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**Notes on the Monetary Policy Strategy
of the Bangladesh Bank**

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Notes on the Monetary Policy Strategy of the Bangladesh Bank

Executive Summary

Background: This document is designed to present a brief but comprehensive view of the real and monetary developments during the immediate past quarters and project the expected developments in the immediate future.

Monetary Policy Framework: It starts by articulating the monetary policy framework (in terms of the goals, the instruments, and the analytic channels of transmission) for greater clarity and transparency benefiting both the policy makers as well as the stakeholders. The appropriate monetary policy goal in the Bangladesh context is to achieve *price stability with the highest sustainable output growth*.

Growth Outlook: In view of strong consumer demand, agricultural growth, stable industrial growth, robust service sector growth, and the steady growth of remittances offsetting the deficit in the trade balance, the FY06 real GDP growth is expected to come in at the 6.3 to 6.8 percent range. However, it ought to be stressed that this forward looking analysis assumes a stable and predictable import regime (including the petroleum price behaviour), a stable exchange rate regime, adequate private sector credit flows, and the continuation of an appropriate cautionary (i.e., tight) monetary policy stance in light of inflationary pressures currently at play.

Sectoral Growth Outlook: An analysis of sub-sectoral growth rates suggests the overall growth for the agricultural sector is likely to be in the 3.8-4.3 percent range in FY06, the principal contribution coming from the crop sub-sector. It is also believed that industrial growth for FY06 would lie in a range of 8.0 to 8.5 percent, which is a shade lower than the 8.6 percent figure realised in FY05, but well in excess of the average recorded over the past five years. Further, the service sector in FY06 is expected to build on the past year's performance, and yield a growth rate of 6.5 to 7.0 percent. These sectoral growth projections are consistent with the overall growth predicted for FY06.

Inflation Outlook: Over and above the risks posed by the high price of crude oil and the consequent balance of payments pressure, there is the spectre of rising real interest rate in the global economy (led by the US) and the associated increase in the inflationary expectations in the industrial countries, the source of most of national imports. In the domestic scene, the possibility of another round of upward revision in the set of administered energy tariffs cannot be ruled out. On the positive side, however, in view of the bumper *aman* harvest, the food component of CPI is unlikely to register much further growth over the balance of FY06. Taking the above factors into account, and on the assumption that the tightened monetary policy stance will be maintained, the 12-month average inflation in FY06 is unlikely to exceed 7.0 percent.

Policy Stance: In view of the continuing inflationary pressure, the Bangladesh Bank remains vigilant as to the necessity of further monetary measures and shall also seek additional coordinating fiscal stance as may be warranted by developments in the real and monetary sectors of the economy. The overall goal will be to contain inflationary expectations, maintain currency stability and ensure smooth credit flow to the growth points of the economy in support of the targeted real output growth.

Notes on the Monetary Policy Strategy of the Bangladesh Bank¹

1. Introduction

The primary objective of the *Monetary Policy Strategy* document is to outline the formulation and implementation of monetary policy of the Bangladesh Bank (BB), and to convey its assessment of the recent and the expected monetary and inflation developments to the stakeholders and the public at large.

The Bangladesh Bank Order of 1972 outlines the main objectives of monetary policy in Bangladesh, which comprises the goals of achieving price stability, maintaining high levels of production, employment and economic growth. Since independence BB operated under a variety of pegged exchange rate systems amid capital controls.² In effect, the exchange rate served as a nominal anchor, with the ultimate goal of maintaining price stability. However, prices of non-tradable goods, given the latter's high share in national expenditure, dominated the inflation behaviour. Indeed the prevailing exchange rate during the 1970s and 80s remained mostly overvalued which was also accompanied by high (typically double digit) inflation.

The conduct of monetary policy in this period was based on direct control over various instruments, such as the volume and direction of credit and interest rates. In parallel measures such as administrative import allocations were needed in order to ration excess demand for foreign exchange. The external competitiveness of the Taka against the relevant trade weighted basket of international currencies came to be noticed from 1985 with the launching of the inflation-adjusted Real Effective Exchange Rate (REER) index. With the adoption of the Financial Sector Reform Program in 1989, the broader monetary policy stance gradually shifted towards indirect control of inflation accomplished by targeting monetary aggregates. Reforms led to the abandonment of directed lending and the gradual liberalization of the structure of interest rates.

The currency peg mechanism was abandoned on 31 May 2003 in favour of a floating exchange rate system. From this point on the market mechanism has been expected to maintain the exchange rate at its equilibrium level in view of evolving macro-economic fundamentals, which allows the monetary instruments to be focussed more effectively on the price and output goals. However short-term exchange rate stability remains a monetary policy objective. The switch of the exchange rate regime took place in an environment of balanced economic fundamentals, and despite some concern, the transition turned out to be rather smooth, and the par value of the currency remained relatively stable in the aftermath of the flotation.

With this brief account of monetary policy in Bangladesh serving as an introduction, the rest of the document proceeds as follows. Section 2 provides an elaboration of the monetary policy framework of the Bangladesh Bank, where the goals of monetary policy, the choice of target variables and their target levels, the choice of policy instruments, and an outline of the conduct of monetary policy are reviewed. The near-term outlook for domestic demand, external trade, price and exchange rate stability is taken up in section 3. A snap shot of the current and forward looking aspects of monetary policy stance in Bangladesh is presented in section 4. Finally a few concluding remarks are put forward in section 5.

¹ This document was edited by the Resident Economic Advisor on the basis of two briefs prepared by (a) Dr. Md. Habibur Rahman and Dr. Sayera Younus, and (b) Dr. Md. Akhtaruzzaman, Dr. Md. Habibur Rahman and Kabir Ahmed, respectively, all members of the Policy Analysis Unit (PAU). Extensive comments and suggestions from Governor Dr. Salehuddin Ahmed, Deputy Governor M. A. M. Kazemi, Dr. Shahabuddin M. Hossain, and Mr. K. M. Jamshed uz Zaman were most helpful. Additional contributions also came from PAU members Md. Shahiduzzaman and Mainul Islam Chowdhury.

² From January 1972 till August 1979, the national currency was pegged to just one currency, the pound sterling, at which point the pegging mechanism was switched to multiple currencies on a trade-weighted basis.

2. The Monetary Policy Framework of the Bangladesh Bank

Historically the Central Bank mandate in Bangladesh has been of a broad nature. The original Bangladesh Bank Order of 1972 that provided the founding charter cited (a) price, (b) exchange rate and (c) economic growth and high level of employment among the major goals.³ All three of these elements had been among the core objectives of most central banks of that epoch. Indeed the practice of monetary policy in Bangladesh has evolved along these guidelines without further discussion as to the mutual ranking of the goals. The amended Order of 2003 is even broader requiring the Bangladesh Bank (BB), among other, to “formulate” its monetary policy, and to formulate a foreign exchange “intervention policy”.⁴ The newer piece of legislation, literally interpreted, allowed an even greater freedom to the central bank in terms of the monetary policy formulation, but hints at a pro-active stance regarding the exchange rate management. However with the currency having been successfully floated on May 31, 2003, the market is expected to bring about any necessary adjustment in the exchange rate prompted by economic fundamentals. Consequently, the Central Bank is left with the residual responsibility to smoothen the *short-term volatility* in the exchange rate. It is interesting to note that the analysis of the interaction between monetary and fiscal policy was added as a major responsibility of the central bank in the 2003 amendment.

2.1 The Policy Target(s)

In this backdrop it is necessary that the monetary policy framework (in terms of the goals, the instruments, and the analytic channels of transmission) be articulated for greater clarity and transparency benefiting both the policy makers as well as the stakeholders. A policy regime, where the goals are transparent and their achievement verifiable, directly adds to the credibility of the central bank. A major objective of this document is to delineate such a framework.

Most industrial economy monetary policy is run with the task of keeping watch on both the *output gap* (i.e., the deviation of actual output from its long-run equilibrium level) and the *inflation gap*, which is similarly defined. In contrast, however, the challenge in the developing world is how to augment the capacity output through both productivity growth as well as via the installation of additional capacity. Faster growth in most developing contexts is necessary to reduce (and eventually eliminate) endemic poverty. Available evidence suggests that a low inflation environment alone may not allow the country to reach the poverty and output growth targets envisioned in the National Strategy for Accelerated Poverty Reduction (NSAPR) document approved recently (Govt of Bangladesh, 2005).⁵

Hence the appropriate monetary policy strategy in the Bangladesh context would be to achieve the goal of *price stability with the highest sustainable output growth*. Any monetary stimulus to foster growth must keep in perspective the broader goal of macroeconomic stability, which is a prerequisite for future growth. Price stability would also encompass the stability of the currency regime. While fiscal policy too is relevant in addressing these goals and thus there is a need for policy coordination, monetary policy must play its due role.

³ The original 1972 Order stated the broad objectives of the Bank: (a) to regulate the issue of the currency and the keeping of reserves; (b) to manage the monetary and credit system of Bangladesh with a view to stabilizing domestic monetary value; (c) to preserve the par value of the Bangladesh Taka; (d) to promote and maintain a high level of production, employment and real income in Bangladesh; and (e) to foster growth and development of the country's productive resources for the national interest.

⁴ The 2003 Order mandates the central bank (a) to formulate and implement monetary policy; (b) to formulate and implement intervention policies in the foreign exchange market; (c) to give advise to the Government on the interaction of monetary policy with fiscal and exchange rate policy, on the impact of various policy measures on the economy and to propose legislative measures it considers necessary or appropriate to attain its objectives and perform its functions; (d) to hold and manage the official foreign reserves of Bangladesh; (e) to promote, regulate and ensure a secure and efficient payment system, including the issue of bank notes; (f) to regulate and supervise banking companies and financial institutions.

⁵ Also note that Bangladesh is a signatory to the IMF's Poverty Reduction and Growth Facility (PRGF) compact, which mandates the country to target suitable growth, inflation and budgetary goals consistent with the timely attainment of the millennium development goals (MDGs).

While leading central banks in the industrial world have increasingly adopted the unitary goal of fighting inflation, interestingly Blinder and Reis (2005) have recently argued that in keeping with actual behaviour of the Fed, it will make sense for the US Congress to augment the FRS mandate by enumerating (a) the promotion of price stability, (b) ensuring full employment, (c) supporting global economic and financial stability (so long as the latter may be targeted without prejudicing the first two goals) as the chief monetary policy goals. In broad terms therefore the latter view is consistent with the BB vision as enunciated above, albeit anchored along different perspectives.

Inflation Target: It is the general wisdom that monetary policy tools are of immediate potency in controlling inflation. However contemporary evidence amply illustrates that monetary policy cannot deal well with the inflationary impact of external shocks such as the recent international price of oil and related energy products. Many central banks as a consequence focus on the *core inflation*, which is typically constructed by subtracting the most volatile components (e.g., food and energy prices, indirect taxes etc) from the consumer price index (CPI). The Bank of Canada argues that it is the core concept that better predicts the underlying price stability in the economy. Hence as a policy goal, core inflation may be a more credible target than CPI inflation. While there is no standard measure of core inflation in the Bangladesh context at this time, the construction methodology is made complex by two facts. First is that food items constitute nearly 60 percent of the CPI index, and while the appropriate commodity group weights may require a re-think, to ignore food entirely in defining the core inflation may render the construction a bit like ‘throwing the baby away with the bath water’. Secondly, in the Bangladesh context, the volatility of the international energy prices appear not to filter down to the CPI since the relevant domestic prices are subsidised by the state. Periodic adjustments in administered energy prices have always lagged the world market changes in both the time line as well as in magnitude often most dramatically.⁶ While it may be useful to focus on the non-food component of the index (which occupies only 41.6 percent of the full CPI) in order to gauge at the build-up of underlying inflationary forces in the economy, it would be unwise to treat this alone as a valid measure of core inflation.⁷

Agreeing with the view that a suitable *core inflation* measure ought to be the central focus, say something between the non-food CPI and the usual CPI, the question is where should the inflation target be set in the Bangladesh context? Note however that numerical targeting of inflation is not common in the South Asian region, which in part may be due to the lack of confidence in the true extent of the relevant transmission processes. However, *it is quite relevant to set an indicative target band that will be realizable over the medium term (say over the next 12-to-18 months’ time)*. Neither the analysis on the nexus between low inflation and growth, nor, the recent developing country experience provides a firm clue as to where to target the rate of inflation (IMF, 2005). However, it is widely held that in order for inflation to remain stable, it ought to be predictable, which in turn is extremely hard to come about if the actual rate is high (relative to its recent history). Low inflation is also believed to be pro-poor, as they possess few *real* assets. At the same time, many argue that a very low inflation may have unintentional contractionary output effects and lead to a loss of *seigniorage revenue*.⁸ Weighing various arguments, the above-cited IMF document recommends a single-digit inflation target for developing countries.

⁶ For the period of July 2004 to July 2005, the 12-month (point to point) CPI rose by 7.68 percent while the “fuel and lighting (along with rental) category” of CPI (with a significant weight of 16.9 percent) only rose by 5.24 percent. The latter pales in contrast with the increase in the international price of crude oil of over 50 percent over the same period. Energy subsidies of this scale have significant consequences on the government’s fiscal balance and beyond.

⁷ The Reserve Bank of India (RBI) appears to watch the wholesale price index, WPI, as well as the CPI (and the associated core measures of both) where the context is not too dissimilar as regards the energy subsidies, though not at the same scale. It is an urgent research agenda to come up with a well-thought out methodology for constructing a measure of *core inflation* relevant for Bangladesh, an index that would better predict the underlying inflationary pressures than would be indicated by the past behaviour of CPI.

⁸ It is standard to define the *seigniorage revenue* as the acquisition of real resources by the government by inducing private agents to hold greater real balances ($\Delta M/P$), where M and P denote, respectively, broad money and the price level. Note that we may write $\Delta M/P = [(M_t - M_{t-1})/P] = \pi_t + (m_t - m_{t-1})$, where the inflation rate at

As already noted, apart from the brief spell of volatility in the mid-seventies, inflation in Bangladesh has been moderate. This is particularly true for the 1990s, when inflation remained mostly in the single digit before falling further to just below 2 percent in FY01 (see Figure 4 below). Two forces tend to drive domestic prices at a faster clip than say in mature industrial economies, one of which arises from the gradual erosion of the nominal value of the national currency thereby boosting the price of tradable goods. The other element arises from the steady growth of income stimulating the price of non-tradables. Food prices appear to keep growing due to trade restrictions of various sorts as well as due to the growing market of processed food (e.g., canning) for both domestic and export markets. For these reasons it may be unrealistic to expect that inflation can be sustained at a very low level (e.g., 2 to 3 percent) as found in some mature economies.

Consequently, *the Bangladesh Bank may set its medium-term indicative mid-point target for a suitably defined core inflation at 5 percent (i.e., a band of 4 to 6 percent), which ought to allow enough flexibility to deal with a range of economic contingencies.* While the design of the suitable core rate is subject of further analysis, note that the current non-food inflation rate of 4.99 percent [as of October 2005 on a 12-month average basis, the point-to-point figure being 7.12], though on an upward trend, indicates that the less volatile component of the price index is well situated within the range of the proposed target band. The full CPI for the above period (at the average rate of 6.77 percent and 7.28 on a point-to-point basis) is on the high side. Accordingly, BB has just announced a further tightening of monetary policy by raising both the cash reserve ratio (CRR) as well as the statutory liquidity ratio (SLR) by one-half and two percentage points, respectively, to 5.0 and 18 percent effective October 1, 2005.

It ought to be emphasised that at this stage of the economic transformation of the Bangladesh economy, the growth strategy that the country is poised at is that of the export-led variety, and hence the real value of the exchange rate ought to be of concern. However as noted above, in a floating rate system, there is no question of a target band for the currency par value, and hence the orderly short-term adjustment in the exchange rate is a necessary accompaniment of the (export-led) growth (and hence poverty reduction) objectives. In order to maintain export competitiveness, one also has to keep an eye on the evolving pattern of sectoral productivity changes in the competitor countries. If inflation or productivity is allowed to slip, the subsequent depreciation in the par value of the currency will fuel further inflation, and one would end up in an un-winnable policy conundrum. However, as further discussed below, the pattern of the inflation-adjusted REER index against a trade-weighted basket of currencies of the nation's trading partners tracked by BB since the mid-1980s appears very stable, and is indicative of the continuing competitiveness of the par value of the Taka.

(b) Growth Target: So long as Bangladesh remains within the NSAPR-PRGF framework, the growth target is already built in there. The latter are based on the *medium term macroeconomic framework* (MTMF), which enshrines the mutual consistency of the monetary and fiscal policies of the nation. Annual updates of the growth and inflation targets, and hence the parameters of mutually consistent monetary and fiscal programs must be based on sound forecasts of the level of consumer demand, investment and the balance of payments (BOP). Only then can the subsequent design of the policy environment, and the requisite means for its implementation can be firmly grounded on reasoned hypotheses. One major constraint in this exercise is the current lack of timely data on macro indicators such as output, industrial employment, and investment. The central bank can play a major role by coordinating with other institutions (e.g., Bangladesh Bureau of Statistics, BBS, the Planning Commission and the Ministry of Finance) the on-going efforts to collect and process quarterly and monthly data on major macroeconomic variables.

2.2 Conduct of Monetary Policy

The consensus modern practice appears to favour a rule-based approach to the conduct of monetary policy. John Taylor (1998) defines a *monetary policy rule* very generally as a description of how the

time- t is denoted by π_t , and, real balances (M/P) at time- t is denote by m_t . This restatement highlights two sources of seigniorage; the first part is the *inflation tax*, i.e., the amount of additional fiat money required to keep real balances constant in the face of rising prices. The remainder is the public's desire to hold additional real balances given the inflation rate.

instruments of policy (e.g., a short-term interest rate) change in response to *target* economic variables. Thus Fed's recent behaviour, especially over the Greenspan era, whereby it routinely monitors the inflationary outlook (typically by examining the evolving pattern of a broad index namely the GDP deflator) and the expected output (by analysing labour market data, namely non-farm employment growth), and periodically decides to adjust the *federal funds rate* or to leave it unchanged, is an example of a monetary policy rule.⁹ For reasons that are well-known interest rate interventions are believed not to be the most direct of tools to influence the aggregate demand in a developmental setting as Bangladesh. The industrial sector demand for private capital would be interest sensitive, other things being equal. The investment climate (inclusive of institutional aspects as well as the tax regime) likely plays an important, if not the dominant role. However given that total private sector credit demand is roughly 70 percent of the total domestic credit delivery, the share of investment credit would be even smaller.¹⁰ Hence the monetary policy tools would be effective to only a part of the total credit. Even here though movements in the short-term interest rates that serve as the Bank's policy instruments, namely the *repo* and the *reverse repo* rates (see below), have little direct pass-through on to the spectrum of lending and deposit rates of commercial banks. Perceptions of high credit risk, non-market interest rates offered by government saving instruments, absence of secondary trading in public debt and the like are cited as reasons for the price rigidities (especially downward) in the financial system. Insofar as private saving and money demand behaviour are concerned, in light of the shortcomings in financial deepening, there are doubts whether the plausible magnitude of the respective interest elasticities are beyond the insignificant level.

Consequently the Bangladesh Bank puts greater reliance on monetary targeting focussed on the reserve money (RM, consisting of currency in circulation and the balances of other banks with the Bangladesh Bank), and thus via the money multiplier, on broad money, i.e., M2, which is the sum of currency in circulation, demand deposits and time deposits. BB programs the required limit of monetary expansion, broad money in this case, based on estimates of GDP growth, CPI and changes in the income velocity of money.¹¹ The simple relationship between broad and reserve money allows the latter to be used as an intermediate target, which is convenient since the policy instruments may directly target RM effectively. While the details of the instruments and modalities are described below, note that the essence of this approach is to routinely (indeed on a daily basis) monitor and influence the supply of liquidity in the private credit market that would be consistent with BB's judgement of the inflation and GDP outlook. However, the success of this strategy squarely depends on a good understanding of the underlying inflationary process and the GDP forecast built into the target money stock growth.

Lately the annual monetary program of the Bank and the fiscal program (i.e., the annual budget) have both been drawn up with reference to the MTMF cited above. Such coordination is expected to lead to greater stability in the policy stance adopted by each of the executing agencies, namely the Bangladesh Bank and the Ministry of Finance, respectively. In the Bangladesh monetary program, M2 was set to grow at 14.2 percent in FY'05 (i.e., to end June), but the actual provisional growth stood at

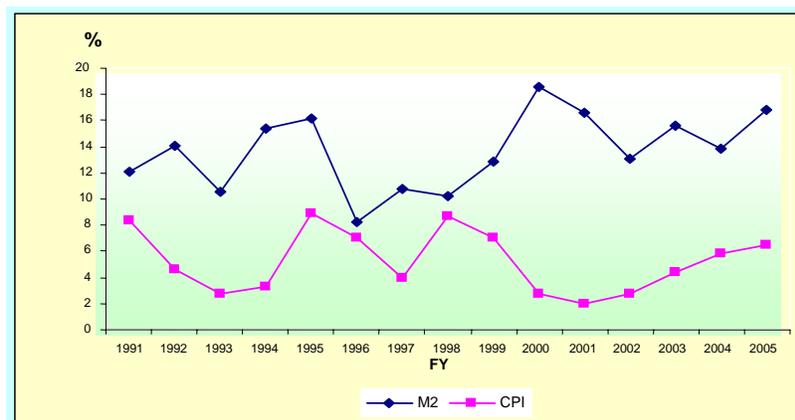
⁹ Recall though that the original rule proposed by Taylor (1993) actually calls for the Fed to adopt a given formula which would stipulate precisely by how much the short term interest rate would be changed in response to a unit change in the deviation of both output and inflation from their long-run levels. This formulation, widely known as the Taylor rule, assumes a constant growth of money stock. The formula of course will undergo revisions in the event of systematic changes in the money growth in response to changes in the interest rate and other variables.

¹⁰ Looking at July '05 over July'04 figures, it is seen that of the total growth of domestic credit of 225 billion taka, total private sector share was about 159 billion (Bangladesh Bank, 2005a). Then there is the Islamic banking component (between 13 and 15 percent of the industry) which is essentially outside the interest rate mechanism.

¹¹ The monetary programming idea can be usefully described by a simple minded growth relationship derived from the old quantity equation: $g_P = (g_M + g_v - g_Y)$, which states that the anticipated inflation rate (g_P) can be decomposed into the sum of the growth rate of broad money (g_M) and velocity (g_v) while netting out the growth rate of real output (g_Y). Broad money (M) may however be related to the operating target, the reserve money (RM), via the money multiplier (m), and in growth form one obtains: $g_P = (g_{RM} + g_m + g_v - g_Y)$. See IMF (2005) for additional details.

16.81 percent. Data for FY'04 shows that year-on-year actual growth had also been greater than the targeted rate (13.8 as against 11.9). The FY'06 currently projected broad money growth rate has been set at 13.5 percent, which is somewhat lower than the immediate past experience. The deviations of targeted money stock growth from the programmed level often indicate the inherent difficulty in strictly adhering to the program in view of shifts in money demand occurring due to financial innovations and due to evolving financial deepening.¹²

Figure 1: 12-month average growth rate of CPI and M2



Source: Constructed by Md. Shahiduzzaman of PAU based on annual data from BB as well as from the ADB website (Key Indicators, 2005)

The success of targeting broad money in order to control inflation is premised on the long-term equilibrium relationship between money and prices. While the subject calls for a detailed analysis, a brief look at Figure 1 suggests that even if the long-term co-movement of the two variables may appear stable, there are significant short-term deviations in such a relationship.¹³ The transmission mechanism between money supply and prices remain tenuous especially in the case of developing economies, and its further analysis is a topic of immediate policy interest.

2.3 Choice of the Monetary Instruments

Since monetary policy goals cannot be influenced directly, like most central banks BB uses a set of indirect instruments. As described above, the broad money (M) can be influenced indirectly by changes in policy instruments that target and monitor the reserve money (RM) via the money multiplier (m). The primary mechanism employed for this purpose is the direct control of liquidity on a day-to-day basis achieved by the *repo*, *reverse-repo* and the weekly T-bill auctions. The latter instruments would in turn have an impact on the *inter-bank call money rate* for overnight transactions, which is the equivalent of the federal funds rate in the US.

The cash reserve requirement ratio (CRR) and the statutory liquidity ratio (SLR) are effective means of announcing the monetary policy stance. In a tightening mode, BB adjusted CRR twice recently (in the third quarter of FY' 05, and again in the first quarter of FY'06, though effective from October 1, 2005). In the latter occasion the SLR was also raised to 18 percent. It is also noteworthy that the Bangladesh Bank has of late encouraged the activation of the inter-bank call money market instead of the reliance of commercial banks on the rediscount window the Central Bank.

¹²The monetary program data is taken from IMF and BB (Bangladesh Bank, 2005a). The FY'06 information is contained in GOB (2005).

¹³ An implicit assumption behind monetary targeting is the existence of a stable money demand function. Some doubt if the money demand function is stable in a developmental setting; however the Reserve Bank of India economists argue that the money demand function is indeed stable at least under recent Indian conditions (Reddy, 1999). While further research using modern estimation methodologies is highly warranted on this important topic, one also has to wonder about the question of the quality of available data.

As the time lag between policy actions and the eventual impact on goals is usually several quarters long, additional information variables such as foreign reserves, short-term interest rates, liquidity situation and domestic credit growth appear handy for policy makers to adapt and revise its policy measures if and as needed. No matter how sound is the monetary programme being pursued and its analytical base, the monetary authorities need to use their judgment deciding the future direction of the policy stance and communicate that rationale to the public.

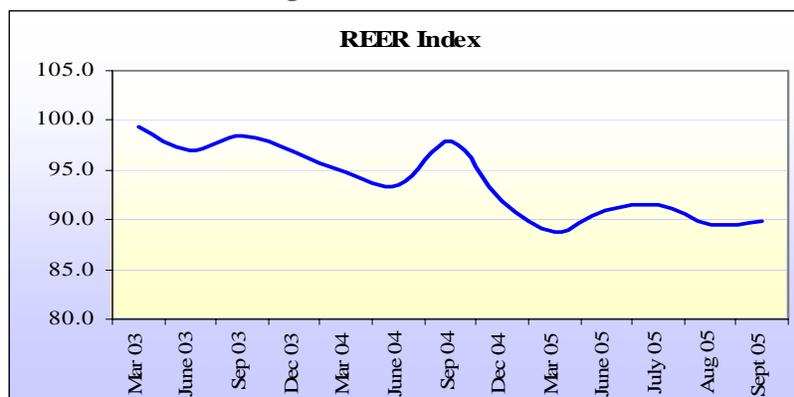
2.4 Exchange Rate Management¹⁴

Movement in the exchange rate has a direct effect on GDP and employment outlook especially through the export channel where the competitiveness of a country's goods depends on the REER. A misaligned rate structure may also lead to resource misallocation in domestic production.

Since the floating of the currency, the short-term currency management issue has come down to ensuring orderliness in the movement in the exchange rate due to temporary events. Toward this end, other than occasional direct intervention (buy/sell) in the currency market, the Bangladesh Bank also has in its toolkit the indirect instruments that can exert an influence on the par value of the currency. These relate to the control over liquidity via *repo*, *reverse repo*, and T-bill auctions.

Over the longer run, however, the primary exchange rate issue has to do with the real value of the exchange rate, namely the *real effective exchange rate* (REER). Fortunately, however, the inflation adjusted par value of the national currency has held up well against its competitors and the pattern has been stable, even depreciating a little during the past two-to-three years. To illustrate, the REER index of the currency stood at nearly 100 in early 2003 (indicating no over-or-under valuation); it has fallen to 90 in the current quarter, which represents a 10-percent depreciation rendering national exports more attractive. In the event of a persistent misalignment that is not being corrected by the market, the instruments at the disposal of BB are same as noted above.

Figure 2: The REER Index



Source: Monetary Policy Department, Bangladesh Bank

In keeping with these objectives, BB therefore articulates its concerns and views on the evolving pattern of both the anticipated temporary discrepancies in demand for and supply of foreign currency as well as on the pattern of REER. Brief statements on these accounts may be released to the media and the public in regular intervals, and of course, at other times should events so warrant. Anticipation of events is likely to make the eventual fluctuations more orderly as time and the risks actually unfold, and thereby render the Central Bank policies more effective.

This section has outlined the logic behind the monetary policy goals set by the Bangladesh Bank, and demonstrates how the multiple goals are being kept in balance by the design of policy tools. It should be stressed that in order to refine the understanding of the policy framework and the associated transmission mechanisms, rigorous empirical investigations need to be initiated on an urgent basis. Issues of the estimation of a stable money demand function in Bangladesh, an in-depth investigation

¹⁴ Adapted from Bangladesh Bank (2005b).

of money-inflation relationship, and the interest rate sensitivity of aggregate demand components (mainly private investment and consumption) need to be reviewed afresh. The absence of a smooth linkage between the short term rate setting targeted by the monetary policy tools and the broader credit market is also an area of further focus. In addition, the development of technical capability in modeling and forecasting the key macroeconomic variables is also crucial in formulating and analysing monetary policy effectively.

3. Macroeconomic Outlook for FY06

3.1 Outlook for Domestic Demand

The revised estimate of the real GDP growth (provisional) for FY05 has been put at 5.4 percent, which is significantly below the highest ever growth of 6.3 percent recorded in FY04. The shortfall is mainly attributed to the effects of the devastating flooding of July-September, 2004 on the agricultural output; indeed the total crop production fell by 3.3 percent in FY05 (against a positive growth of 4.3 percent in the previous fiscal year).¹⁵ The big surge in the international price of oil is also believed to have contributed to the diminished GDP growth. The government's latest revised projection of output growth for FY06 is, however, higher (6.5 percent) as discussed in MTMF which was prepared within the context of the Poverty Reduction Strategy Paper, NSAPR (GOB, 2005).

(a) Assessment of growth prospect in FY06: The October issue of the first ever *Monetary Policy Review* (Bangladesh Bank, 2005c) assesses the outlook for growth for FY06 to be in the range of 6.3 to 6.8 percent much in line with the MTMF expectation. This growth outlook implies a modest rise in domestic demand which will be significantly aided by higher expected growth in agriculture and the service sector, and also by robust growth of remittances offsetting the deficit in trade balance. Historically, the trade balance has detracted from the GDP growth. Analysis of the detailed outlook for private and public sector consumption spending, investment spending, and net trade is outlined below.

(b) Prospects for Aggregate Spending: Demand-side Outlook. Both export and import figures for July-September, 2005 period show a significantly decelerated pattern in a month-to-month comparison with the preceding fiscal year. For example, exports grew by 6.1 percent over the first quarter of FY06 vis-à-vis 24.7 percent in the same period of FY05, all figures measured in USD. The comparable figures for import growth (USD, C&F, though only for the July-August period), on the other hand, were 15.8 (FY06) versus 25.1 (FY05). However, the commodity composition of imports appears to be moving away from consumer goods. It is anticipated that the recent monetary policy stance will lead to a further decline in the growth of imports.

Remittance flows recorded a significant increase of 30.39 percent during July-August, 2005 over the corresponding period of the preceding year, where growth is much higher than the 14.77 figure obtained in FY05. These transfers are likely to remain robust in FY06 on account of technological advances, improved efforts by the formal channels to mediate transfer of funds from abroad, as well as higher anticipated growth in the petroleum exporting countries, which are among the major sources of these earnings. Hence one may predict a narrowing of the current account deficit, and thus on the overall balance of payments (BOP) in FY06, which would sustain the anticipated GDP growth. The remittance growth is also expected to boost aggregate consumption in the economy.

Domestic credit grew at an annualized rate of 16.5 percent during the first quarter of FY06, which is supportive of higher import growth as well as higher private investment. While looking at the growth picture of sectoral credit disbursement, agricultural credit disbursement registered a growth of 9.69 percent (provisional figure) during July-August of FY06 over the corresponding period of the preceding year. Further, household consumption spending is also expected to grow robustly in FY06 boosted in part by the steady growth of remittances.

Government revenue collection during the first quarter of FY06 recorded a strong growth of 14.8 percent over the corresponding period of the previous fiscal year which is very close to the yearly

¹⁵ Note that "crops and horticulture" occupied 11.5 percent share of GDP in FY 05.

targeted growth rate of 16 percent. In view of the administrative measures underway at the National Board of Revenue (NBR), it is anticipated that the current trend will continue which would support higher public sector spending capacity as well as public outlays in gross fixed capital formation. Sustained high international price of oil and the consequent borrowing forced upon the government remains a major element of downside risk in the above equation.

(c) Prospect for Sectoral Output Growth: Supply-Side Outlook

Agriculture: The MTMF embedded in the NSAPR document expects that the buoyancy in the overall agricultural sector growth, especially aided by the crops sub-sector and the fishing and livestock sub-sectors, will experience further boost. The recent projection of the Directorate of Agricultural Extension, Ministry of Agricultural (MOA), GOB, indicates a very strong rebound in FY06 after a dismal record in FY05. MOA expects agricultural growth to be led by expected bumper production of cereal products (12.63 percent), and particularly strong growth for all varieties of rice (12.07 percent). The major assumptions behind the higher growth projection of cereal products including rice are the adequate rainfall recorded in the current monsoon, and also higher public expenditure and higher credit disbursement for the agricultural sector. Furthermore, the quantum index for domestic fertilizer output also shows steady growth which again supports the expectation of higher agricultural growth in FY06. The higher cost of diesel for irrigation during the dry season however remains a possible element of downside risk affecting the yield of the *boro* crops.

Based on a detailed analysis of sub-sectoral growth rates, it is projected that the overall growth for the agricultural sector is likely to be in the 3.8 - 4.3 percent range in FY06.

Industry: Overall industrial output growth is estimated to have been 8.6 percent in FY05 which is 0.95 percentage points higher than that of FY04. This higher growth is partly due to the robust manufacturing activities in the fourth quarter of FY05. Available quantum index of industrial production (base of 1988-89) shows that the large and medium size firms have recorded a growth of 9.6 percent during July-May in FY05, which is consistent with the overall industrial growth pattern. Evidently, industrial growth is intimately connected with the export potential, where of course woven and knitwear products make up nearly 80 percent of total exports. The first quarter update for exports suggests a growth in value (USD) terms of 6.1 percent. One positive sign is the growing market share of knitwear products which so far has more than offset the relative decline in the export of woven products.

Industrial credit utilisation in the current fiscal year appears to be growing at a slower pace than in FY05. However, overall private sector credit has grown robustly by 3.43 percent during the first quarter of this fiscal year, which is actually slightly higher than the 3.25 percent growth registered in the corresponding period of FY05. A review of past behaviour indicates an element of seasonality in credit flows, which suggests a strong likelihood of faster growth later in the year. It must be noted however that while the first-quarter credit growth figure appears to be consistent with the revised FY06 monetary program of BB, given the high level of public borrowing from the banking system in the last few months, concern arises about meeting the needs of the private production sector. The issue is how to divert credit flows from the public as well as the household sector to the production sectors in agriculture, industry and services.¹⁶ The scope of the equity market is also of relevance here.

Overall taking these and related considerations into account the likely industrial growth for FY06 is expected to lie in a range of 8.0 to 8.5 percent, which is a shade lower than the 8.6 percent figure realised in FY05, but well in excess of the average recorded over the past five years.

Services: While a good part of the service sector activities remain structured around agricultural and industrial sectors of the economy (e.g., transportation, port and warehouse services tied to foreign trade), the newer and fast-growing components appear to be quite detached from the above nexus. The

¹⁶ The high and unsustainable public borrowing behaviour of the recent months is clearly fuelled by the continuing high price of petroleum products as well as the delayed release of funds by the development partners, which are subject to some conditionalities. While the second of the two may well turn out to be a problem of cash-flow mismatch, the former is a structural one engendered by the current government policy of the administered price regime.

latter examples would include telecommunication, computer and internet, education, financial intermediation, health care and the like. All of these sectors have grown faster than GDP over the past several years, and it is anticipated that this process will continue into FY06. Growth of investment in these sectors is indicative of future growth of the related service sub-sectors.

The expansion of the service sector share of GDP is also explained by the growth of urbanization as well as increasing activities in trade and commerce. The addition of retail space for domestic, commercial and foreign trade activities in response to buoyant demand is also indicative of continuing growth in these areas. All these developments show evidence of sustained activity in the growth points of the service sector in FY06, and collectively these units represents a major component of the service sector output.

It is therefore expected that in FY06, the service sector would build on the past year's performance, and yield a growth rate of 6.5 to 7.0 percent.

3.2 Outlook for Net Trade

As imports are expected to grow faster than exports, Bangladesh is likely to face further trade deficit in FY06. In fact, the first two months (July-August) of the current fiscal year compared with the corresponding period of the previous fiscal year were characterized by robust growth in the value of knitwear exports (19.6 percent), which was largely offset by a 9.1 percent decline in the export of woven garments. Total exports increased by 3.4 percent in the first two months of FY06 over the corresponding period of FY05, much in line with the overall performance of the RMG sector. However, the revaluation of China's currency (RMB) by 2.1 percent against USD on July 21, 2005, and the continuing pressure on China to further revalue its currency are likely to have a favourable effect on Bangladesh's RMG exports in FY 06. The Chinese case has been further weakened by trade restrictions being enforced both by US and EU. Despite stiff global competition, in view of the continued expansion into US market, growth in RMG exports is expected to remain healthy in FY06.

Growth in imports is expected to continue to be robust in FY06, having already grown by 20.6 percent in FY05. Indeed during the July-August 2005 period imports grew by 15.8 percent. For example, food grain, POL, capital machinery, fertilizer, oil seeds, iron and steel grew by 67, 83.3, 36.5, 200, 336 and 52 percent, respectively, during this period. Given the crop forecasts, import of food grain is expected to moderate significantly. Price of crude oil in the international market signals a downward trend, declining from \$70.85 per barrel on September 4 to \$59.56 per barrel on October 26, 2005. Nonetheless, the continuing high cost of POL has contributed to the pressure on the current account balance (as well as on the domestic fiscal balance) in FY06. High growth of capital machinery appears to continue in FY06 in view strong demand from sectors such as RMG, telecoms and power generation. In view of the modest growth of exports, trade deficit is likely to be further widened in the new fiscal year. However, since the current account balance is greatly influenced by inward remittances, strong growth in the latter is expected to narrow the current account balance deficit in FY06.

Summing up the outlook for aggregate demand, the October issue of MPR expects the FY06 real GDP growth to be in the 6.3 to 6.8 percent range (Table 1). The chief elements contributing to the higher growth in the current fiscal year include a strong rebound of agricultural output (mainly the crop sub-sector), steady RMG (particularly knitwear) exports and a robust growth of remittances. However, it ought to be stressed that this forward looking analysis takes for granted that the Bangladesh Bank will succeed in running an appropriate cautionary (i.e., tight) monetary policy stance in light of inflationary pressures currently at play without unduly depriving the private sector of the credit support it would need in order to meet the growth target.

3.3 Exchange Rate Outlook

The foreign exchange market in Bangladesh witnessed a continued depreciating pressure on the nominal exchange rate. The Taka-Dollar exchange rate increased from Tk.60.50 in July 2004 (weighted average) to Tk.63.79 on July 2, 2005 in the inter-bank market reflecting about *five* percent depreciation. The rate fell to Taka 65.75 per USD on October 25, 2005 resembling a further *three*

percent depreciation in the first four months of FY06. The weakening trend of the nominal exchange rate however has not affected the REER index one way or the other (Figure 2). The distance between the unofficial and the REER based rates has been stable over the past six months or so (Figure 3).

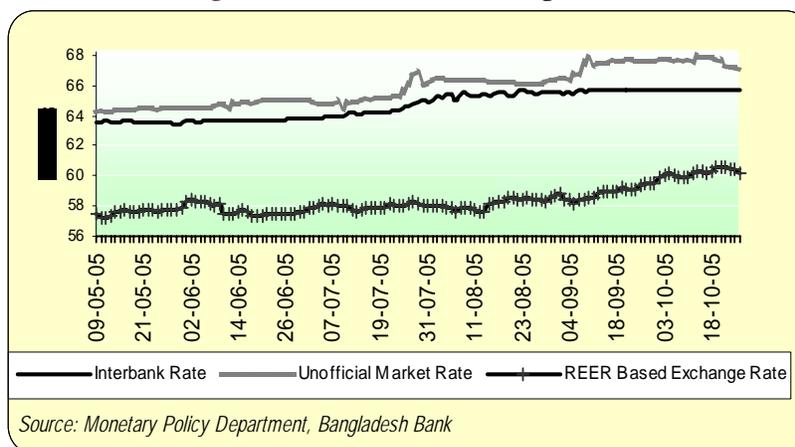
Table 1: FY06 GDP Projection

Sector	GDP Share in FY05 (%)	Average Growth FY00-04 (%)	FY05 Growth (%)	FY06 Growth Projection Range	
				Low	High
Agriculture	21.9	2.12	0.3	3.8 (0.83)*	4.3 (0.94)*
Industry	28.4	7.48	8.6	8.0 (2.27)*	8.5 (2.41)*
Services	49.7	5.72	6.6	6.5 (3.23)*	7.0 (3.48)*
Overall GDP	100.0	5.34	5.4	6.33	6.83

*Numbers in the parenthesis indicate sectoral contribution to overall GDP growth.

Given that the structural shortfall in merchandise exports over imports will take time to correct itself (i.e., allowing for exports to grow sufficiently and/or the oil price to come down significantly), it is plausible that the recent weakening of the currency to persist well into FY06. However in view of prospective performance in the leading export sectors along with the visibly healthy flow of workers' remittances, it is anticipated that any further weakening of the currency to be both orderly and moderate in magnitude.

Figure 3: Movements in Exchange Rates



3.4 Price Stability

(a) Recent Behaviour of Inflation: Historically Bangladesh has experienced a moderate (i.e., single-digit) and more or less stable price situation since the late 1980s.¹⁷ The rate of inflation remained below 5 percent from 1991 to 1994. Food grain shortages and political turmoil together triggered the rate to rise above 6 percent in 1995. Although severe floods occurred in 1998-99, the country managed to escape much of an inflationary shock due to bumper crops, an efficient distribution mechanism, and pragmatic macroeconomic policies. The inflation rate fluctuated within the 2-5

¹⁷ Events such as the post-independence reconstruction, deficit spending, periodic floods/droughts, political unrest, and disruption of transportation and distribution network caused price instability at various points from the 1970s to till mid-80s.

percent range during the 2000 to 2004 period. The historical trend of inflation during FY83-FY05 is depicted in Figure 4.

Consumer price inflation however continued to show an increasing trend during FY05. While the 12-month point-to-point CPI increased from 5.6 percent in FY04 to 7.4 percent in FY05, the 12-month average movement indicated a more moderate increase from 5.8 percent in FY04 to 6.5 percent in FY05. These figures moved to 7.3 and 6.8 percent, respectively, in October'05. The recent increase in the price level has been mainly due to increases in the price of food items, petroleum and other imported products. The point-to-point food price inflation stood at 8.7 percent in June 2005 up from 6.6 percent in June 04, and reached 9.4 percent in August before moderating to 7.4 percent in October'05. The comparable pattern of non-food prices were 4.3, 5.3, and 7.1 percent, respectively at the end of June'04, June'05 and October'05 (Figure 5).

Figure 4: Inflation Rate (12-month CPI average)

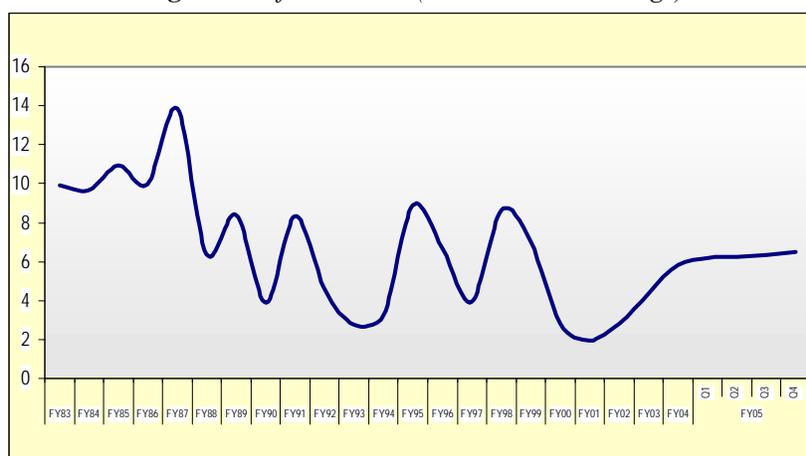
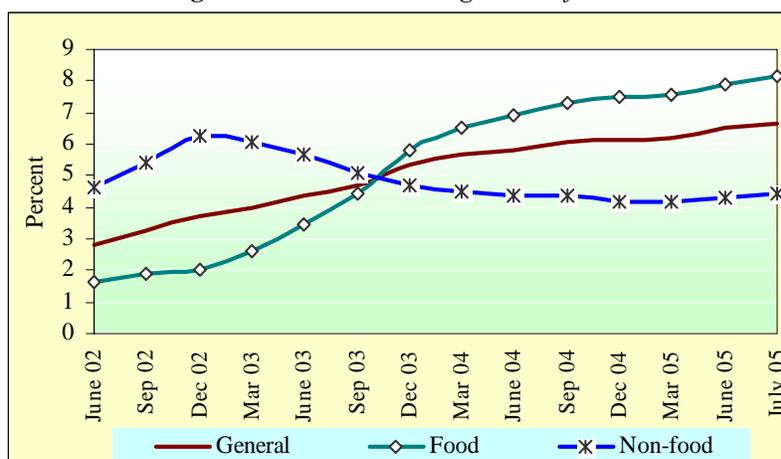


Figure 5: 12-Month Average CPI Inflation

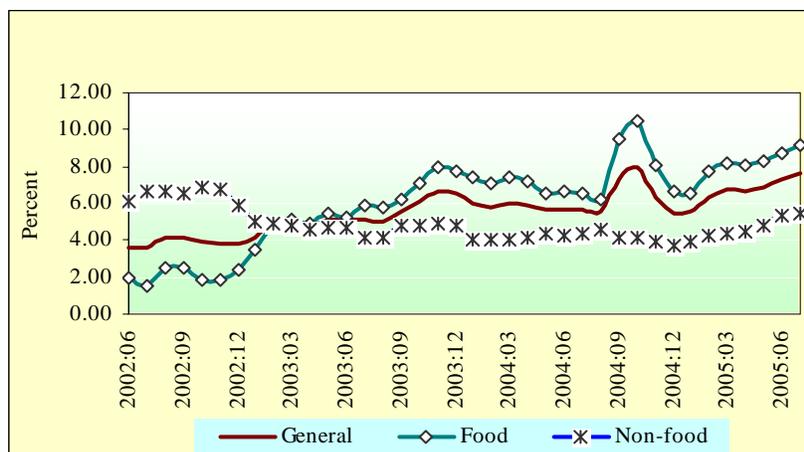


The 12-month average food prices, on the other hand, increased by 7.9 percent in FY05 compared with the 6.9 percent increase in FY04, while the non-food component increased at a much slower rate of 4.3 percent in FY05 compared with the 4.4 percent observed in FY04. The 12-month average food and non-food price indices rose respectively at 8.0 percent and 5.0 percent in October'05 (Figures 6).

(b) Near Term Outlook for Inflation: Globally inflation in 2005 has been showing an increasing tendency due mainly to higher energy prices in the international market. Direct inflationary effects of the oil price increases have been limited in Bangladesh due to the incomplete pass-through in view of the government's policy of administered retail price of petroleum products in the domestic market.

However, increased prices of imported goods combined with the rise in import prices due to the currency's nominal depreciation also fuelled inflationary pressures in the economy. It is worth noting that high food price in the pre-harvest season as well as the upward, even if moderate, adjustment in the administered energy prices explain most of the current bout of inflationary pressure.

Figure 6: 12-Month Point-to-Point CPI Inflation



The continuing risk elements include the possible consequences of excess public borrowing, the weak currency markets, and the possibility of another round of upward revision in the set of administered energy tariffs, each of which adds another dimension to the inflation build-up. Then there is the spectre of rising real interest rate in the global economy (led by the US) and the associated increase in the inflationary expectations in the industrial countries, the source of most of Bangladesh imports. On the positive side, however, in view of the bumper *aman* harvest, the food component of CPI is unlikely to register much further growth over the balance of FY06. Taking these factors into account, and on the assumption that the tightened monetary policy stance will be maintained, it is expected that the 12-month average inflation in FY06 is unlikely to exceed 7.0 percent.

4. Monetary Policy Stance Going Forward

4.1 Monetary Policy Stance during FY05

Bangladesh Bank conducted its FY05 monetary policy under challenging economic conditions emanating from adverse shocks, domestic as well as external. As a result, the focus of monetary policy in FY05 was on the need to facilitate continuing growth momentum in one hand, while containing inflationary pressures and ensure currency stability on the other. At the beginning of the FY05, BB pursued an accommodative monetary policy due to additional expenditures incurred by the government to pay for oil imports as well as to rebuild following the losses caused by two consecutive floods occurring within the quarter. Year-over-year growth of public and private sector credit exceeded the programmed level in every quarter of FY05, so that by the end of the fiscal year, credit to the non-financial public sector (i.e., inclusive of BPC) rose by 25.8 percent against the target of 10.6 percent. Of course a good part of the excess borrowing was on account of the sustained high international price of petroleum products. Rationale for the accommodating monetary policy also arose from the anticipation that the country's major exporting sector, i.e., the garments sector, might experience a jolt following the expiry of MFA from January 2005.

In the backdrop of accommodative monetary policy stance, the private sector credit growth combined with the agricultural credit write-off following the floods, the high world price of many importables and the depreciation of Taka against major currencies started creating inflationary pressure in the economy. Further, there was the concern over an adverse trend in the current account balance; all these factors prompted the Bangladesh Bank towards a tighter monetary policy stance from the second quarter of FY05. Accordingly, repo and reverse repo rates were also raised substantially (typically in excess of 50 percent) to mop up excess liquidity in the money market beginning with

second quarter of FY05.¹⁸ The call money rates rose sharply in response to the tightened money market stance; the lending rate for example went from 5.42 percent in October '04 to 12.78 percent in January '05 before peaking at 15.1 percent in May '05. By June '05 however the rate has settled down to 6.71 percent.

The yield on short-term treasury bills and bonds moved up later in the fiscal year. While the 28-day T-bill yield stood at 4.04 percent in December '04, by June '05 it had gone up by more than 50 percent to 6.6 percent, most of the correction being completed during the last quarter of FY05. Yields on longer term T-bills (both the 128- and 364-day maturities) also rose from 6 to 7 percent range over the last quarter of FY05. These measures were seen necessary to contain high credit demand by the private sector, and thus restrain aggregate demand.

In the recent history of the money markets in Bangladesh increases in the repo/reverse repo rates have not quite led to lock-step increases in the schedule of deposit and borrowing rates in the banking system.¹⁹ The deposit behaviour may be somewhat non-responsive to the market rates, since a lot of saving is done in the form of various government (including the postal savings) issued bonds which typically offer (high) non-market yields. The lack of secondary trading in these securities also works to distance this market from the deposit behaviour with the commercial banking system. Inadequate financial deepening is believed to be a major obstacle to greater interest rate responsiveness in the private sector activities.

Consequently, the Bangladesh Bank has to take recourse to more direct measures in an attempt to influence the rate of credit growth. BB revised the Cash Reserve Requirement (CRR) for the scheduled banks from 4 to 4.5 percent of their demand and time liabilities effective March 1, 2005, but kept the SLR unchanged at the existing level of 16 percent.

4.3 Monetary Policy Stance for FY06

The goal of price stability consistent with sustained high growth has been incorporated in the monetary program for FY06. BB predicts the real GDP growth in FY06 to come in somewhere in the vicinity of 6.5 percent (i.e., within the band of 6.3 to 6.8 percent), which is also consistent with the target growth in FY06 as envisioned in the MTMF and the NSAPR documents. Finally, the policy stance has to focus on the level of foreign exchange reserves build-up (determining the net foreign assets). Thus while the broad money growth is projected to slow down to the rate of 13.5 percent in FY06 (and 13.4 percent in FY07) to bring about a reduction in inflation, the challenge will be to meet the requirements of the fast pace of expected growth without jeopardising monetary stability.²⁰ These money growth figures are sharply lower than the broad money growth in FY05 that stood at 16.1 percent. Correspondingly private sector credit flow has been programmed to grow at 14.0 percent in FY06 vis-à-vis actual growth of 17.0 percent in FY05. While conceptually the targeted growth can come about within this credit program, eventual success will depend on the inflation outcome. Thus it will be useful to monitor the expansion of private sector credit. The early indication is that while total credit grew at an annual rate of 16.5 percent over the first quarter of FY06, private credit grew at 13.7 percent, which while lower than programmed, is actually a little above the comparable figure for FY05.

In recent months public borrowing has been stretched due to delays in donor fund disbursement. The provisional figures for the first quarter indicate very high growth of public borrowing (at an annualized rate of 25.0 percent). Insofar as the latter is propelled by the cost of imported petroleum and other energy products, the structure of administered prices would require further rationalisation during FY06. There would appear to be persuasive arguments in favour of aligning the latter prices

¹⁸ The reverse repo (1-2 day) rate rose from 2.53 percent in December '04 to 4.50 percent in March '05, and remained at about the same level to the end of the fiscal year. For the repo (1-2 day) auction, the rate rose from 4.5 percent in Nov '04 to 9.86 percent in Jan '05, but had settled back to 8.0 percent in June '05.

¹⁹ As just observed, while the short term repo/reverse rates moved up by a figure in excess of 50 percent over the last two quarters of FY05, the deposit and lending rates structure (for each segment of the market, i.e., NCBs, PCBs etc) remained totally unaffected over the same period.

²⁰ This relates to the October 24, 2005 revisions of the monetary program compatible with the MTMF.

with those prevailing in the border states of India, which will prevent smuggling and thus put a stop to the this source of drain on the treasury.

In terms of monetary instruments, while the repo-reverse repo rates have been generally stable over the first quarter of FY06, the call money rate has moved up from the year end level. The T-bill rates have also moved up rather gradually during this period. While the SLR and CRR have been raised to 18 and 5 percent, respectively, with effect from October 1, 2005, in view of persisting inflationary pressures additional steps may well be warranted in the near future.

Turning to the deposit lending behaviour in the banking system, attention needs to be given to the environment conducive to the continued availability of deposits for on-lending. In order to improve the functioning of the interest rate mechanism to influence the aggregate demand, the banking system has to strive to allocate credit to most productive uses. Here again the balance is tight; banks have to offer positive real return in the long run and also cover their intermediation costs in setting the lending rates. Given that the deposit-lending margin at the foreign banks is wider than for other segments, the remainder of the banking system has a large leeway to improve their operational efficiency and add to the market share. The Central Bank has a role to play here too insofar as it undertakes the treasury functions on behalf of the GOB in marketing the latter's debt and bills. It can provide guidance as well as mediation so that the eventual rate structure on government bonds remains close to the relevant risk-adjusted market rates of a comparable maturity. This latter task would be largely irrelevant were there a fully functioning bond market in public and private debt.

5. Conclusion

Taking the above factors into account, and on the assumption that the tightened monetary policy stance will be maintained, it is expected that the 12-month average inflation in FY06 is unlikely to exceed 7.0 percent, which is largely consistent with the MTMF projections. Nevertheless the Bangladesh Bank remains vigilant as to the necessity of further monetary measures and is prepared to seek additional coordinating fiscal stance as may be warranted by developments in the monetary and the real sectors of the economy. The overall goal will be to contain inflationary expectations, maintain currency stability and ensure smooth credit flow to the growth points in the productive sectors of the economy in support of the targeted real growth in output and employment.

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