Monetary Policy Statement

January - June 2019

Bangladesh Bank

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UNITY, a sculpture by Hamiduzzaman Khan
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Monetary Policy Department and Chief Economist's Unit

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www.bb.org.bd

Table of Contents

Highlights

- The robust seven plus percent FY18 GDP growth momentum in H1FY19 remained strong, well supported by both domestic and export demand. The sharply widened FY18 bop current account deficit (from spiking flood damage related food grain imports and some big ticket investment related imports) moderated substantially in H1FY19, coming down towards sustainable levels.
- Inflationary pressures remained well contained in H1FY19. Aided by moderating food inflation from lower rice prices, headline CPI inflation (point-to-point) continued its declining trend, although non-food inflation, rising since early 2018, reached 4.51 percent in December 2018. Headline CPI inflation declined gradually to 5.35 percent in December 2018 from 5.54 percent in June 2018. Consequently, 12-month average inflation edged down to 5.54 percent in December 2018 from 5.78 percent in June 2018.
- BB's policy measures in FY18 (reducing CRR by one percentage point, repo rate by 75 basis points, and introducing repo tenors up to 28 days) eased liquidity tightening from the negative NFA growth due to the sharp widening of current account deficits. These measures helped avoid interest rates spikes. However, uptick in trend of core CPI inflation and the outcomes of BB's inflation expectation survey indicate persistence of inflationary pressures to confront on the path ahead.
- Balancing inflation and output risks, given the near-term domestic and global inflation and growth outlook and the associated risks, repo and reverse repo rates will be maintained at current levels of 6.0 and 4.75 percent, respectively, for H2FY19. The H2FY19 monetary program targets broad money (M2), domestic credit (DC), and private sector credit growth ceilings at 12.0, 15.9, 16.5 percent respectively, sufficient to accommodate attainment of real GDP growth and CPI inflation projections of the FY19 national budget (7.8 and 5.6 percent respectively).
- BB's usual support and promotion of adequate credit flows to job creating priority productive sectors will continue in H2FY19, including in MSMEs, agriculture, green transition of output practices, and entrepreneurship. Massive investment mobilization needed for realizing Bangladesh's aspirations for rapid high growth require rapid financial and capital market development, which in turn requires maintaining market based flexibility of Taka interest and exchange rates. The marked H1FY19 slowdown in private sector credit growth may largely have been from uncertainties in the run up to national election, but whether the recent rigidity in lending and deposit interest rates have also contributed (with high yield NSCs siphoning away much of household savings, causing growth slowdown in bank deposits bearing much lower interest rate) will be clearer in H2FY19. Addressing these issues, and bringing down banking sector NPLs by instilling strict lending and recovery discipline remain the key imperatives.

Monetary Policy Statement

The Second Half of the Fiscal Year 2019: January-June 2019

This Monetary Policy Statement (MPS) reports Bangladesh Bank's (BB) monetary policy stance for the second half of the fiscal year 2019 (H2FY19), as the second leg of its monetary program for FY19. As in the past, the monetary program and the monetary stance for H2FY19 have been formulated taking into account the actual outcomes of H1FY19, domestic and external developments, and feedback received from the stakeholder consultations with academics and policy analysts, current and former policymakers, the BB Board of Directors, real and financial sector representatives.

Monetary Policy Performance for H1FY19

The monetary policy stance pursued in H1FY19 supported robust domestic demand in line with the Government's growth target, while ensuring price and financial stability. A broad-based pick-up in economic activity continued in H1FY19, driven by robust domestic and export demand. Moderate private sector credit growth together with a rebound in exports and remittance inflows helped boost consumption demand. At the same time, aided by favorable financing conditions and fiscal policy supports, public and private investment remained buoyant. On the supply side, the growth momentum was driven by the industry and the service sectors and the recovery in the agriculture sector from the flood related output loss of the previous fiscal year.

During H1FY19, domestic credit growth gradually picked up, reaching 13.3 percent in December 2018 and supporting domestic demand, while remaining within the programmed target of 15.9 percent, as the pick-up in credit to the public sector (13.3 percent in December 2018 and above the programmed target of 8.6 percent) more than compensated the moderation in private sector credit growth to 13.3 percent. The private sector credit growth trajectory reflected a combination of demand and supply factors, including the base-effects of a five-year high growth in the previous fiscal year, the liquidity impacts from a negative net foreign asset growth (-0.2 percent in December 2018), some rigidity in interest rate flexibility, and the moderation of pre-election investment-related credit demand, as observed in most developing economies.

Moderate movement of monetary aggregates, with M2 and M3 growth at 9.4 and around 11.5 percent respectively in December 2018 which is close to or below the nominal GDP growth and the program ceiling of 10.2 percent M2 growth, supported price stability. The onset of the reversal of the sizeable current account deficit of FY18 (-3.6 percent of GDP) contributed to easing of the liquidity tightening cycle from the corresponding negative NFA growth (-4.2 percent in FY18). During H1FY19, the current account deficit benefitted from a moderation of import growth (5.7 percent in December 2018) from a peak of over 25 percent a year ago, favorable global commodity prices, and a pickup in export growth at 14.4 percent and remittance growth at over 8.0 percent. The improving current account dynamics and BB's policy measures, including foreign currency sales of around 1.3 billion US dollars (till January 27, 2019), helped avoid excessive volatilities in the foreign exchange market. The monetary policy actions in April 2018, along with the steady course of policy rates as laid out in the previous monetary policy statement, helped ensure adequate and well-distributed supply of liquidity in the financial system, with call money rates ranging between 2-4 percent in recent months. Monetary aggregates in line with the monetary program and favorable domestic and global food and energy prices facilitated to curb the inflation. Average (12-month) inflation moderated to 5.54 percent in December, 2018 in line with the Government's price objectives, although non-food inflation has steadily increased to 4.5 percent from the recent low of 3.5 percent a year ago.

Monetary Policy Stance for H2FY19

BB's monetary and financial policies, in line with the Government's medium- and long-term market development agenda and focus on achieving the SDGs by 2030, have long prioritized the government's inclusive and sustainable growth agenda, by fostering price and financial stability. These growth supportive policies aim at creating more and better jobs in environmentally sustainable production pursuits, through supporting micro, small, and medium enterprises (MSMEs) in the manufacturing, agriculture and service sectors. Monetary program for H2FY19 and the ongoing implementation of macro-prudential policies are aimed at providing adequate supply of quality credit to support the Government's growth and inflation targets, while promoting domestic and external financial stability amid the shifting global and domestic risk considerations.

Given the near-term domestic and global inflation and growth outlook and the associated risks, repo and reverse repo rates will be maintained at its current level of 6.0 and 4.75 percent, respectively, for H2FY19. The H2FY19 monetary program targets broad money (M2) and domestic credit (DC) growth ceilings at 12.0 percent and 15.9 percent respectively, sufficient to accommodate real GDP growth of up to 7.8 percent and contain average annual CPI inflation rate within 5.6 percent. Public sector borrowing, projected to grow by 10.9 percent, in line with the recent borrowing trends and well above the FY18 outturn of -2.4 percent, is expected to leave adequate space for private sector credit to grow within the FY19 target ceiling of 16.5 percent. Beyond the program targets, BB plans to continue regular monitoring of the banks' adherence to the ALM and Foreign Risk Management guidelines, which have helped banks' better align their lending behavior with their deposit mobilization. With a significantly lower import growth accompanied by a more favorable performance in exports and remittance projected for FY19, current account deficits and overall balance of payments are expected to improve, contributing to a reserve money growth of 7.0 percent in FY19.

The lessons from other developing and emerging markets show that monetary transmission mechanism critically hinges on the size and quality of the financial system, which affects how effectively any changes in the short-term policy rates transmit to the medium- and long-term interest rates faced by risk-free and risky borrowers in the banking system and in the capital markets. The transmission channel is therefore contingent of the two-way market flexibilities in both the interest rates and foreign exchange rates. As experienced by other emerging economies during their middle-income phase, improving monetary transmission mechanism goes hand in hand with increasing interest and foreign exchange rate flexibility, which are also preconditions for developing the markets and increasing the quality and quantity of investment financing that can create more and better jobs and support financial inclusion and external competitiveness.

Finally, the efficiency of financial intermediation is, inter alia, a function of NPLs, which at the current levels, on average raise interest rates by around 1 percentage point, creating a wedge between the deposit and the interest rates. BB's ongoing emphasis on implementing risk-based supervision and on upgrading banks' internal risk management practices and corporate governance would benefit from an effective implementation of the corporate insolvency regimes and increased efficiency in the judicial recourse. Furthermore, higher risk-free rates of NSCs are posing additional challenges for financial deepening and efficiency. Introducing a market rate-linked pricing of the NSCs along with a strict monitoring of the buyers' compliance with their limits will help monetary policy implementation and modernization.

Global Growth and Inflation Outlook

According to the latest IMF World Economic Outlook (January 2019), global growth has been revised down by 0.2 and 0.1 percentage points for 2019 and 2020 respectively (Table 1). The

Table 1: Overview of the World Economic Outlook

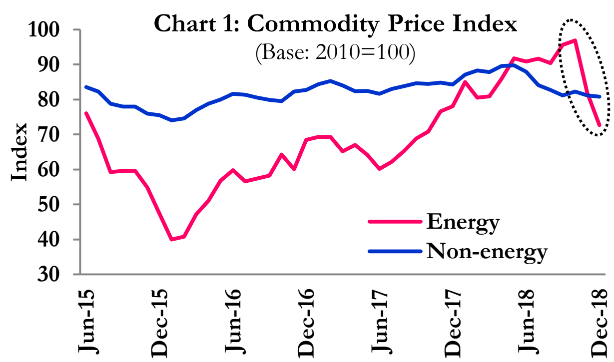
GDP at constant prices	Percentage Change				Difference from October 2018 WEO Projection	
	Actual	Estimate	Projection			
	2017	2018	2019	2020	2019	2020
World	**3.8**	**3.7**	**3.5**	**3.6**	**-0.2**	**-0.1**
Advanced Economies	2.4	2.3	2.0	1.7	-0.1	0.0
USA	2.2	2.9	2.5	1.8	0.0	0.0
Euro Area	2.4	1.8	1.6	1.7	-0.3	0.0
Other Advanced Economies	2.8	2.8	2.5	2.5	0.0	0.0
Emerging Market and Developing Economies	4.7	4.6	4.5	4.9	-0.2	0.0
China	6.9	6.6	6.2	6.2	0.0	0.0
India	6.7	7.3	7.5	7.7	0.1	0.0

Source: World Economic Outlook Update (January, 2019), International Monetary Fund.

downward revision reflected continued trade tension, tighter global financial conditions, and higher commodity prices, as well as a weaker outlook for some key emerging market and developing economies arising from country-specific factors.

Among the advanced economies, US growth steadily increased during 2017 and 2018, driven by the strong fiscal stimulus and is anticipated to moderate in 2019, partly due to the protective trade measures against the backdrop of a maturing business cycle (World Economic Outlook, January 2019). Growth performance for 2018 and the outlook for 2019 in the Euro Area are also anticipated to decline in 2018 and 2019 due to the Brexit and the recently adopted trade measures by the US administration. Among the emerging and the developing economies, China and a number of Asian economies are also expected to experience somewhat a weaker growth in 2019. However, India's growth rate is expected to rise from 6.7 percent in 2017 to 7.3 percent in 2018 and 7.5 percent in 2019, with some support from the structural reforms. Among the oil exporting countries, particularly the Middle East, growth received boost from higher oil prices, though price increases have sharply reversed since November 2018 from higher production. The ongoing trade tension could have some positive spillover on the Bangladesh economy through higher demand for the Bangladeshi readymade garments. The pickup in the construction activities in the Middle East from the high oil prices till October 2018 is expected to support labor demand from Bangladesh.

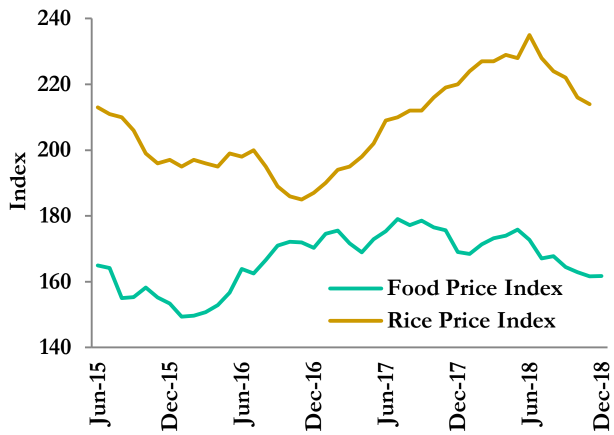
Global energy prices have sharply reversed during the last quarter of 2018. Since October 2018, crude oil prices declined by around 30 percent



Source: The World Bank.

from their recent highs, reflecting both supply and demand factors. Although given the regulated domestic fuel prices in Bangladesh, oil price decline would have less immediate impact on inflation but it would have positive impact on the current account dynamics. Similarly, global food prices have declined during the second half of 2018 when food production in Bangladesh has also picked up in the aftermath of the floods in 2017. Both global and domestic commodity prices therefore have favorably lessened the short- to medium-term inflation risks since the last monetary policy statement.

Chart 2: Food Price Index
(Base: 2002-2004=100)



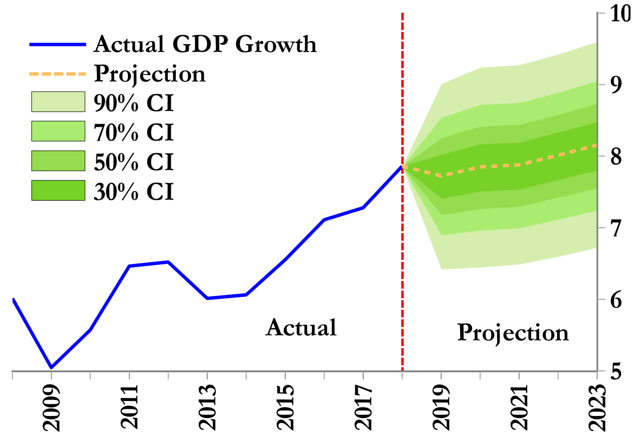
Source: Food and Agriculture Organization of the United Nations

Domestic Growth and Inflation Outlook

According to the final estimates of Bangladesh Bureau of Statistics, GPD grew by 7.86 percent in FY18, up from 7.28 percent in FY17, driven by strong domestic demand with support from robust credit growth, exports, and remittance inflows. Economic activities remained buoyant in H1FY19, aided by strong domestic demand, growth in remittance inflows at over 8.0 percent in December 2018 and a pick-up in exports (14.4 percent in December 2018). Government expenditure also supported domestic consumption and investment. Buyers' confidence in the RMG industry underpinned by improving workplace safety conditions, and external demand, including from the strong US growth momentum and the diversification of RMG orders away from China aided exports. Improved energy supply and political calmness also supported economic activities. In terms of the sectoral performance, monthly industrial production indices suggest strong growth at around 19 percent in Q1FY19.

The service and agricultural sector activities remained buoyant in H1FY19, supported by relative political stability and favorable climate. Based on the recent sectoral trends and econometric estimates, BB projects GDP growth in the range of 7.5-8.2 for FY19, assuming

Chart 3: Projection of GDP Growth for FY19-FY23

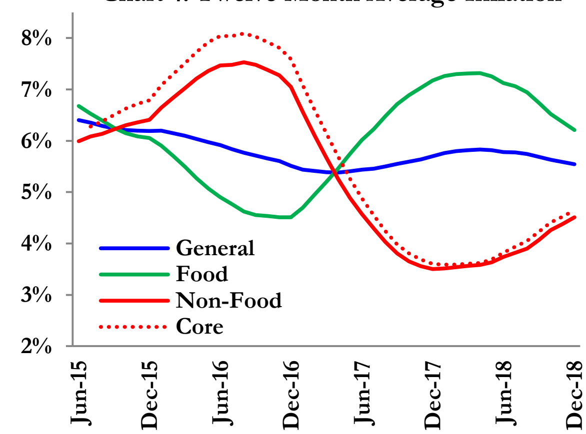


Source: Bangladesh Bank Staff Projection

continued political stability and no large external shocks (Chart 3).

Aided by moderating food inflation from lower rice prices, headline CPI inflation (point-to-point) continued its declining trend, although non-food inflation, rising since early 2018, reached 5.45 percent in December 2018. Headline CPI inflation declined gradually to 5.35 percent in December 2018 from 5.54 percent in June 2018.

Chart 4: Twelve Month Average Inflation

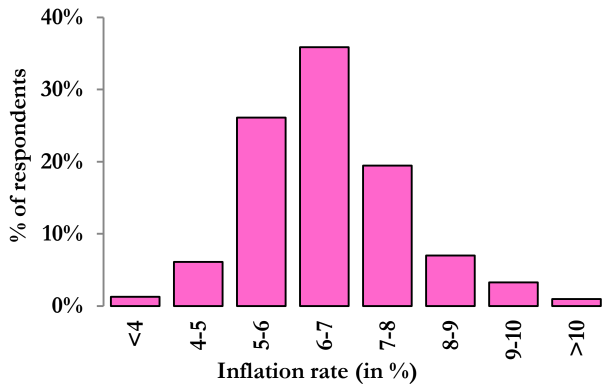


Source: Bangladesh Bureau of Statistics

Consequently, 12-month average inflation edged down to 5.54 percent in December from 5.78 percent in June 2018.

Looking ahead, there are mixed forces on the inflation dynamics. Global food and energy prices and favorable domestic production reduce inflation risks over the short to medium term. But core inflation, a traditional measure of gauging inflation pressure, steadily increased since December 2017 and reached 4.5 percent in December 2018, partly reflecting the base effects. Inflation risks are also reflected in the recent BB's inflation expectations survey. Expectation of one-year ahead average inflation is around 6-7 percent,

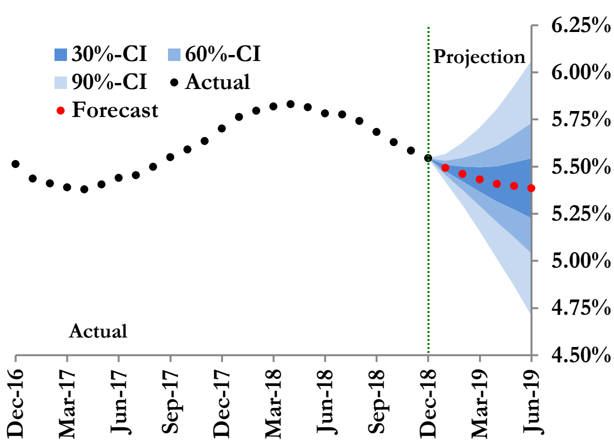
Chart 5: Distribution of Inflation Expectation*



* One year ahead general inflation
Source: BB inflation expectations survey, December 2018.

with around 70 percent of the respondents anticipating inflation to be above 6 percent (Chart 5). BB staff projections show average inflation to be around 5.3-5.6 percent in June 2019 (Chart 6),

Chart 6: Projection of Inflation for H2FY19*



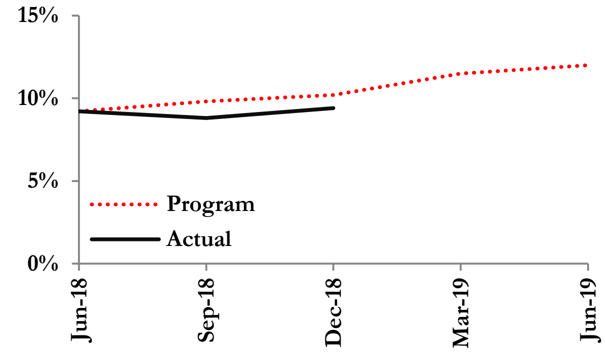
* Twelve Month Average
Source:Bangladesh Bank Staff Projection

assuming no further domestic or external shocks including a relatively favorable global inflation outcome.

Money Supply and Credit Growth

During H1FY19, most of the key monetary and credit aggregates remained broadly in line with the programmed paths outlined in the first Monetary Policy Statement for FY19. In December 2018, broad money (M2), domestic credit (DC), and

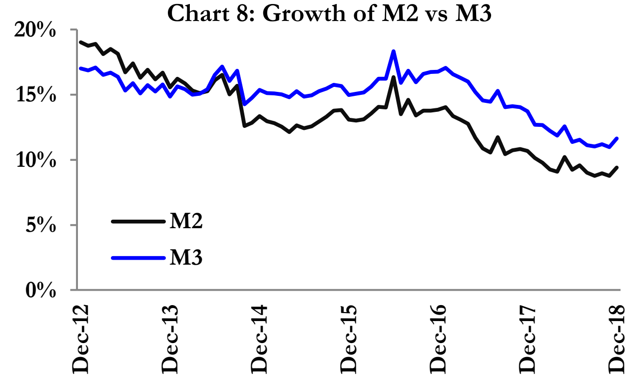
Chart 7: Broad Money (M2) Growth



Source: Bangladesh Bank.

reserve money, the key aggregates of monetary policy framework, grew by 9.4, 13.3, and 8.2 percent, respectively, remaining below or close to the program targets (10.2, 15.9, and 8.0 percent, respectively). M3, a broader measure of monetary aggregate that includes resources procured through NSCs, ranges around 11.5 percent,

Chart 8: Growth of M2 vs M3



Source: Bangladesh Bank.

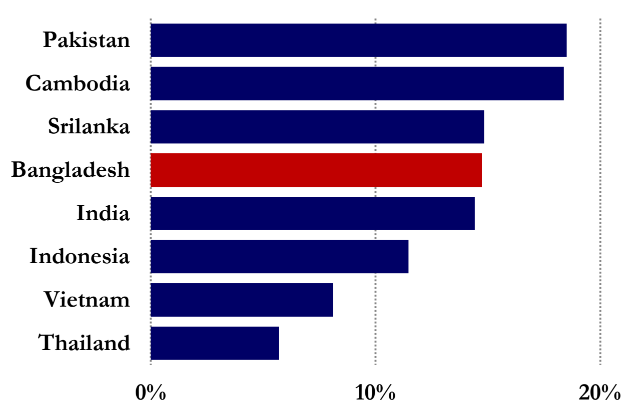
suggesting continued financial deepening. Put together, these outcomes of the aggregate anchors of the monetary policy helped moderate inflationary pressures, while supporting growth.

The moderating but still sizeable current account deficit also continued to exert a contractionary impact on the growth of monetary variables through net foreign assets, which shrank by 0.2 percent, less than the H1FY19 programmed target. Although private sector credit growth moderated to 13.3 percent in December 2018, down from a five-year high of over 18 percent in

H1FY18, credit flows into the productive sector remained adequate to support the Government's growth target, especially considering the additional credit supports by the micro-finance institutions and other non-bank financial institutions. In addition to the base effects, the moderation likely reflected some impact of the interest rate rigidity, and the phased investment demand and expectation of higher uncertainties in the run-up to the national election.

BB's focus on strengthening supervision to ensure quality credit growth and rationalizing advance-deposit ratio of banks along with asset-liabilities management, foreign exchange risk management helped banks better align their credit behavior with deposit mobilization. That said, based on the experience of the peer economies, private sector credit growth in Bangladesh remains adequate to

Chart 9: Cross-Country Private Sector Credit Growth



Source: Respective Central Banks' Websites, Latest Available Data.

support investment, growth and create more and better jobs (Chart 9).

In terms of the sectoral composition of credit available up to September 2018, the industrial sector received the largest amount of private sector credit (41.3 percent) followed by trade and commerce (33.6 percent), construction (9.4 percent), consumer finance (7.2 percent), and agriculture, fishing and forestry (4.6 percent). During Q1FY19, credit growth to the construction, trade, and industry sector remained buoyant (Table 2).

Table 2: Sectoral Growth of Private Sector Credit

(Y-o-Y Growth in %)

Major Industry Group	Jun-17	Mar-18	Jun-18	Sep-18[P]
Industry	18.3	26.0	23.5	17.3
Trade	16.4	12.7	11.1	12.6
Construction	20.2	17.7	19.8	20.2
Consumer Finance	4.6	5.4	9.0	7.5
Agriculture	9.9	14.8	12.6	8.3
Other	20.4	21.8	22.2	22.4
Total	**16.2**	**18.0**	**17.0**	**15.0**

Source: Bangladesh Bank. P = Provisonal

During H1FY19, as in the recent years, domestic financing of fiscal deficit has been met primarily through NSCs available on tap. But public sector credit growth picked up in H1FY19 and exceeded 13 percent in December, 2018 as the Government increased the pace of expenditure, with the emphasis on improving project implementation. Heavy reliance on the non-market instruments like NSCs significantly reduces the two-way flexibility of interest rates and complicates the monetary policy transmission channels. Market-rate linked rationalization of NSCs pricing accompanied by enhanced monitoring to ensure that NSCs reach the target groups and within the approved limits remains a high priority for market development and fiscal discipline.

To support investment and growth while managing inflationary pressures in FY19, domestic credit growth is programmed to increase by 15.9 percent. The table below summarizes the key monetary aggregates, outcomes up to December 2018, and projections for June FY19.

Table 3: Key Monetary and Credit Programs

(Y-o-Y growth in%)

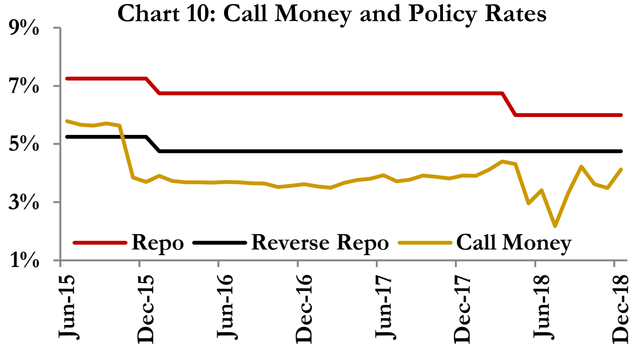
Item	Actual			Program
	Jun-18	Sep-18	Dec-18	Jun-19
Net Foreign Assets	-4.2	-1.9	-0.2	-3.4
Net Domestic Assets	14.2	12.6	12.6	16.8
Domestic Credit	14.6	13.0	13.3	15.9
Credit to the public sector	-2.4	0.5	13.3	10.9
Credit to the private sector	16.9	14.7	13.3	16.5
Broad money	**9.2**	**8.8**	**9.4**	**12.0**
Reserve money	**4.0**	**6.1**	**8.2**	**7.0**

Source: Bangladesh Bank

Policy Interest Rates

During H1FY19, Bangladesh Bank maintained the repo and reverse repo rates at 6.0 and 4.75 percent, after reducing CRR by 1 percentage point, repo rate by 75 basis points and increasing the repo tenors (7, 14 and 28 days) to moderate any sharp spike in liquidity pressures, given the segmentation of the financial system and the widening of current account and overall balance of payments deficits. Subsequently, liquidity pressures appear to have moderated, as reflected

Chart 10: Call Money and Policy Rates

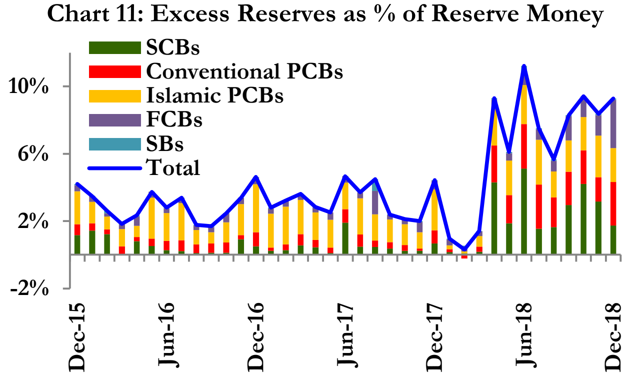


Source: Bangladesh Bank.

in the behavior of the call money rates ranging between 2.2-4.2 percent throughout H1FY19 (Chart 10).

The monetary policy actions in H2FY18 and the ongoing realignment of credit growth with deposit growth in the individual banks helped

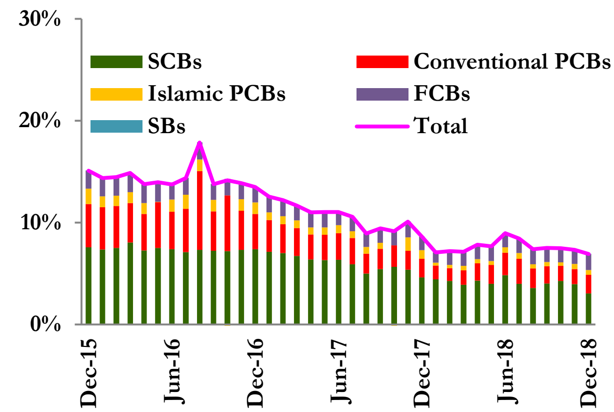
Chart 11: Excess Reserves as % of Reserve Money



Source: Bangladesh Bank.

with the stability of excess liquidity in H1FY19 (Chart 11). Furthermore, liquidity conditions as measured by the ratio of excess of SLR Assets to Total Demand and Time Liabilities (TDTL), often referred to as "excess liquidity" exhibited stability during H1FY19, after moderating steadily during the last three years (Chart 12).

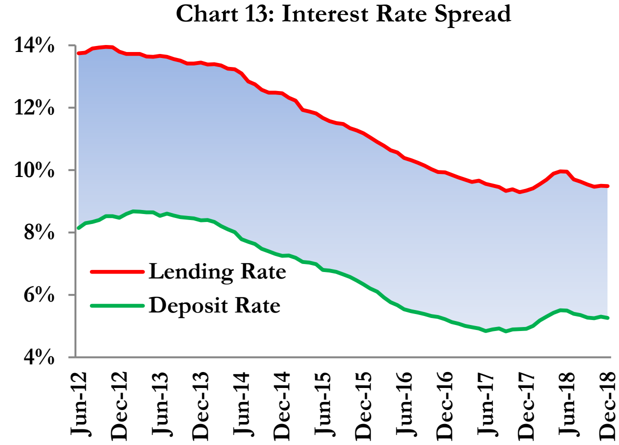
Chart 12: Excess Liquid Asset as % TDTL



Source: Bangladesh Bank.

Reflecting the prevailing liquidity conditions and moderating credit demand, weighted average lending and deposit rates slightly declined in H1FY19 to 9.49 and 5.26 percent, respectively,

Chart 13: Interest Rate Spread



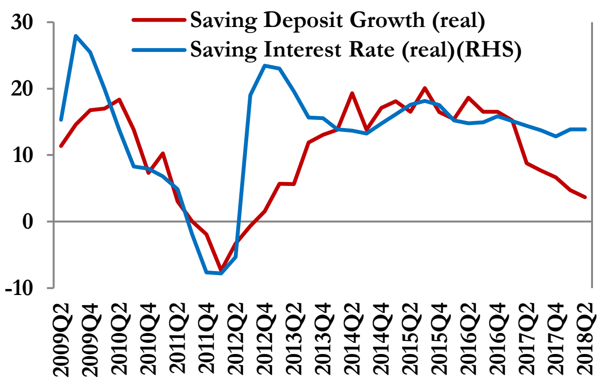
Source: Bangladesh Bank.

reversing the increases of the previous months and resulting in a respectable narrowing of spreads by 22 basis points (Chart 13). NPLs at around 11.5 percent in September 2018 contribute to 1 percentage point of the spread. Given the level of inflation in Bangladesh, the real deposit rates remained close to zero, which has implications for deposit mobilization and financial deepening. Interest rate flexibility that reflects the market forces is a pre-requisite for financial development and stability that can support growth and investment during the middle income transitions in Bangladesh.

Compared to the many high growth South and South East Asian economies, average real lending rates in Bangladesh remained adequately supportive for investment and growth. During Bangladesh's middle income transitions, lowering inflation and NPLs, and increasing banks' operational efficiency can help banks to sustainably reduce their lending rates, while improving their profitability and financial stability.

Financial deepening can significantly benefit from Bangladesh's relatively high national savings. Interest rates that are determined in line with the market forces and sufficiently compensate investor can help sustainable financial deepening. In Bangladesh, deposit growth has been closely linked with the level of real deposit rates (Chart 14).

Chart 14: Deposit Growth and Interest Rate



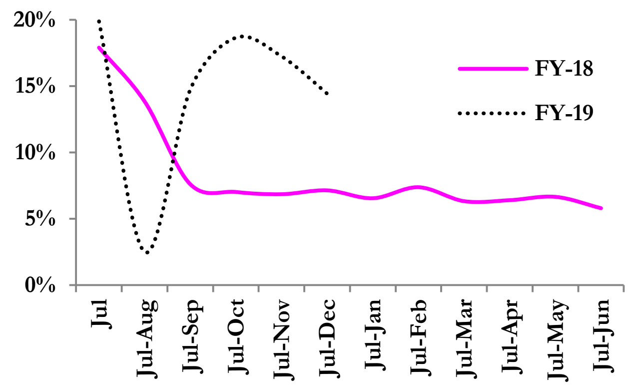
Source: Bangladesh Bank.

Balancing the inflation and output risks, in spite of improving liquidity conditions and moderating food inflation, BB has decided to keep policy rates unchanged at their current levels due to elevated inflation expectation, exchange rate pressure, and rising global interest rates. As in the previous policy cycles, economic and financial variables will be monitored on a continuous basis and policy rates may also be adjusted promptly as and when conditions warrant.

External Sector Developments and Outlook

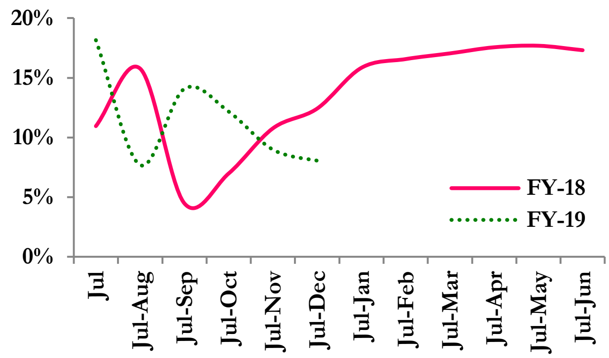
The FY18 current account dynamics was dominated by the strong import growth at over 25 percent, reflecting higher demand for investment goods, and the flood-related food imports in 2017, which resulted in a sharp widening of the current account deficit to around 3.6 percent of GDP and created foreign exchange pressures. During H1FY19, the current account deficit is moderating, driven by lower import growth (5.7 percent up to December, 2018) and strong export performance and remittance inflows (Chart 15 and 16). The moderation of import growth has benefitted from the tapering of one-off factors (e.g., food), favorable commodity prices, and the base effects following the sharp increase of FY18. RMG exports have registered a robust growth of 15.7 percent in H1FY19, owing to the strong demand from the advanced economies and some reallocation of demand away from China against the backdrop of escalating trade tension.

Chart 15: Cumulative Export Growth



Source: Bangladesh Bank.

Chart 16: Cumulative Remittance Growth



Source: Bangladesh Bank.

According to BB projections for FY19, robust export growth and moderation of imports are expected to continue, improving the current account dynamics. BB projects export growth at 14 percent, remittance growth at around 11 percent, and import growth at 7.5 percent in FY19. The projected import growth, considering the tapering of the one-off factors, favorable global commodity prices, and high base, would provide sufficient space to import capital and intermediate goods to support the growth momentum. Current account deficit is expected to moderate to below 2 percent of GDP, in line with the sustainable norm for an emerging market economy at Bangladesh's current phase of development. Higher exchange rate flexibility could provide additional support to the ongoing moderation of the current account deficit.

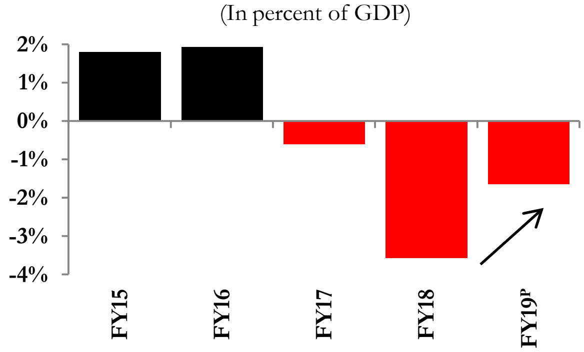
Table 4: Balance of Payments Highlights

In million US$

Major Items	Actual		Outlook
	2016-17	2017-18	2018-19
Trade balance	-9,472	-18,258	-17,274
Services	-3,288	-4,574	-3,534
Primary income	-1,870	-2,392	-2,723
Secondary income	13,299	15,444	17,143
of which: Workers' remittances	12,769	14,982	16,630
CURRENT ACCOUNT BALANCE	**-1,331**	**-9,780**	**-6,388**
Capital account	400	292	150
Financial account	4,247	9,076	5,672
Errors and omissions	-147	-473	0
OVERALL BALANCE	**3,169**	**-885**	**-566**

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

Chart 17 : Current Account Balance
(In percent of GDP)

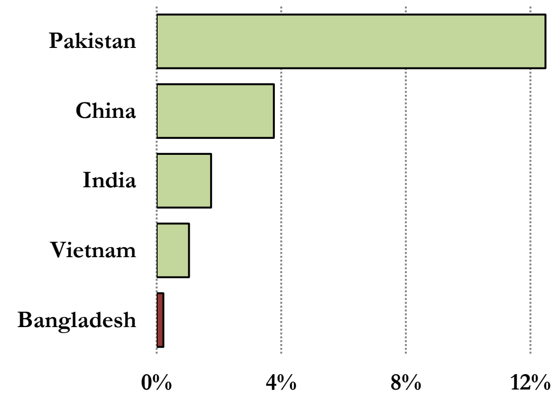


Source: Bangladesh Bank, P = Projected

Exchange Rate and Foreign Exchange Reserve

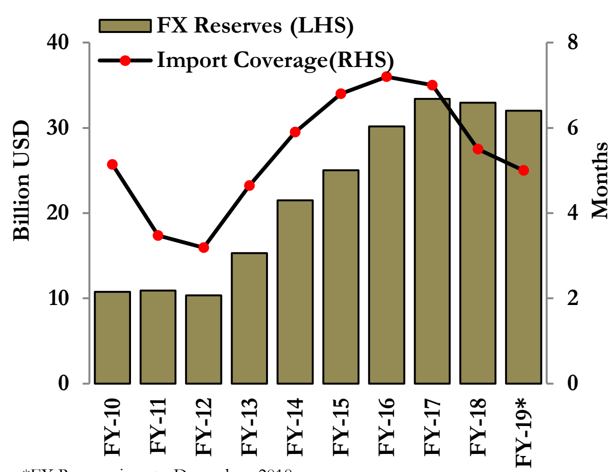
Reflecting the current account and overall balance of payment deficit, foreign exchange market faced some pressures in H1FY19, and Taka against US dollar depreciated by 0.2 percent during July-December 2018, a moderate level of depreciation relative to the peer economies (Chart 18). Forex reserves stood at USD 32.02 billion at the end of December 2018, from USD 32.94 billion in June 2018; reserve coverage of imports decreased marginally but remains broadly adequate at around 5 months of import (Chart 19).

Chart 18: Exchange Rate Depreciation During H1FY19



Sources: Respective Central Banks' Websites.

Chart 19: Forex Reserve and Import Coverage



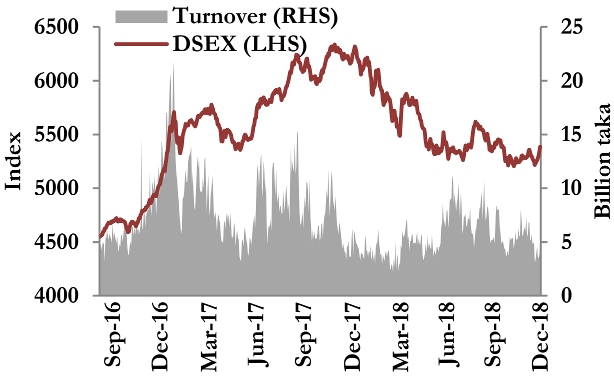
*FX Reserve is upto December, 2018
*Import Coverage is upto November, 2018
Source: Bangladesh Bank.

In line with the market forces, nominal exchange rate depreciated modestly by 0.2 percent as BB sold over USD 1.1 billion during H1FY19 to avoid excessive volatilities. During this period, REER appreciated by around 6 percent, largely reflecting the movements of US dollar against the major currencies. The strong performance of exports during this period attest to Bangladesh's competitiveness in RMG. Looking ahead, additional foreign exchange flexibility would likely be needed to ensure that exchange rates remain well-aligned with the fundamentals and market forces during the middle-income transitions. Furthermore, increased forex flexibility can play a supportive role in managing external stability and in fostering market development.

Capital Market Developments and Prospects

During H1FY19, amid higher trading volume, prices declined reflecting external and domestic factors. The daily average turnover increased to BDT 6.5 billion during H1FY19 from BDT 4.6 billion in H2FY18 (Chart 20) but DSEX index slid by more than 2 percent during H1FY19.

Chart 20: DSEX Index and Turnover

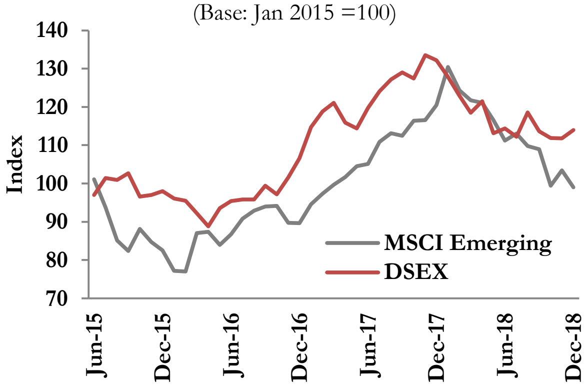


Source: Dhaka Stock Exchange.

Given Bangladesh's growing trade and financial integration and the increased participation of global portfolio investors in DSE, the price index of Bangladesh capital market closely tracked the movements in the global markets (Chart 21).

Chart 21: Synchronization of DSE with Global Markets

(Base: Jan 2015 =100)



Sources: Dhaka Stock Exchange and www.msci.com.

The DSE market capitalization remained around 20 percent of GDP at the end of December 2018. Bangladesh's relatively high national savings can support capital market development, with the companies shifting their long-term financing away from the banking system toward the capital market, accompanied by continued improvement in governance, technology and information disclosure.

Updates on Market Development and Monetary Management Initiatives

Bangladesh Bank has long prioritized various measures, initiatives, and programs to nudge finance to address the long-term investment needs of the society and by avoiding short-termism and risks that often jeopardized financial stability across countries. By promoting financial inclusion, creating more and better jobs (including in MSME, agriculture, and green initiatives) and protecting the environment remain critical for Bangladesh in achieving the Sustainable Development Goals by 2030 and in successfully completing the middle income transitions.

Looking ahead, sustained growth accompanied by economic diversification would also require the diversification of the excessively bank-centric financial system, which is less suited to meeting the longer-term financing needs of the economy during its middle income phase. As mentioned in the previous monetary policy statements, BB will continue to encourage banks to nudge their larger corporate clients to tap into the capital market (bonds and stocks) for longer-term financing. In this regards, the emerging signs of banks and corporates being rated by well-reputed rating agencies could catalyze the market development initiatives. Increased flexibility in the market-based pricing of interest and foreign exchange rates, as highlighted in the Government's financial sector priorities, would help deepen markets and increase the volume of savings intermediated through the formal financial system. Foreign exchange flexibility can deepen markets and help reduce foreign exchange risks by increasing the capacity to better absorb the external shocks.

During Bangladesh's journey towards being a developed economy, catalyzing the adoption of new technology in agriculture, manufacturing and in the service delivery in education, health and finance will be increasingly important for innovation, which can support the inclusive growth agenda. BB previously held dialogues with investors and startup entrepreneurs on how best to foster an finance ecosystem for the necessary risk capital, including through venture capital providers and angel investors. To foster and carry further this agenda, BB will be proactive to work with the capital market regulators and other stakeholders to provide a supportive regulatory framework for crowdfunding that can support MSMEs in the technology space, based on the best practice lessons from the regional peers in South and South East Asia.

Monetary Policy Implementation Challenges and Risks

Although monetary and credit aggregates (M2, DC) remain close to or well below the FY19 targets and inflation has been on a declining trends, inflation risks can emerge from strong domestic demand, elevated inflation expectations, and additional exchange rate flexibility needed to support external stability. It is important to note that interest and foreign exchange flexibilities are inter-linked in that one requires the other and both are pre-conditions for market development to facilitate the Government's goal of achieving the SDGs by 2030.

Market rate-linked rationalization of NSCs pricing remains an important priority for improving the monetary transmission channels, fostering fiscal sustainability and developing the bond market - public and private. Recent encouragement by the banks to the large corporates to rely on the capital market for long-term financing is a step in the right direction. Being rated by reputable credit rating agencies can help both banks and large corporates to improve competition, governance, and market access.

NPLs remain one of the key challenges of monetary transmission channels, making interest rates downward sticky and less sensitive to the monetary policy actions. Higher and more concentrated corporate leverage can also constrain monetary policy space and effectiveness. In this context, instituting appropriate debt resolution and bankruptcy procedures based on the lessons from relevant peer economies is critical. In order to achieve these goals, continued improvement in intensive and intrusive risk-based supervision that can help lower concentration risks and NPLs is needed for a more efficient monetary policy transmission mechanism.

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