à-vis 0.84 in FY05) of GDP reaching 42.1 percent of total, while foreign financing declined from 1.34 percent in FY05 to 1.21 percent of GDP in FY06 (or, to 37.5 percent of total). In comparison, during FY06 the stock of SOE debt rose by 0.94 percent of GDP reaching 3.63 percent (Tables II.2 and III.1, BB, 2006c).

first nine months, food prices shot up by 15.60 percent in the 4th quarter (at annualized rates), which led to a rise of 8.81 percent in food inflation over the entire fiscal year. The tighter monetary management however is believed to have contributed to the decline in non-food inflation as measured by12-month point-to-point index, which fell from 6.57 in March to 5.73 percent in June '06.

While the foreign exchange market remained under pressure over the first three quarters of FY06, with the Taka losing about 9.4 percent of its nominal value against the US Dollar in this period, the behaviour during the 4th quarter was rather stable.[117] Indeed the currency gained back some of the loss such that the FY06 depreciation in USD terms came down to 8.5 percent. The gradual depreciation no doubt contributed to the record growth of exports and remittances over the whole year, and particularly in the 4th quarter, which led to a large (USD 341 million) positive current account balance (CAB) for the quarter. However the financial account, which traditionally has been robust in recent years, ended the year in a small deficit (USD 24 million). The primary reason was that "other" investment flows (inclusive of medium and long-term loans), but excluding FDI and portfolio investments, turned negative in every quarter of the fiscal year.[118] However, given the sizeable CAB surplus, the overall balance of payments (BOP) turned strongly positive in the 4th quarter (USD 402 million), which resulted in a healthy overall surplus for the entire fiscal year of USD 365 million. The latter development helped to bolster the foreign exchange reserves, which allowed for the much needed stability in the foreign exchange market in the last quarter of FY06 with a minor appreciation of the currency as already noted.

6. 2 Monetary Policy Stance for FY07

In view of evident inflationary expectations at the close of FY06, Bangladesh Bank (BB) reiterated once more the continuation of a cautious and restrained monetary policy stance in the *Monetary Policy Statement* of July 2006 (BB, 2006b). The interim (FY07 first quarter) developments analyzed in this *Review*, and further highlighted below also leads to a similar conclusion. The analysis of Chapter 5 suggests a slight moderation of food and non-food prices vis-à-vis last year's, though food inflation remained high enough to allow any complacency. The 12-month average inflation at the national level was recorded at 6.97 percent in September '06, slightly higher than 6.83 observed a year earlier.

The policy response so far in this fiscal has been of an appropriate measure. During the first two months of the new fiscal year, domestic credit expanded by 1.41 percent (i.e., at an annualized rate of 8.46 percent) as opposed to the corresponding growth of 2.0 percent (i.e., 12.0 percent annualized) in the last fiscal. The 1-2 day reverse repo rate increased within the first quarter of FY07 by 46 basis points (from 6.04 to 6.50), while the yield on T-bills of 28- and 91-day maturities have also risen by 14 and 12 basis points as of September '06 since the end of FY06. These were clear signals of continuation of the tightened bias of monetary policy stance being pursued. However the GDP growth forecast for

[117] The end month Taka-Dollar exchange rate (mid-value of commercial bank transactions) which stood at 63.75 in June 2005 declined to 70.35 by March 2006, and ended the fiscal year at 69.67.

[118] In other words, the positive FDI (combined with the minor portfolio investments) flows were outweighed by the negative flows of "other investment".

FY07 is sufficiently high (between 6.6 and 7.1), which will require adequate private sector credit growth to be sustained. Hence the programmed level of growth (set at 14.0 percent) built into the monetary program ought to be regularly monitored both in light of the intensity of productive activities as well as inflationary developments.

A detailed sector-wise trend analysis of expected inflation based on data since January 2004 offered in Chapter 5 lead to an overall predicted range for the 12-month average CPI inflation in FY07 of 6.20 to 6.70 percent, well below the end-FY06 figure of 7.16 percent. However, note that this prediction does *not* take any explicit account of several well known risk factors, one being the domestic price level of diesel and kerosene. The large existing subsidy on diesel and kerosene, estimated at about 50 percent of the selling price, would likely call for further revisions in the administered prices of these products even if world prices remain unchanged. There would appear to be persuasive arguments in favour of aligning the latter prices with those prevailing in the border states of India, which will prevent alleged widespread smuggling and thus put a stop to the this source of drain on the treasury, a point already made in the first issue of MPR (BB, 2005). The pricing issue thus assumes even greater importance due to the continuing accumulation of BPC (and other SOE) debt jeopardizing their own financial solvency and at the same time rendering the lending commercial banks (typically NCBs) vulnerable to systemic instability (BB, 2006c).

While credit growth early in FY07 has been encouraging in its moderation since FY06, the weak revenue generation by NBR in the first quarter of FY07 remains a concern, which poses a risk of excessive reliance on debt by the government in order to finance revenue and development expenditures. Thus the public-private share of credit expansion should remain under stringent scrutiny over the fiscal year.

Among risk factors that have been allowed in the moderate inflation forecast cited above, foremost is the recent strengthening of the Bangladesh foreign exchange reserves and the consequent enhanced currency stability. In order to preserve this advantage, one has to be on guard lest broad stability is compromised, which would require amicable resolution of the employer-employee tension in the RMG sector and smooth parliamentary transition. Inflows of FDI and foreign financing of development program are each likely to be contingent on the latter outcome. These factors leave sufficient risks of worsening domestic inflation implying that the currently restrained bias of monetary policy would need to continue in FY07, and adjusted appropriately in the face of continuous monitoring of unfolding events.

References:

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