Monetary Policy Statement

January - June 2017

Monetary Policy Department

Bangladesh Bank

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Highlights

- Broad money (M2) grew by 13.8 percent in November 2016, remaining within the FY17 ceiling of 15.5 percent to support the GDP growth target of 7.2 percent and the inflation ceiling of 5.8 percent, respectively. In the first half of this fiscal year, private sector credit growth exceeded 15 percent, a three-year high but within the FY17 ceiling of 16.5 percent.

- Both food and non-food CPI inflation moderated, aided by favorable agricultural production, modest rise in global commodity prices, and growth supportive yet cautious monetary policy stance. Average CPI inflation declined to 5.5 percent by December 2016, a five-year low and well within the FY17 ceiling. Bangladesh Bank (BB) projects annual average inflation to be around 5.3-5.6 percent in FY17. Projected rise of global commodity prices in 2017, however, may continue exerting some upward pressure on domestic prices.

- Domestic demand-driven economic activity remains relatively buoyant, as indicated by credit growth, industrial activity, and import trends. Despite some moderation, garment exports growth has held up well relative to peers. The recent decline in remittance reflects a combination of global and local factors, but mainly driven by weaker economic activity in the Middle East. Recovery in remittance growth can be expected over the near to medium term from oil price stabilization boosting Middle Eastern economies, as also from the recent upsurge in manpower exports from Bangladesh. Based on the recent economic indicators and econometric analysis, BB projects GDP growth to be above 7 percent in FY17.

- Balancing the upside potential and the risks, BB maintains the current policy stance: repo and reverse repo rates will remain unchanged at 6.75 and 4.75 percent, respectively, to support growth while mitigating inflation risks. Broad money and private sector credit growth targets for FY17 are 15.5 and 16.5 percent, respectively.

- Given the pickup in credit growth, BB's supervisory vigilance on lending efficiency and risk management in the financial sector will continue to be strengthened, with particular emphasis on transparent, accountable corporate governance, and substantial reduction in loan defaults.

- While the recent capital market buoyancy may reflect a recovery from its prior depressed state since 2011, caution is warranted in ensuring that exuberance remains rational. Bangladesh Securities and Exchange Commission (BSEC) has already taken welcome steps with cautionary messages, financial literacy promotion, and so forth. Some restrictions on margin loans against sponsors' shares and shares with abnormally high price earning (*PE*) ratios may also be desirable. BB is also responding with intensive monitoring about banks abiding by statutory limits on their capital market exposures. BB may also direct banks to prevent diversion of business and consumer loans into stock markets and remains ready to take prompt policy actions.

- In line with the government's SDG priorities of an inclusive, environmentally sustainable growth, BB is for quite some years now promoting inclusive, green financing (targeting SME, agriculture and green initiatives), fostering financial sector wide a socially responsible financing ethos. BB has now taken up a consultative initiative of formulating Guidance Notes on the do's and don'ts of socially responsible financing to better foster social cohesion, with output initiatives that promote entrepreneurship, create more and better jobs, and protect environment.

Bangladesh Bank's Monetary Policy Stance

The Second Half of the FY2017: January-June 2017

This Monetary Policy Statement (MPS) reports Bangladesh Bank's monetary policy stance for the second half (H2) of FY17 as the second leg of its monetary program for FY17. As in the past, the FY17 monetary program and the monetary stance for H2 FY17 have been formulated taking into account actual outcome for H1 FY17, external sector developments, and feedbacks from a stakeholder consultation with economists, policymakers, the representatives from major think tanks, the business community and the financial sector.

Monetary Policy Stance for H2 FY17

The main objective of Bangladesh Bank's monetary policy is price stability, alongside supporting inclusive output and employment growth. Over the years, in addition to the short-term business cycle agenda, Bangladesh Bank has also been making efforts to nudge the financial system toward addressing long-term sustainability concerns, by supporting an inclusive, job-intensive, and environmentally sustainable growth. Sustainable finance can help foster social cohesion and long-term macroeconomic stability, which are critical for a rapidly growing, manufacturing-led economy, with a relatively large, young population and with exposure to weather shocks and climate change vulnerabilities.

The monetary program for H2 FY17 takes into account the recent economic and financial sector developments and will target a monetary growth path aiming at keeping average inflation below 5.8 percent. The monetary program framework is based on the ceilings for broad money and reserve money growth of 15.5 and 14.0 percent, respectively. This is consistent with domestic credit growth within 16.4 percent and private sector credit growth within 16.5 percent by June 2017. These are indicative ceilings deemed sufficient to accommodate projected GDP growth target, even allowing for some unforeseen extra growth spurt.

Global Developments

Global growth is expected to pick up to 3.4 percent in 2017 and 3.6 percent in 2018, according the IMF World Economic Outlook Update, January 2017. Growth in emerging market and developing economies is expected to rise slightly in 2017 to 4.5 percent. Despite an improving outlook for the advanced economies, growth risks have increased reflecting policy uncertainties and implementation risks, accompanied by the balance sheet weaknesses in the euro area, geopolitical tensions in the Middle East and other parts of the world. In Asia, India's growth forecast for the current fiscal year has been trimmed by one percentage point to 6.6 percent, largely due to the negative spillovers on consumption and investment from the demonetization measures. China's growth forecast has been revised up to 6.5 percent in 2017, due to expectation of continued policy support but the risks of a sharper slowdown from rapid credit growth-related vulnerabilities remain elevated.

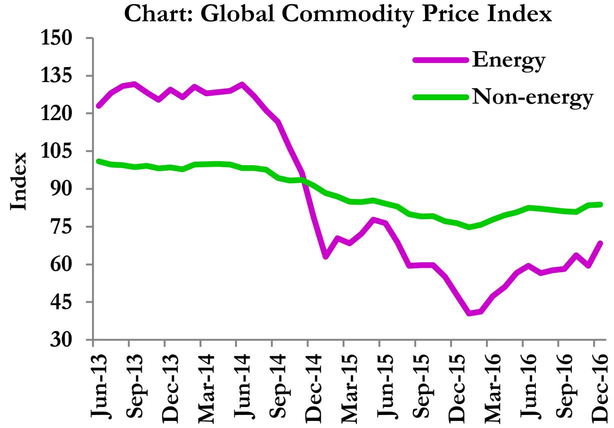
Table: Overview of the World Economic Outlook

GDP at constant prices	Percentage Change					Difference from October 2016 WEO Projection	
	Actuals		Estimate	Projections			
	2014	2015	2016	2017	2018	2017	2018
World	**3.4**	**3.2**	**3.1**	**3.4**	**3.6**	**0.0**	**0.0**
Advanced Economies	1.9	2.1	1.6	1.9	2.0	0.1	0.2
USA	2.4	2.6	1.6	2.3	2.5	0.1	0.4
Euro Area	1.1	2.0	1.7	1.6	1.6	0.1	0.0
Other Advanced Economies	2.8	2.0	1.9	2.2	2.4	-0.1	0.0
Emerging Market and Developing Economies	4.6	4.1	4.1	4.5	4.8	-0.1	0.0
China	7.3	6.9	6.9	6.5	6.0	0.3	0.0
India	7.2	7.6	6.6	7.2	7.7	-0.4	0.0

Source:World Economic Outlook Update (January, 2017), International Monetary Fund

According to the latest IMF and World Bank projections, global inflation is on an upward trajectory, edging up from their recent lows. Commodity prices are expected to rise in 2017,

Chart: Global Commodity Price Index



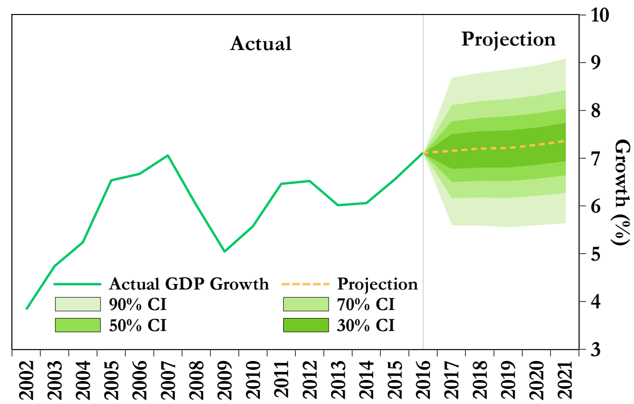
Source: World Bank

with oil prices increasing by over 20 percent, following a decline of over 15 percent in 2016. Non-energy prices are also projected to go up, reversing a decline of 3.1 percent in 2016. Inflation in Euro zone picked up in December 2016 on the back of surging oil prices, recording at 1.1 percent, nearly double the rate of 0.6 percent in November 2016 and the highest in more than three years. A projected fiscal stimulus in the US and narrowing excess capacity have increased the probability of a faster pace of monetary tightening in the US.

Economic Growth

Several indicators point to robust economic activity in the first half of FY17, aided by macroeconomic and political stability, and strong domestic demand. Private credit growth at around 15-16 percent is at a three-year high, with strong demand coming from trade, construction, and small and medium enterprise (SME) sector, which helps productivity and job creation. Medium and large-scale manufacturing industry also grew robustly. Export growth moderated but has held up relatively well (4.4 percent in December 2016), compared to peers and is expected to pick up. The buoyancy in activity is somewhat softened by

Chart: Projection of GDP Growth for FY2017 - FY2021



Source: Bangladesh Bank staff projection

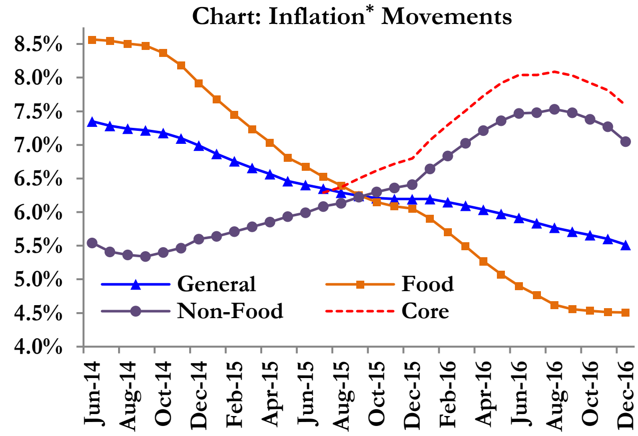
the decline in remittance. Based on the recent economic developments, BB's econometric model estimate, and sectoral analysis, growth is projected to be above 7 percent (7-plus) in FY17.

Looking ahead, the government's reform initiatives to improve the business climate and ease infrastructure bottlenecks, including by developing special economic zones, should help crowd in both private domestic and foreign direct investments that can create more jobs, raise productivity, and potential growth.

Inflation

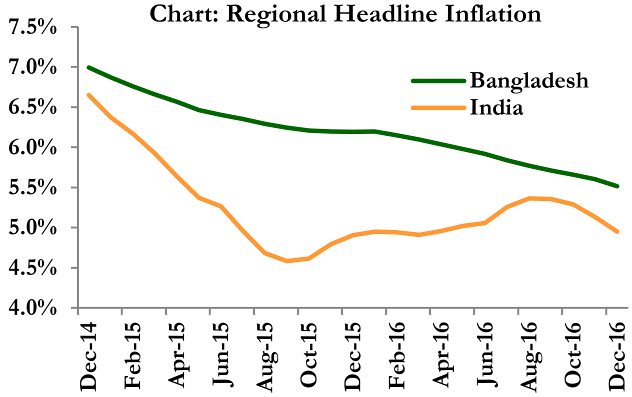
CPI inflation has been steadily coming down to 5.03 percent (point-to-point) in December 2016, pulling down annual average to 5.5 percent, benefitting from both favorable food and non-food inflation dynamics. Non-food inflation has eased to 4.5 percent (point-to-point) in December, down from 7.1 percent a year ago,

Chart: Inflation* Movements



Source: Bangladesh Bureau of Statistics , * Twelve Month Moving Average reflecting favorable domestic production and global commodity prices. Average core inflation (non-food, non-fuel), a traditional measure of underlying long-term inflation, has also nosed down but remains elevated at around 7.6 percent in December, indicating inflation can pick up if buffeted by adverse shocks.

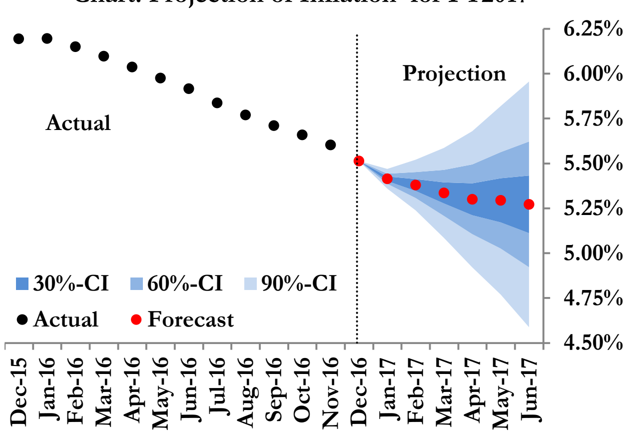
Chart: Regional Headline Inflation



Source: Bangladesh Bureau of Statistics; Reserve Bank of India

The inflation dynamics in the first half of FY17 reflects a confluence of factors like domestic output growth supported by inclusive financing, continuing moderation in global commodity prices, and BB's growth supportive yet cautious monetary stance. Looking ahead, the global commodity outlook suggests some upward price pressures may emerge from higher import prices.[1]

Chart: Projection of Inflation* for FY2017



Source: Bangladesh Bank staff projection , * Twelve Month Moving Average

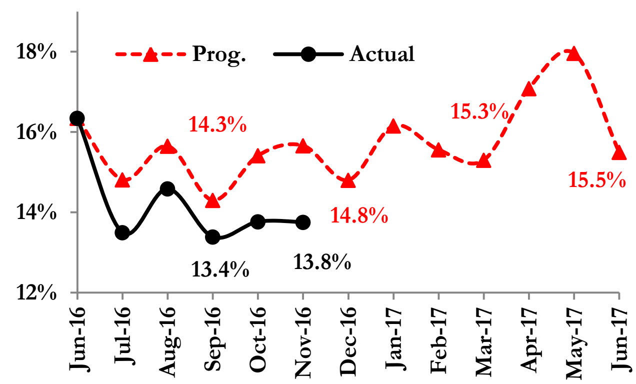
[1] Given the large weight of food items in the CPI basket (over 56 percent), inflation dynamics in Bangladesh significantly benefitted from the declining food prices. Ongoing staff research finds that, during 2000-2015, food inflation in Bangladesh has been twice as volatile as non-food inflation.

According to the BB's latest inflation expectation survey of December 2016, the one-year-ahead inflation expectation hovers around 6 percent, broadly unchanged from a year ago, implying a strong persistence in the way expectations are formed. Based on the BB's analytical models and the recent economic developments, average inflation is projected to be within 5.3-5.6 percent in June 2017.

Money Supply and Credit Growth

Available data indicate the key objectives of the monetary program and policies for the H1 FY17 are largely met. Broad money (M2) growth stood

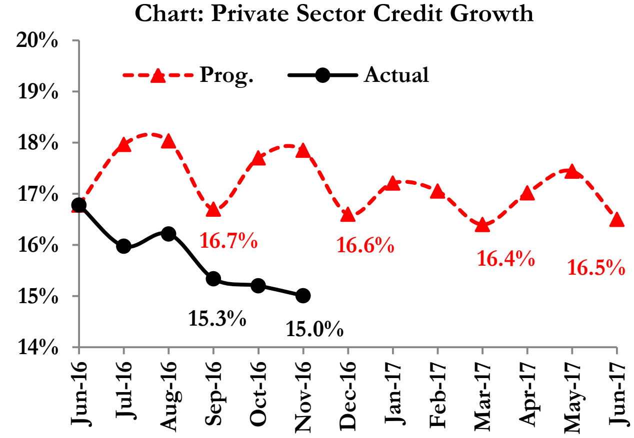
Chart: Broad Money (M2) Growth



Source: Bangladesh Bank

at 13.8 percent in November 2016, against the programmed ceiling of 14.8 by December 2016. Private sector credit grew by 15.0 percent in November. Credit to the public sector, however, has declined by 1.3 percent in November 2016,

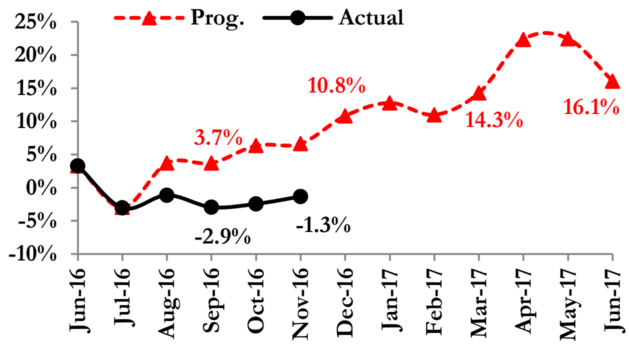
Chart: Private Sector Credit Growth



Source: Bangladesh Bank

far below the programmed ceiling of 10.8 percent growth. The government did not borrow from the banking system to finance the budget deficit (planned bank financing of budget at Taka 389 billion); instead, repaid outstanding loans to the

Chart: Public Sector Credit Growth



Source: Bangladesh Bank

tune of Taka 111 billion. Non-bank budget financing shifted from market-based tools (bank loans and government securities) to non-market instruments, e.g., National Savings Certificates (NSCs). It may be noted that, during July-November, 2016, net NSC sales, at Taka 203 billion, has already exceeded the full-year target of Taka 196 billion in FY17. Such large scale recourse to non-market borrowing is creating an environment stifling development of bond market, pension funds market and so forth.

Table: Monetary Aggregates (Y-o-Y growth in%)

Item	Actual		Program	
			Jul-16 MPS	Jan-17 MPS
	Jun-16	Nov-16	Jun-17	Jun-17
Net Foreign Assets	22.8	19.6	10.6	10.1
Net Domestic Assets	14.3	11.8	17.1	17.3
Domestic Credit	14.4	12.3	16.4	16.4
Credit to the public sector	3.3	-1.3	16.1	16.1
Credit to the private sector	16.8	15.0	16.5	16.5
Broad money	**16.3**	**13.8**	**15.5**	**15.5**
Reserve money	**30.1**	**18.5**	**14.0**	**14.0**

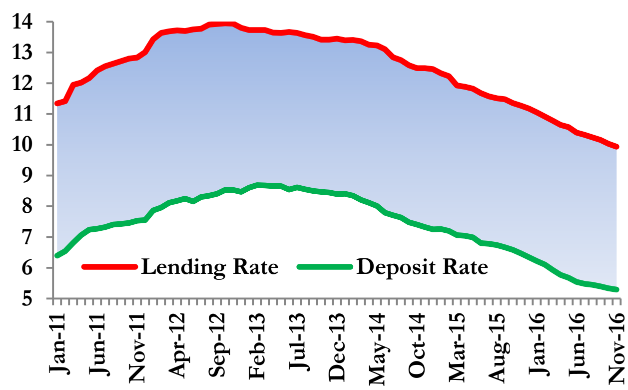
Source: Bangladesh Bank

In order to keep reserve money growth in line with the program path and prudently manage liquidity in money market, during the first half of FY17, Bangladesh Bank mopped up excess liquidity from the banking system through various monetary operations.

Policy Interest Rates

During June-November 2016, the average (weighted) lending and deposit rates have declined by 45 and 25 basis points to 9.94 and 5.29 percent, respectively, leading to a narrowing of average spread by 20 basis points to 4.65 percent. The decline in interest rates reflects favorable

Chart: Interest Rate Spread



Source: Bangladesh Bank

inflation performance, ample liquidity, and an increase in competition in the banking system. That said, the average figure masks significant variation within the banking system.

Although inflation has steadily declined in recent months, considering the fact that core inflation and inflation expectations remain elevated and inflation risks from higher commodity prices are on the upside, Bangladesh Bank's policy rates will be kept unchanged at the current level, with repo rate at 6.75 percent and reverse repo rate at 4.75 percent. However, policy rates will be reviewed on a continuous basis and can be changed promptly if needed.

External Sector Developments

During July-November 2016, the current account balance recorded a deficit of US Dollar 0.7 billion, down from a surplus of US Dollar 1.3 billion during the same period of the preceding fiscal year. Strong import growth (9.5 percent) coupled with a moderate growth in export (6.2 percent during July-November) and a slowdown in remittance inflows (-15.6 percent) contributed to the deficit. But, strong capital and financial account performance underpinned by net foreign

Table: Balance of Payments Highlights

In million US$

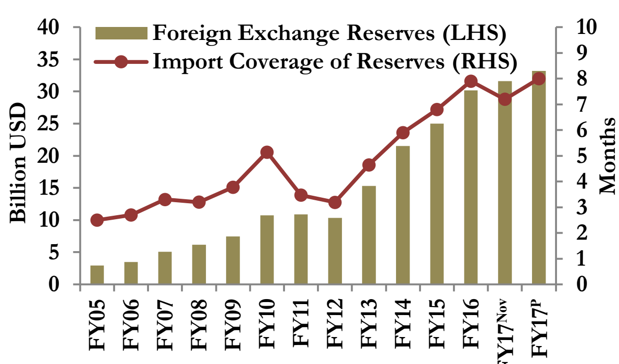
Major Items	Actual		Outlook
	2015-16	2016-17 Jul-Nov	2016-17
Trade balance	-6,274	-3,880	-7,570
Services	-2,793	-1,460	-3,653
Primary income	-2,582	-832	-2,856
Secondary income	15,355	5,446	13,512
of which: Workers' remittances	14,717	5,124	12,951
CURRENT ACCOUNT BALANCE	3706	-726	-567
Capital account	478	82	200
Financial account	894	2901	3242
Errors and omissions	-42	-354	0
OVERALL BALANCE	5036	1903	2875

Source: Bangladesh Bank, EPB and the Ministry of Finance.

direct, portfolio and other investments led to an overall balance surplus of US Dollar 1.9 billion during July-November 2016.

Export is expected to pick up, with improving growth outlook in some advanced economies. But this outlook is subject to substantial geopolitical risks and policy uncertainties in the US, UK, and euro area. Declining remittance would likely receive some support from the higher number of workers going abroad and the better economic prospects in the Middle East, aided by rising oil prices. Import is projected to remain buoyant, reflecting higher domestic demand, driven by both investment and consumption. Bangladesh

Chart: Forex Reserve and Import Coverage



Source: Bangladesh Bank, P=Projected

Bank projects the FY17 overall balance surplus at US Dollar 2.9 billion, which would help the reserve coverage to remain around 7-8 months of prospective imports of goods and services in FY17.

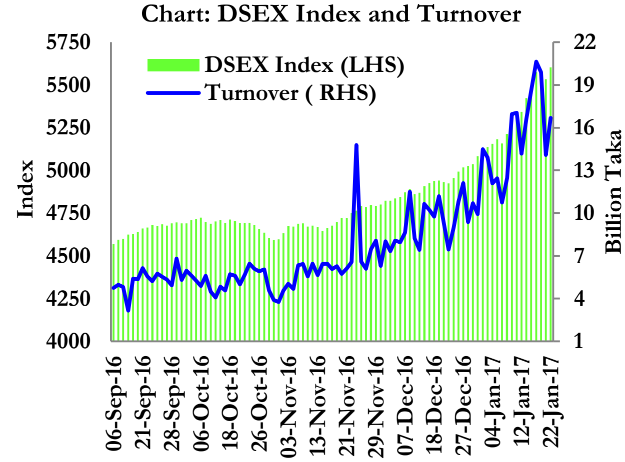
Since the adoption of flexible exchange rate regime in May 2003, BB has allowed sufficient flexibility in the exchange rate movements, while smoothing out large day-to-day fluctuations. After a prolonged spell of appreciation pressure on Taka, it is depreciating slowly against USD since October 2016, in line with the gradual erosion of BOP current account surplus.

While exchange rate remained broadly stable in the inter-bank foreign exchange market, Taka-Dollar exchange rate has recently moved by a larger margin in the kerb market, driven by a demand shock for cash dollar, in part stemming from Indian's demonetization measures. Bangladesh Bank has already initiated steps for ironing out impediments to the availability of cash USD notes in the banks.

Capital Market Developments

Capital markets are showing increasing buoyancy. After moving sideways in recent years, the Dhaka Stock Exchange Broad Index (DSEX) has increased by 23 percent and trading volume by 3 times since November 2016. Although stock

Chart: DSEX Index and Turnover



Source: Dhaka Stock Exchange

market capitalization in Bangladesh remains modest at around 15 percent of GDP, it can play an important role in financing long-term investments, as long as valuations reflect fundamentals and do not pose financial stability risks.

To ensure that capital market can finance long-term investment while exuberance remains rational, banks need to upgrade their surveillance of loan usages of their customer borrowings away from the intended purposes. BSEC has already taken some welcome steps with cautionary messages, financial literacy promotion, and so forth. Bangladesh Bank has tightened monitoring to ensure banks abide by statutory limits on their capital market exposures. Bangladesh Bank may also direct banks to prevent diversion of business and consumer loans into stock markets and remains ready to take prompt policy actions.

Monetary Transmission Mechanism

As witnessed in other emerging market economies, monetary transmission channels in Bangladesh will rapidly evolve during its middle income transitions. Ongoing staff research at BB finds that monetary policy has a lagged impact on inflation and that broad money growth and credit growth exhibited a relatively stable relationship with inflation in Bangladesh, with a lag of 4-6 quarters. But with growing external integration, monetary policy framework will need to pivot from money stock targeting toward interest rate targeting. Analytical work based on cross-country evidence to design the medium-term transition path for the monetary framework is already underway at the Bangladesh Bank.

A critical ingredient for an interest-targeting monetary framework is a well-functioning bond market that can help the short-term policy rate influence the longer-term interest rates. In this context, it is important to gradually rationalize various risk-free interest rates (e.g., rates of NSCs and government securities) and shift the composition of government financing toward the market-based instruments. Bangladesh Bank is also working with the Ministry of Finance to lengthen the maturity of the government securities yield curve to 30 years. A longer-dated yield curve would help long-term infrastructure financing by providing a risk-free benchmark for pricing.

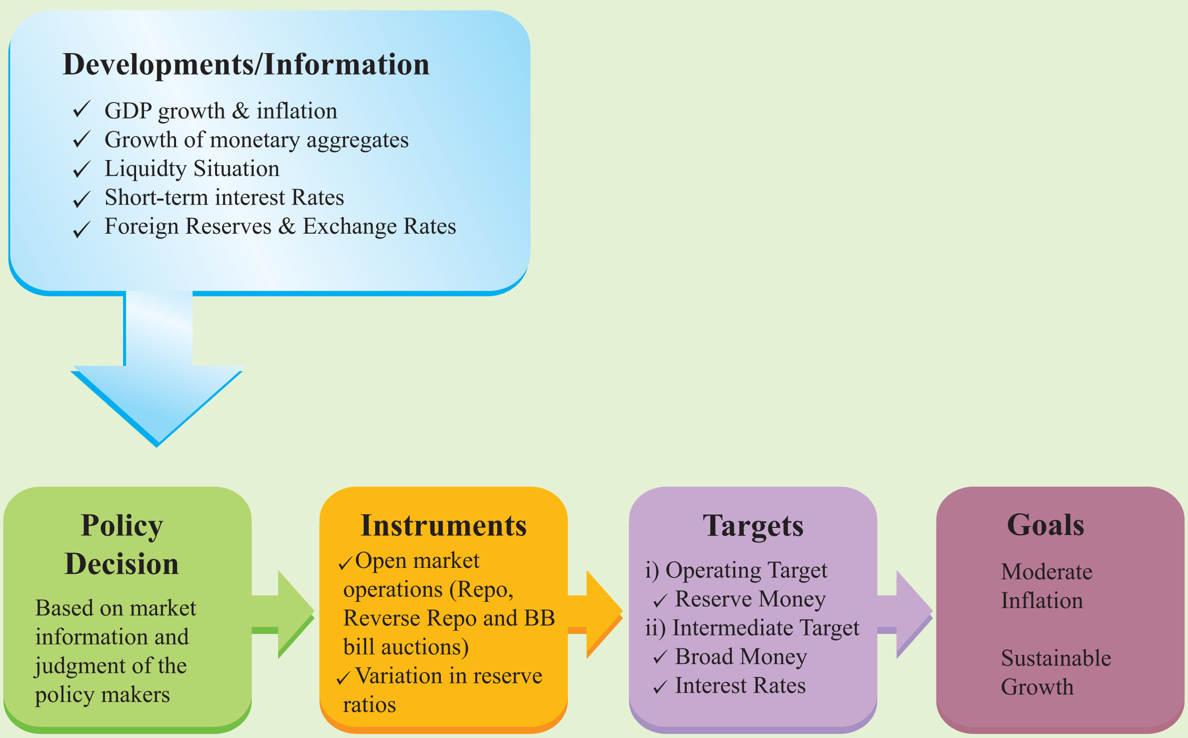
In addition to the above market development agenda, the quality of corporate governance affects financial intermediation efficiency and monetary policy effectiveness. High levels of NPLs weaken the transmission channel, by widening spread and by decreasing downward flexibility of lending rates. As witnessed in East Asia in the 1990s, lax corporate governance and risk management practices can complicate financial stability risks and weaken the quality of growth. To improve corporate governance, Bangladesh Bank is further strengthening its supervisory scrutiny, including by IT-based online supervision tools and placement of observers in banks with governance challenges.

Sustainable Finance

Bangladesh Bank has taken various initiatives aimed at ingraining a socially responsible financing ethos and mainstreaming financial inclusion initiatives. A strategic focus has been placed on nudging finance toward fostering social cohesion by devising policies to create a stronger base of the pyramid. Furthermore, given our population density and vulnerabilities to weather shocks and climate change, environmental sustainability is a central part of the national growth strategy. Green initiatives can also offer new growth opportunities, which are less subject to the vested interests of the existing sectors.

In line with government's SDG priorities of an inclusive, environmentally sustainable growth, Bangladesh Bank is for quite some years now promoting inclusive, green financing (targeting SME, agriculture and green initiatives), fostering financial sector wide a socially responsible financing ethos. Bangladesh Bank has now taken up a consultative initiative of formulating Guidance Notes on the do's and don'ts of socially responsible financing to better foster social cohesion, with output initiatives that promote entrepreneurship, create more and better jobs, and protect environment. Bangladesh Bank's sustainable finance agenda would benefit from a closer coordination among and monitoring of various initiatives, programs, financial institutions, including MFIs, that are already in place to serve the base of the pyramid.

Monetary Policy Framework



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