Bangladesh Bank

Monetary Policy Statement

14 January 2009

Executive Summary

Introduction: The Monetary Policy Statements (MPSs) issued bi-annually by Bangladesh Bank (BB) outline the monetary stance that will be adopted over the next half year in pursuit of the objective of supporting the highest sustainable growth of domestic output while containing consumer price inflation within tolerable levels. These ex-ante announcements based on realistic near-term outlook on GDP growth and inflation intend to anchor inflation expectations of market participants and the general public. This issue of MPS accordingly outlines the monetary policy stance and approaches that will be employed in the second half (January-June) of FY09 in supporting attainment of the projected real GDP growth while limiting inflation within the targeted ceiling.

Growth outcome and outlook: Following 6.2 percent real GDP growth in FY 08 under challenging circumstances, momentum in growth of domestic output continued largely unimpaired in H1 FY09, in benign conditions of climate for agricultural output and of downturn in global prices of fuel oil and other major import commodities. The global financial turmoil originating from collapse of price bubbles in assets and commodities has not impacted Bangladesh significantly because of our limited exposure to short term external capital flows; but the continuing slowdown in global output growth poses some uncertainty about near term prospects for export growth, workers' remittance receipts, ODI, FDI and FPI. July-October FY 09 exports of jute, jute goods, leather, electronics and vegetables were weaker than in the same period of FY08, export demand for items such as shrimps and high quality ceramic tableware may also weaken in the coming months. The risks are however perceived as lower for apparels, the major export; the shift of customers from upscale items to the more basic items that constitute the bulk of our exports is viewed as likely to keep order books of Bangladeshi apparel exporters full. The climate of confidence for new investments has strengthened by the end of political uncertainties with orderly assumption of office by an elected government. **Attainment of the initially projected 6.5 percent FY09 real GDP growth therefore still remains a realistic possibility subject to export growth not weakening very substantially; and even in a more downbeat scenario of significant slowdown in export, FY09 real GDP growth can be expected to be above or around 6.0 percent.** The overall growth outlook will be clearer in Q3 FY09, with information on post Christmas export trends to North American and European markets.

Inflation outcome and outlook: Satisfactory domestic agricultural output and the collapse of global commodity price bubble afforded respite in Q2 FY 09 from the unrelenting uptrend of CPI inflation of the recent past. Annual average CPI inflation of 9.94 percent as of June 08 crept up further to peak at 10.06 percent as of September 08, declining to 9.8 percent and 9.37 percent in October and November 08 respectively. Decline in fuel oil import prices have partly been passed on to consumers, with the remainder easing the fiscal burden of price subsidies. The lower prices of other imports are also gradually passing through to local consumer prices, and **annual average CPI inflation is expected to decline further, to around 8.5 percent by the end of FY09, against the initial projection of 9.0 percent in the MPS issued in July 08.**

Monetary outcome and outlook, stance for H2 FY 09: **The revised outlook for FY09 GDP growth and CPI inflation mentioned above warrant no major change in the monetary policy stance announced in the July 08 issue of MPS** seeking to ensure adequate monetary accommodation for 6.5 percent real GDP growth in a scenario of 9.0 percent CPI inflation. The pursued policy stance has yielded good results in respect of growth, inflation and shielding of the economy from the global financial turmoil; with the macroeconomic fundamentals and stability of the Bangladesh economy widely viewed as being amongst the best in the South Asian and other comparator countries. A net FPI outflow of USD 7 million in the first four months of FY09 was minuscule compared to the massive outflows from other emerging markets, and although the BOP current account balance for July-October 08 turned negative mainly due to heavy import payments against LCs opened in Q4 FY08, lower prices of new imports would ease pressure on external sector balances in the coming months. **Unlike economies facing heavy capital outflows and credit crunch in the current global turmoil, credit and liquidity conditions remain easy in the Bangladesh economy,**

with no need for any blanket, economy-wide monetary or fiscal stimulus. However, problems and weaknesses if any arising in specific sectors will be addressed with appropriate monetary and fiscal support.

The year-on-year growth of domestic credit has remained high (24.01 percent as of November 08, with 24.3 percent growth in credit to private sector) in H1 FY09, well above what would be warranted for the initially projected 6.5 percent real GDP growth and 9.0 percent CPI inflation or for the revised projections made here. Apart from delaying pass through of declining international prices into domestic consumer prices, this high credit growth has created bubble-like pressures on real estate prices, and is also causing high asset growth in non-essential, even wasteful 'lifestyle' loans for such purposes as ostentatious wedding festivities, holidaying abroad, conspicuous consumption etc. Rapid growth of such lending particularly by the private sector banks has predictably caused some recent worsening of their asset quality. Against this backdrop, BB's enhancement of repo and reverse repo interest rates by 25 basis points in September and November 2008 respectively sought to nudge credit growth towards the targeted program path consistent with the GDP growth and inflation objectives.

BB will continue to support adequate credit growth for activities facilitating production and supply of goods and services, providing refinance against lending in the priority sectors (SME, agriculture, low cost housing etc.) under-served by the market; while discouraging excessive expansion of non-essential consumer credit and similar other demand-side lending. BB will continue to maintain pressure on banks for enhancing management efficiency and slimming down of intermediation spreads, so as to permit lowering of interest rates on loans for productive and supply augmenting activities while also maintaining real positive interest rates on bank savings.

1. Policy tools and approaches

Monetary policies pursued by BB seek to accommodate adequate credit growth for attaining the projected real GDP growth and to contain CPI inflation within the targeted ceiling, with smooth adjustment to the transient internal or external shocks facing the economy. Annual monetary programs consistent with the projected real GDP growth and CPI inflation are formulated every financial year, with broad money (M2) and reserve money (RM) respectively as the intermediate and operating targets.

BB routinely uses the repo and reverse repo interest rates and operations in regulating the levels of reserve money, to influence the growth of broad money and its components on the asset (credit) and liability (currency and deposit) side, these in turn impacting the activity levels and price levels in the real economy.

Changes in Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) for scheduled banks are the other monetary policy tools that are used less often, in situations of drastic imbalance resulting from major shocks.

2. The global financial turmoil and its impact on Bangladesh economy

The sustained Bull Run in global commodity prices fuelled to a large extent by speculative transactions swung rather abruptly into downturn from mid 2008, triggered by the market wide freeze-ups of lending activities in major financial institutions deeply distressed in the earlier collapse of house price bubbles in major economies, laying bare their shocking dereliction in risk management in heavy exposures to opaque derivatives based on sub-prime mortgages and on loans to excessively leveraged corporates. The credit crunch and freeze-up in the major financial markets are being addressed with massive bailouts and stimulus packages to overcome the resultant economic slowdown; but it may take all of the year 2009 and perhaps even longer for the global economy to be restored back on trend growth path.

Because of the limited openness and exposure to short term external capital flows, the Bangladesh economy has thus far remained well shielded from the financial turmoil and credit crunch in the global financial market. The USD 7 million net FPI outflow during July-October 2008 was minuscule compared to the massive outflows from most other emerging markets. Foreign assets of banks in Bangladesh, comprising the modest nostro balances maintained with correspondents for settlement of current payment obligations, were free of toxic assets based on sub-prime mortgages etc. Liquidity and credit conditions in the domestic financial market remain easy and comfortable; Taka USD exchange rate, foreign exchange reserve levels and market interest rates on Taka loans have remained stable, without any undue volatility. BOP current account consistently in surplus over past several months turned into deficit in October 08 due mainly to heavy import payments against import LCs of Q4 FY08 at high prices then prevailing; but is expected to be back in surplus soon as lower prices are bringing down import payment liabilities in the subsequent months. The downturn in global commodity prices is also easing domestic consumer price pressures and fiscal burdens of input and output price subsidies for producers and consumers.

The continuing slowdown in global growth is however of significant concern for Bangladesh in respect of near term prospects for growth in exports, workers' remittance receipts (job prospects in middle east countries being sensitive to falling oil prices), ODI, FDI and FPI inflows. Workers' remittance receipts have so far remained healthy, with 31.2 percent growth in H1 FY09, and FDI inflows increased 116.3 percent year on year during July-October 2008. Exports of jute, jute goods, leather, electronics and vegetables were however lower during July-October 2008 than in the corresponding period of FY08; export demand for items such as shrimps and high quality ceramic tableware are also likely to weaken in the coming months. The risk of demand slowdown is perceived as lower however for apparels constituting over three fourth of total exports of Bangladesh; the shift of customers from costlier up scale items to the more basic items that constitute the bulk of our exports is seen as likely to keep the order books of Bangladeshi apparel exporters full. The outlook will be clearer in Q3 FY 09; with information on post Christmas trends in exports to North America and Europe.

Some protective/ preventive measures initiated or being contemplated by BB in bolstering defenses of the local financial market against distresses from global financial turmoils are mentioned in the subsequent paragraphs.

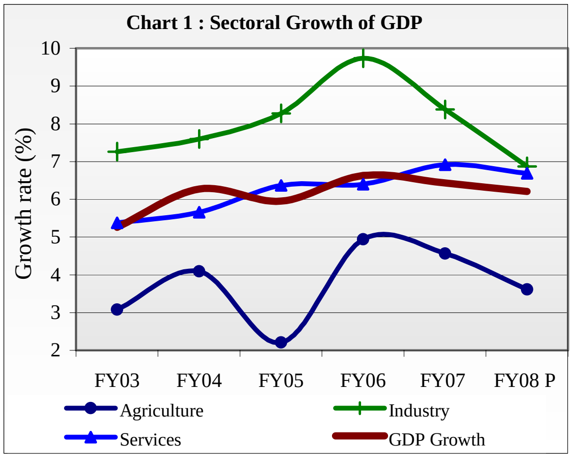
3. Domestic macroeconomic outcome and outlook

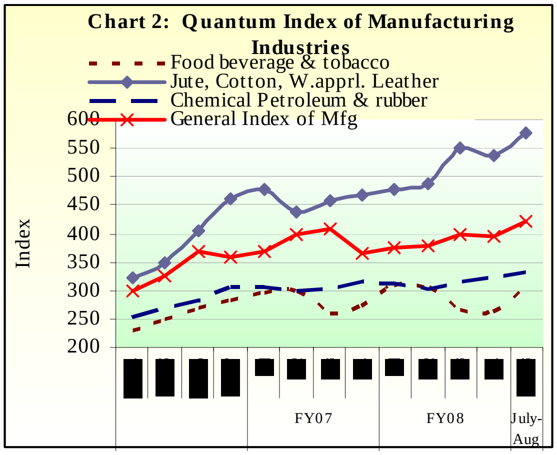
a. Growth: Following 6.2 percent real GDP growth in FY08 under challenging circumstances of flood and cyclone damages and soaring prices of major import commodities, growth momentum has continued unimpaired in H1 FY 09 in more benign conditions, well supported by domestic and external demand.

Agriculture: The agriculture sector attained 3.6 percent overall real growth in FY08 aided by 18.7 percent growth in the major boro rice crop harvest, despite some decline in the aman rice output due to floods and cyclone damages. Climatic conditions remained favorable in H1 FY09, and the government has targeted 15.32 percent growth in domestic food grain production to 33.43 million metric tons. Bumper harvests of boro rice, maize, wheat and potato in FY08 have already been reported; outlook is good also for the upcoming aman and aus rice crops in benign weather condition, with the authorities facilitating timely availability of inputs. Except for localized relapse of bird flue in a few northern districts, prospects for output of various non-crop sub sectors of agriculture also look bright; and overall growth in the agriculture sector output in FY09 is projected to be in the range of 3.8-4.0 percent.

Industry: Following 6.9 percent FY 08 industry sector output, manufacturing activities remained buoyant in H1 FY09, with domestic demand supported by domestic credit growth at rates well above twenty percent; and with still healthy export demand indicated by 30.7 percent export growth during July-October FY09. The tepid 5.9 percent output growth of the construction sub sector facing soaring cost of construction materials in FY08 is due for some growth boost in FY09 as these costs have declined. Overall industry sector output growth for FY 09 is projected to be in the range of 7.4-7.9 percent.

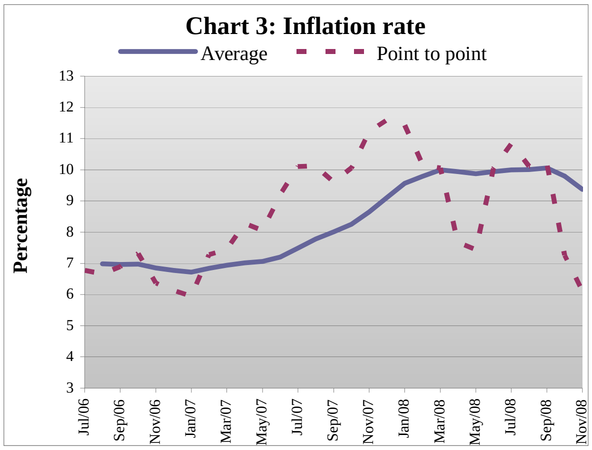
Services: The expected higher output growth in agriculture and industry sectors will be attended by correspondingly higher growth in the supporting service sector, including the sub sectors of trading, transportation, storage and communication, financial intermediation etc. Overall services sector output growth for FY 09 is projected to be in the range of 6.5-6.7 percent.

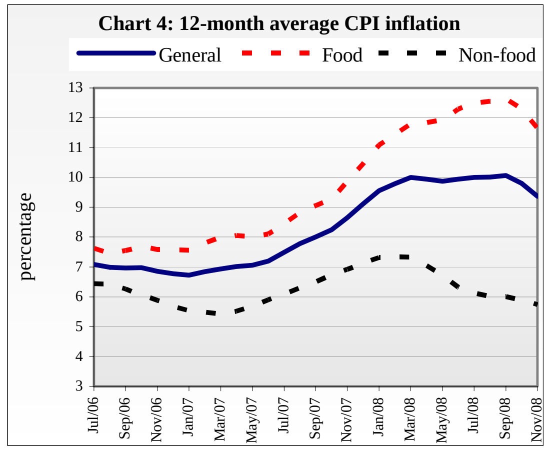




As the economy has performed well in H1 FY09 and as investment confidence has got a boost from the ending of political uncertainty with orderly assumption of power by an elected government, overall real GDP growth looks poised to attain the initially projected level of 6.5 percent in FY09, subject to exports not getting hurt drastically in H2 FY09. Even with some weakening of export growth in the remaining months of FY09, overall real GDP growth for FY 09 looks unlikely to fall below 6.0 percent. The outlook will be clearer in Q3 FY09 with information of export trends to North American and European markets.

b. Inflation: Annual average CPI inflation continued on uptrend in Q1 FY09, rising from 9.94 percent of June 08 to peak at 10.06 percent in September 08; easing down thereafter to 9.80 and 9.37 percent respectively in October and November 08 as the decline in global commodity prices started pass through into local retail prices. The decline in local CPI inflation has tended to be lower and slower than the declines in global commodity prices. The recent major decline in fuel oil import prices has only partly been passed on to the administered local prices, the remainder easing the fiscal burden of price subsidies. Private sector importers have tried to recoup costs of unsold inventories imported at previous higher prices by postponing and scaling down the pass through of lower global prices to local retail prices.





The declining trend of CPI inflation is expected to continue in the coming months, in the favorable combination of circumstances of good domestic output and softening import prices of key production inputs, food grains and manufactured products. Annual average CPI inflation is projected to come down to around 8.5 percent by the end of FY09.

One concern particularly about the falling trend of domestic food grain prices is that it should not result in disincentive for future production by local growers, who will face losses if the costs of their needed inputs remain sticky while prices of their produces continue to decline. The government's decision to increase price subsidies on fertilizer and diesel fuel for irrigation is an appropriate immediate response; promoting crop insurance protecting growers against price risks and output risks will be a market based alternative more appropriate over the longer term.

While CPI inflation has been eased by the favorable supply side developments mentioned above, continued caution is necessary against build up of demand side pressures arising from monetary expansion at rates out of line with the rate of growth of nominal GDP (real GDP growth rate plus inflation rate); which creates incentives for speculative asset price bubble formation and ballooning of consumer credit for non-essential uses. Broad money and domestic credit has expanded strongly in H1 FY09, at year on year rates exceeding twenty percent; real estate prices are soaring close to bubble-like levels, and consumer loans in asset books of private banks have expanded fast under labels like 'lifestyle' loans and 'any purpose' loans, for holidaying abroad, ostentatious wedding festivities, expensive purchases with credit cards and so forth. Encouragement of consumer loans is warranted in economies needing to stimulate demands for spare idle output capacities. The prevailing Bangladesh situation is the exact opposite, with insufficient output capacity to cater to unmet demand. **BB's monetary policy stance, therefore, accords priority to credit support for creation and expansion of output capacities rather than for stoking of demand pressures.**

Keeping track of asset price inflation is of relevance for monetary policies because asset price pressures eventually surface in consumer price pressures via the wealth effect (with capital gains encashed by trading down or used as collateral in borrowing for consumption). Of the two major asset classes in asset menus of households (real estates, stocks and shares), information on prices of stocks and shares are readily obtainable from the stock markets. Dependable time series data on prices of residential or commercial real estate in Bangladesh are however as yet unavailable. The continuing sharp escalation of real estate prices in Bangladesh in the context of collapse of house price bubbles in many major economies adds urgency to the need for dependable time series information on real estate prices. **BB is therefore contemplating taking up an initiative to put in place an arrangement for regular periodic collection of data on house prices from such sources as the housing loan providers and the association of property developers; using these data to construct time series of a suitable house price index.**

c. <u>Fiscal developments</u>: Upfront draw downs of expenditures on new social safety nets, subsidies and elections, insufficiently covered by slower than expected growth in tax receipts caused the government's bank borrowings in H1 FY 09 to exceed the projections in BB's monetary program, increasing by Tk 75.34 billion during July-15th December 08 against BB projection of Tk 43.0 billion for the entire H1 FY09. The increase was however well within the budgetary projection of Tk 136.0 billion for full FY09.

Tax revenue receipts grew by 17.0 percent during July-October 08 against budgetary projection of 18.3 percent annual growth rate. Import duty receipts increased by only 11.9 percent over July-October 08 against a high 31.7 percent increase in import LC settlements though there was no major change in duty rates. The reasons behind the low growth in import duty receipts inspite of high increase in import LC settlements may be worth looking into.

The USD 294.5 million ODA receipts net of repayments during July- October 08 were lower than the receipts in the same period of the previous year (USD 330.1 million). ODA receipts for the full FY 09 are not expected to fall far short of budgetary estimates however, the ODA commitments, mainly from MDBs, being unlikely to be affected by the global slowdown in the immediate term. Although FY09 import duty receipts are likely to be lower than the initial estimates because of the decline in prices of import commodities, price subsidy expenditures will also be lower for the same reason; and the overall fiscal deficit financing is expected to remain well within the budgetary estimate of 5.0 percent of GDP.

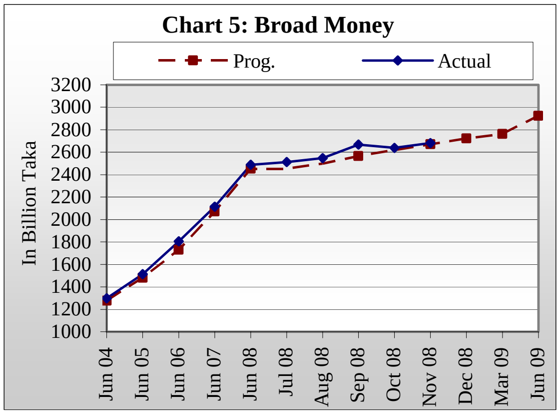
d. Money and credit developments: Broad money (M2) and domestic credit (DC) growth trends maintained upward bias in H1 F 09 relative to their program levels (cf., Chart 5,6,7,8 and Table 1); the divergences were particularly pronounced in September and December 08, coincident with seasonal spikes in liquidity demand for festivities, viz., Eidul Fitr and Durga Puja (September 08) and Eidul Azha (December 08). To nudge the monetary and credit aggregates closer to their program paths, BB's repo and reverse repo interest rates were enhanced by 25 basis points in September and November 08 respectively to 8.75 and 6.75 percent. With no further seasonal spike in liquidity demand due for the second half of FY09, broad money and domestic credit growth paths are expected to be retained close to their program paths in H2 FY09, with appropriate active use of the repo and reverse repo tools. Retaining M2 and DC closely along their program paths will mean correspondingly close attainment of the net foreign assets and BB foreign exchange reserve level objectives.

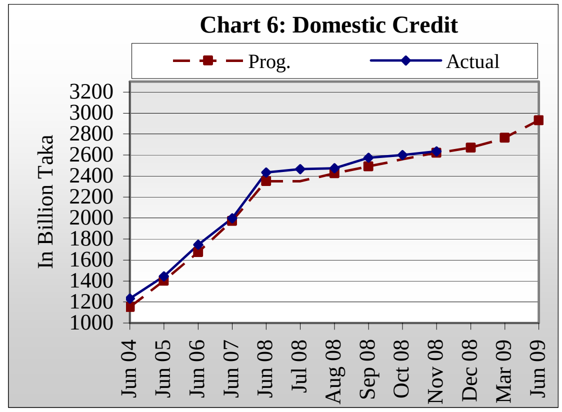
Table 1: Monetary Aggregates (y-o-y growth in percent)

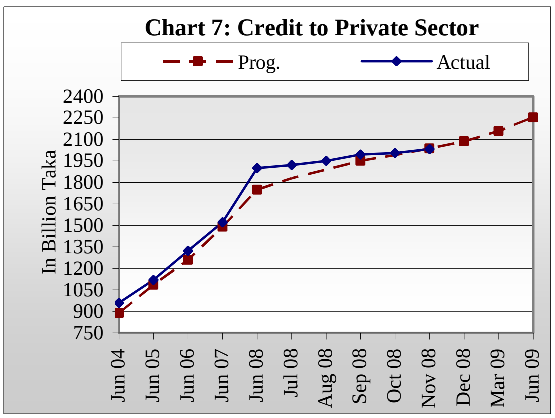
	FY 07	FY 08	Jul-08	Aug-08	Sep-08	Oct-08	Nov. 08	Jun-09 (Prog.)
1. Net Foreign Assets	49.42	15.07	13.98	11.17	1152	-1.17	2.82	14.3
2. Net Domestic Assets	12.57	18.08	19.83	21.12	25.78	24.53	24.15	18.1
Domestic credit	14.39	21.83	22.47	22.84	25.33	24.44	24.01	20.4
Credit to the public sec.tor including Govt.	12.43	11.87	12.23	11.91	21.29	23.53	23.02	27.25
Credit to the private sector	15.01	24.94	25.72	26.14	26.55	24.72	24.31	18.5
3.Broad money	17.06	17.61	18.91	19.58	23.54	20.63	21.02	17.5
4.Reserve money	16.1	20.64	18.82	18.40	31.51	22.10	24.50	17.2

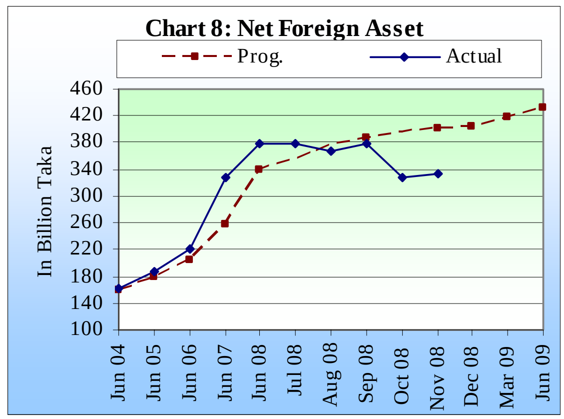
In the overall growth of domestic credit, growth of credit to private sector remained strong; year on year growth in November 08 was 24.3 percent. Composition of bank credit by economic purpose was generally healthy as of end September 08, with the bulk going into productive and supply augmenting uses. 21.1 percent of total bank advances were for industry, 35.4 percent for trade, 2.3 percent for transport and communication, 16.0 percent for working capital, 6.8 percent for agriculture and 18.4 percent for other purposes. The share of advances for agriculture remains low relative to the GDP contribution of the sector, with private banks little engaged thus far. **BB has therefore recently made engagement in agriculture lending mandatory for all banks including private and foreign banks. Promotion of well functioning crop insurance arrangements**

suggested earlier to protect interests of growers would also be beneficial in reducing risks for agricultural loan providers.









The share of consumer loans in total bank advances is still small (4.57 percent as of September 08), but many private banks have gone for rapid expansion of their consumer lending, lured by the higher rates of interest charged thereon. The higher risks associated with these loans may have been the cause of the recent increases in defaulted loans in their asset portfolios. For reasons mentioned earlier in the section on inflation, **BB policies accord priority to expansion of relative shares of supply side loans such as those for agriculture and SMEs, and not of non-essential demand side consumer loans. This does not mean that consumer lending must necessarily decline or stagnate, but that it should grow no faster than the overall growth rate of bank lending.**

BB has introduced Basel II capital adequacy assessment for banks from January 2009 (initially on a parallel run side by side with the requirements based on Basel I) to instill precise quantitative awareness in banks about all material risks associated with their operations vis-à-vis their capital bases. Further, to prevent the kind of gross risk management failure that brought many major global financial institutions down to their knees in the ongoing global financial turmoil, **BB has initiated steps to get the core risk management guidelines issued in 2003 revised and updated by the local bankers associations, in line with subsequent developments in global best practices compiled and issued from time to time by the Basel Committee for effective Bank Supervision (BCBS).**

The tendency in Bangladesh of dependence on high borrowing instead of equity has strained the availability of lending resources for financing new growth supportive projects, especially large infrastructure or manufacturing projects. **BB feels that it is high time for introducing mandatory safe limits of debt equity ratios in bank lending to projects,** to prevent tendencies of excessive leveraging, a major factor deepening the financial distresses and economic slowdown in the current turmoil.

4. Monetary policy stance for H2 FY09

The differences between the GDP growth and inflation projections in the July 08 MPS and the revised projections made now are not large enough to warrant any major change in the policy stance for FY09 announced in the July 08 MPS or in the monetary program based thereon. The monetary and financial policies pursued by Bangladesh have proven their worth remarkably by maintaining stability of the Bangladesh economy in respect of output growth, macroeconomic balance, inflation, exchange rate, interest rate and market liquidity; amidst financial turbulences raging beyond her borders.

Monetary policies in H2 FY 09 will as before accord priority to ensuring adequate credit accommodation for productive supply-side economic activities, providing refinance support where necessary for income and employment generating priority sectors under-served by the market, including agriculture and SMEs. The policy stance will also continue to discourage unduly high expansion in non essential demand side lending, to avoid build up of inflationary pressures. Repo, reverse repo interest rates and operations will continue to be the main day to day tools for monetary management. Banks will continue to be under BB pressure to narrow down their intermediation margins (spread between the lending and deposit interest rates) by improving management efficiency and asset quality; enabling lowering of interest rates on loans for productive purposes while also maintaining real positive interest rates on bank savings.

Because the Bangladesh economy has not faced large capital outflows or credit crunch in the ongoing global turmoil; there is no need for any blanket economy-wide stimulus. Specific sectors and their financiers may however face difficulties if the slowdown in global trade hurts our export growth drastically. If and when that happens, the affected sectors will need to be provided timely monetary and/or fiscal support as appropriate. **BB will maintain close continuous watch on developments in the real and financial economy, to be in readiness with appropriate response wherever necessary towards maintaining the momentum of pro-poor growth, income generation and employment.**