Policy Analysis Unit
Bangladesh Bank

Monetary Policy Review

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The Monetary Policy Framework and its Implementation : As outlined in the first issue of *Monetary Policy Review* released in December 2005, monetary policy in Bangladesh has the objective of maintaining price stability underpinned by the highest sustainable output growth, and is therefore formulated around inflation and output growth rates as the basic policy targets.

Globally inflation gained momentum during FY04 to FY06 both on account of the gradual closing of the output gap as well as supply side developments in the form of sustained increase in international commodity, energy and related fuel prices. On the domestic front, during FY06, expansion of domestic credit, currency depreciation, and world commodity prices exerted inflationary pressures on both demand and supply sides in the domestic market. The 12-month average inflation rate in Bangladesh increased to 7.16 percent in FY06 from 6.49 percent in FY05, which is consistent with the global trend, though slightly breaching 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. Prices moderated somewhat in the first quarter of FY07 such that the average 12-month inflation came down to 6.97 percent.

In response to sustained inflationary pressure, BB pursued a restrained monetary policy stance as reflected in increases of CRR and SLR of scheduled banks during FY05 and FY06 and by steady upward movement of the key policy rates, e.g., repo, reverse repo, and short and long term T-bills. For example, the yield on 28-day treasury bills rose from 6.60 percent at the end of FY05 to 7.10 percent by end FY06, which reached 7.24 percent in September '06. The central bank's 1-2 day repo and reverse repo rates also rose from 8.00 and 4.50 percent, respectively, as of end FY05 to 8.50 (in May '06) and 6.49 percent (in September, '06), respectively. Further, repo operation was held only in January and May during the entire FY06 and none since. By contrast, Bangladesh Bank used its reverse repo tool more frequently to mop up excess liquidity from the market. The tighter monetary management may have contributed to the decline in non-food inflation as measured by 12-month point-to-point index, which fell from 6.57 to 5.73 percent between March and June '06 and further to 4.86 percent in September '06. The monetary policy regime may also be argued to have influenced food inflation, which, though stubborn, has remained much below that in neighbouring countries. The inter-bank call money rate, which had been volatile during the last two quarters, stabilised during the first quarter of FY07 with the rate actually falling dramatically from 10.84 percent to 7.36 percent between June and September '06.

Credit expansion to the private, and especially to the public sector, grew much faster than targeted, which generally indicates continuing inflationary expectations on the part of the market participants. Indeed deposit mobilization grew by 18.7 percent in FY06, while domestic credit grew by 20.5 percent. The larger (nearly three-fourths of total) private sector credit actually increased moderately from 17.0 percent in FY05 to 18.3 percent in FY06. Credit growth to the central government and to "other public sector" (i.e., SOEs) rose, respectively, from 16.8 and 24.8 percent in FY05 to 23.6 and 34.9 percent in FY06. Overall, credit to the public sector (inclusive of SOEs) expanded by 27 percent (against 19.1 in FY05) in order to finance both the widening fiscal deficit as well as the import of petroleum products.

Since FY04, the share of deficit financing from the domestic sources has increased markedly mainly due to high cost of energy imports and a concomitant decline in the realized level of official development assistance. Further, borrowing from the non-bank public (typically via NSD certificates) had dominated bank borrowing until FY04. However the share of each converged to 0.8 percent of GDP in FY05. The picture was turned on its head in FY06 as bank financing of deficit shot up to 1.4 percent of GDP versus 0.7 for the non-bank source.

Growth Outlook : In light of current and unfolding developments, Bangladesh Bank (BB) has been evaluating and appropriately setting the GDP growth projections for monetary policy formulation. The earlier issue of MPR had forecasted real GDP growth to lie in the 6.3 to 6.8 percent range for FY06, and correspondingly FY06 monetary program had taken 6.5 percent as the target growth rate (BB, 2006), which turned out to be rather close to the eventual provisional BBS estimate of FY06 GDP growth of 6.7 percent.

(a) Based on a detailed analysis of sub-sectoral growth rates, it is projected that overall agricultural sector is likely to grow in the 2.8 to 3.4 percent range in FY07.

(b) Taking the detailed sub-sectoral analysis into account, this *Review* would put the likely industrial growth for FY07 to lie in a range of 9.5 to 10.5 percent, which is well in excess of the trend average recorded over the past ten years. Should the RMG labour tension dissipate soon, it is even likely that eventual industrial growth may well top the range predicted here.

(c) This *Review* expects FY07 service sector to build on the past year's performance, and yield a growth rate of 6.6 to 6.8 percent.

(d) Overall therefore it is seen that the aggregate GDP growth projection for FY07 is in the range of 6.6 to 7.1 percent. The forecast is consistent with the target 6.8 being currently used by BB in the monetary program for FY07.

Inflation Outlook : In monetary policy formulation, the target level of CPI inflation is chosen taking into account the recent inflation history, current price developments, and the unfolding domestic and external shocks that may plausibly impact on the current trend of domestic inflation. Accordingly, a detailed disaggregated analysis offered in Chapter 5 of the current issue of MPR projects FY07 average inflation to moderate to the range of 6.20 to 6.70 percent. The expected gain on the inflation front in FY07 is premised on the continuation of Bangladesh Bank's policy of restrained monetary and credit expansion, a sobering outlook of world energy prices, the cautious policy stance of the US Federal Reserve and the European Central Bank (ECB), and the strengthening of the Bangladesh foreign exchange reserves and hence enhanced currency stability.

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*, also leads to a similar conclusion. The analysis of Chapter 5 suggests a slight moderation of food and non-food prices in FY07 vis-à-vis last year's, though food inflation is likely to remain high enough to allow any complacency.

The FY07 output and inflation projections cited above do not take an 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 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).

Evidently positive early-FY07 developments in industrial, export and remittance growth, which resulted in a healthy development of the current account, would get a further stimulus from a smooth parliamentary transition process, and contribute to further anchoring the BOP environment and the attendant stability of the domestic currency.

The relatively 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 current and development expenditures. Thus the public-private share of credit expansion should remain under stringent scrutiny over the fiscal year. Overall therefore there remain 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.

Note : The entire document as well as an Executive Summary can be downloaded from the following web-sites:
www.bangladesh-bank.org
or, www.bangladeshbank.org.bd