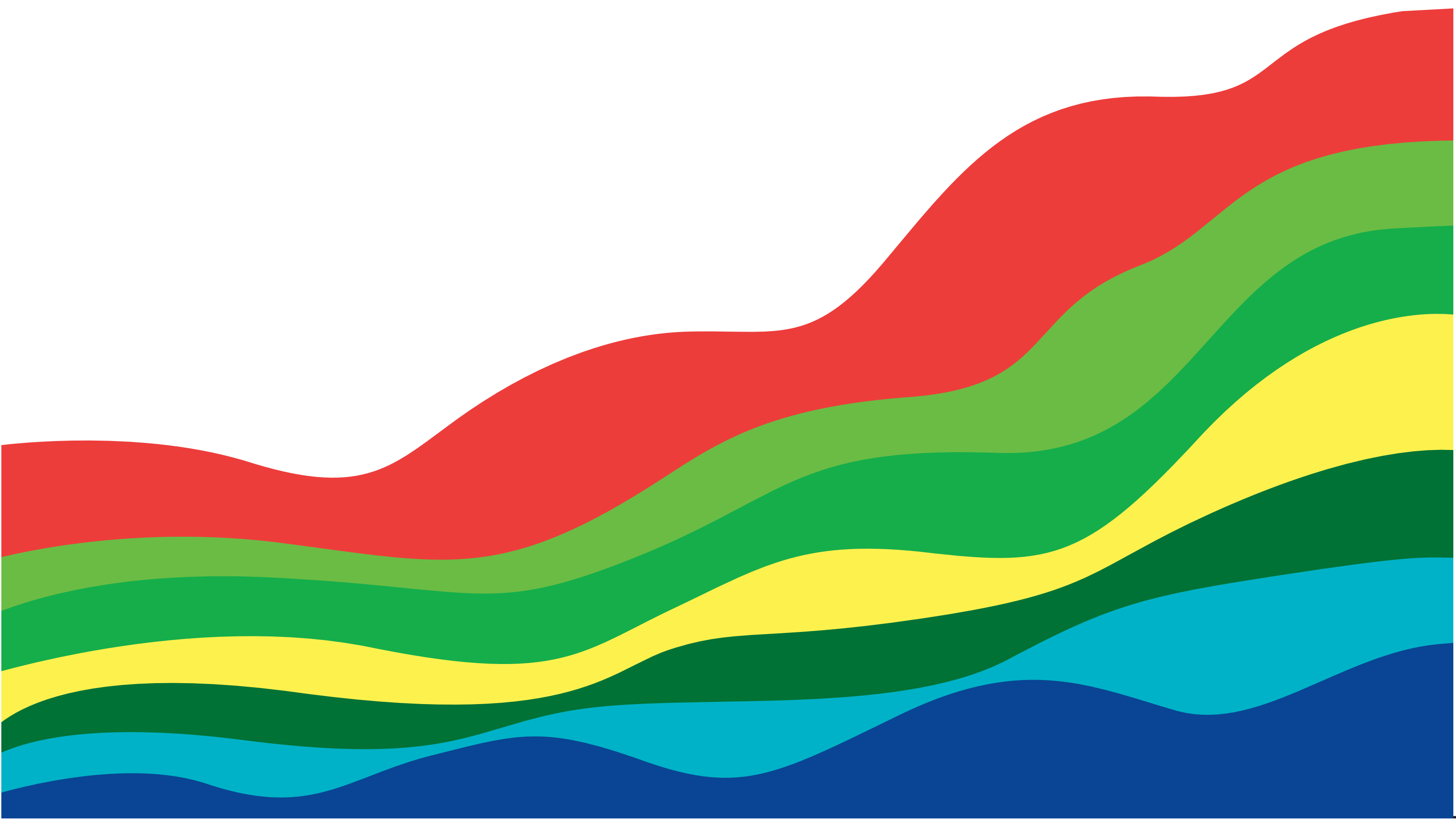
Monetary Policy Statement

July - December 2016



Monetary Policy Department and Chief Economist's Unit

Bangladesh Bank

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Highlights

- Broad money (M2) growth for FY17 is set at 15.5 percent, based on the FY17 GDP growth and CPI inflation targets of 7.2 and 5.8 percent, respectively.

- Domestic credit is projected to grow by 16.4 percent y-o-y in FY17, with credit to private sector growing by 16.5 percent and credit to the public sector by 15.9 percent.

- Downward edging annual average CPI inflation eased to 5.9 percent in June 2016. But its higher nonfood component is under pressure from wage gains of rural laborers and public employees; offset somewhat by continuing moderate trends of global commodity prices. This, coupled with proactive management of market liquidity, is expected to keep FY17 CPI inflation at or close to the 5.8 percent target level.

- The declining trends of interest rates in the domestic market will be sustained by strengthened supervisory oversight on efforts of bringing down nonperforming loans. Bangladesh Bank's policy interest rates (repo, reverse repo rates) will continue to remain unchanged at the current levels of 6.75 and 4.75 percent, respectively.

- Grounded on the growth supportive developmental mandate in its charter, Bangladesh Bank's motivational efforts and supervisory surveillance will continue to focus on inclusive, productive use of credit; with particular attention to adequacy of credit flows to agriculture, SMEs, and environmentally benign 'green' output initiatives.

Bangladesh Bank's Monetary Policy Stance

for the First Half of the FY2017: July-December 2016

This issue of Monetary Policy Statement (MPS) outlines Bangladesh Bank's monetary policy stance for the first half (H1) of the FY17 as the first leg of its monetary program for the FY17. The MPS is drawn up in the backdrop of sustained spell of CPI inflation moderation gains in output growth momentum upheld by cautious but explicitly growth supportive stance of monetary and financial policies pursued in the recent years. As earlier, the FY17 monetary program and the monetary policy stance for the H1 of the FY17 have been chalked up drawing on the experience with the preceding program and on inputs from stakeholders' consultations.

Monetary Policy Performance: FY16

Available data (mostly up to May 2016) indicate attainment of almost all key objectives of the monetary program and policies for FY16. Broad money (M2) growth remained below target ceiling until May 2016 and is likely to remain within the ceiling of 15.0 by end June 2016. Private sector credit grew robustly throughout FY16, at 16.4 percent as of May 16 overshooting the targeted end June ceiling of 14.8 percent. However, with government's belated small net bank borrowing at the closing end of FY16, overall domestic credit growth remained below the targeted path and is likely to be within the 15.5 percent ceiling by end June 2016.

Strong FY16 private sector credit growth and FDI inflows helped the economy attain 7.05 percent real GDP growth while annual average CPI inflation dipped below the 6.2 percent target in June 2016; even as the pass through of global oil price decline to consumers was belated and minimal. Government's nearly entire FY16 domestic borrowing in the costly route of high yield nonbank NSD instruments was noninflationary, though afflicting banks with a liquidity glut and Bangladesh Bank with a high sterilization cost burden.

Core Objectives

The main objective of Bangladesh Bank's monetary policy is moderation and stabilization of CPI inflation alongside supporting output and employment growth. Bangladesh Bank would accordingly emphasize on stabilizing CPI inflation. Bangladesh Bank's monetary and financial policies will continue supporting inclusive, environmentally sustainable growth; addressing its developmental role in the longer term risks to macro-financial stability. The following are the highlights of the stance of monetary policies to be pursued in H1 FY17:

- stabilizing inflation at a moderate level targeted in the national budget and other macroeconomic policy pronouncements,
- supporting the public policy objectives of inclusive, environmentally sustainable growth, and
- stabilizing the market exchange rate of Taka around levels protecting external competitiveness while also facilitating absorption of external inflows in output and investment activities in the real economy.

As always, Bangladesh Bank formulates its monetary policy keeping in view the events and developments continually unfolding in the domestic and global economic scenes.

Global Developments

Monetary policy difficulties in the USA and Europe, Brexit repercussions, tensions in the Middle East, uncertainties in the future direction of fuel prices, China's coming back to its new normal and India's contrasting invigoration, and weaknesses in Latin America and Africa – all have set a confusing global backdrop, further compounding the already substantial difficulties facing monetary policy formulation in developing economies like Bangladesh.

Bangladesh, like a few other developing economies, sets a different tone of optimism in the sound ambiance of macro stability. Investments are likely to gear up in FY17 as the fiscal and monetary authorities are coordinating in the areas of inflation, interest rates, exchange rates, revenue collection, and ADP implementation.

Table : Overview of the World Economic Outlook

GDP at constant prices	Percentage Change: Actuals 2013	Actuals 2014	Actuals 2015	Projections 2016	Projections 2017
World	**3.3**	**3.4**	**3.1**	**3.1**	**3.4**
Advanced Economies	1.2	1.9	1.9	1.8	1.8
USA	1.5	2.4	2.4	2.2	2.5
Euro Area	-0.3	0.9	1.7	1.6	1.4
Other Advanced Economies	2.3	2.8	2.0	2.0	2.3
Emerging Market and Developing Economies	4.9	4.6	4.0	4.1	4.6
China	7.7	7.3	6.9	6.6	6.2
India	6.6	7.2	7.6	7.4	7.4
Bangladesh	**6.0**	**6.3**	**6.4**	**6.6**	**6.9**

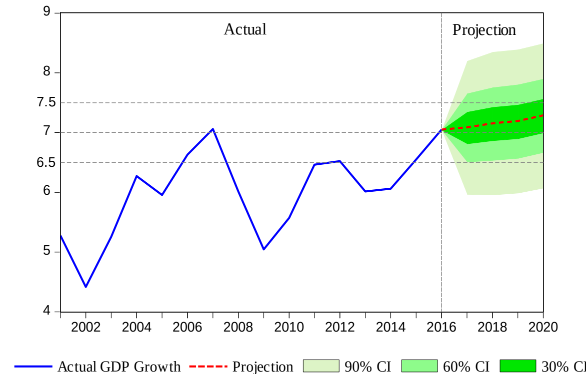
Source:World Economic Outlook Update (July, 2016), International Monetary Fund

The government attained significant improvements to augmenting the availability of infrastructure and energy. Political turbulence, as we saw in early 2015, does not appear to loom on the horizon.

Economic Growth

While the government targeted economic growth at 7.2 percent for the FY17, Bangladesh Bank forecasts – one based on an ARMA model and the other one on sector-wise 10-year average growth – show a range from 7.1 to 7.3 percent. The World Bank projects growth for 2017 at 6.3 percent while the IMF at 6.9 percent, evidencing a remarkable difference in the projections of the two international agencies.

Chart: Forecasting GDP Growth: FY2017 - FY2020

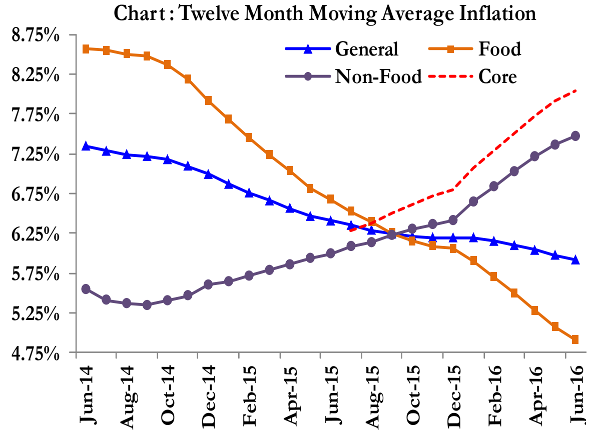


Providing electricity, gas, and infrastructure to businesses is the priority to ensure slightly upward growth in a sustained fashion. Faster implementation of ADP will be helpful to promoting revenue and growth potentials for the country.

Inflation

Twelve-month average CPI inflation in Bangladesh has shown a slowly declining trend for the last couple of years. Inflation, which was 7.28 percent in July 2014, gradually fell to 5.92 percent in June 2016. Further decline in inflation owing to lower fuel and commodity prices may not be strongly ascertained. However, the inflation rate is now in a safe zone. Data and studies suggest that 6 percent inflation along with one standard deviation is a growth maximizing threshold.

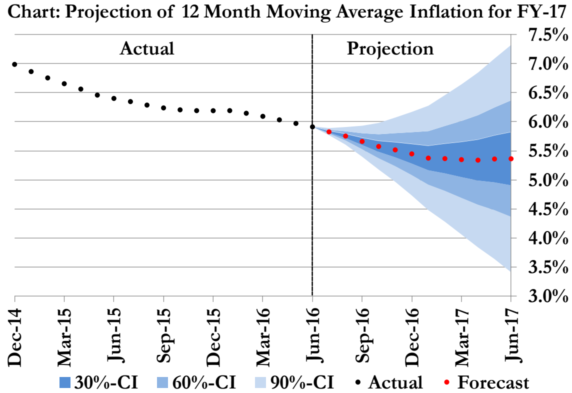
Chart : Twelve Month Moving Average Inflation



The decline in average inflation is mainly attributable to the falling food prices while nonfood inflation edges up primarily because of the consumption boost in the wake of the historically highest salary hike in the public sector. As past evidence suggests, the private sector is likely to follow suit in a staggered fashion, putting an upward pressure on nonfood inflation. Food inflation of as high as 8.55 percent in July 2014 skidded down to 4.90 percent in June 2016 while nonfood inflation of as low as 5.41 in July 2014 percent kept on rising to reach 7.47 percent over the same period. Core inflation that excludes both food and fuel components rose from 6.29 percent in July 2015 to 8.04 percent in June 2016.

The forecast by the Bangladesh Bank team finds an inflation rate of 5.45 percent in December 2016. This forecast, however, does

Chart: Projection of 12 Month Moving Average Inflation for FY-17



not incorporate other external shocks. An inflation-expectations survey conducted by Bangladesh Bank provides us with two figures: 6.35 percent by general people and 5.90 percent by professionals. All these numbers indicate that inflation will center around 6 percent, which is quite moderate for a developing economy like Bangladesh. However, the central bank will remain watchful about inflation and will adjust monetary growth and policy rates if and whenever necessary.

Money Supply

Based on the conflicting signals from general inflation and core inflation, we decide to remain on our partly cautious but generously supportive stance for inclusive, sustainable output growth. Following the growth supportive stance, we plan to increase broad money (M_2) at the rate of 15.5 percent.

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

Item	Actual		Program	
	Jun-15	May-16	Dec-16	Jun-17
Net Foreign Assets*	21.2	21.7	16.2	10.7
Net Domestic Assets	9.9	11.6	14.3	17.2
Domestic Credit	10.1	13.2	15.9	16.4
Credit to the public sector	-2.5	-2.4	11.9	15.9
Credit to the private sector	13.2	16.4	16.6	16.5
Broad money	**12.4**	**14.0**	**14.8**	**15.5**
Reserve money	**14.3**	**20.9**	**11.0**	**14.0**

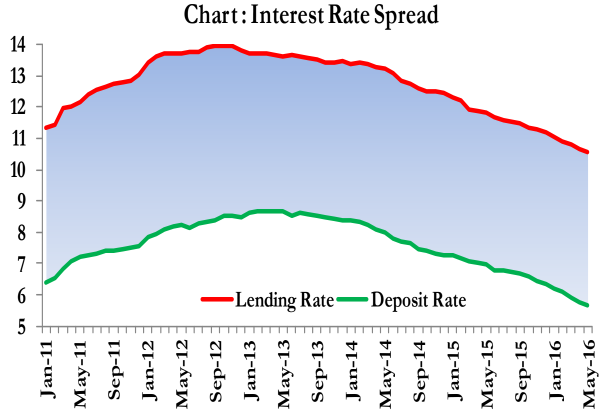
**Constant exchange rates of end June 2016 have been used.*

This stance of money supply complies with the output growth target, absorbs moderate inflation, and finally takes the required level of monetization into account.

Policy Interest Rates

The low-interest-rate option of foreign borrowing by industrial undertakings exerted downward pressure on domestic lending rates. The average lending rate fell from 12.84 percent in July 2014 to 10.57 percent in May 2016. The average deposit rate fell from 7.71 percent to 5.67 percent over the same period.

Chart : Interest Rate Spread



Consequently, the average spread, which sits on top of the average deposit rate to give us the average lending rate, fell from 5.13 percent in July 2014 to 4.90 percent in May

2016. The call money rate has fallen from 8.57 percent in January 2015 to 3.71 percent in June 2016.

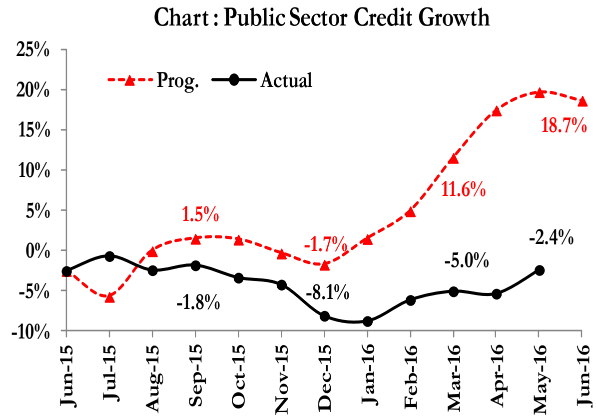
Market interest rates on declining trend are already facilitating investments with lower borrowing costs. Bringing down the nonperforming loan levels in the financial sector will bring down borrowing costs further, and Bangladesh Bank will strongly focus supervisory attention toward this in FY17. Bangladesh Bank's policy interest rates (repo, reverse repo) will remain unchanged for the time being at their current levels of 6.75 and 4.75 percent, respectively.

Trends in Growth of Net Foreign and Domestic Assets

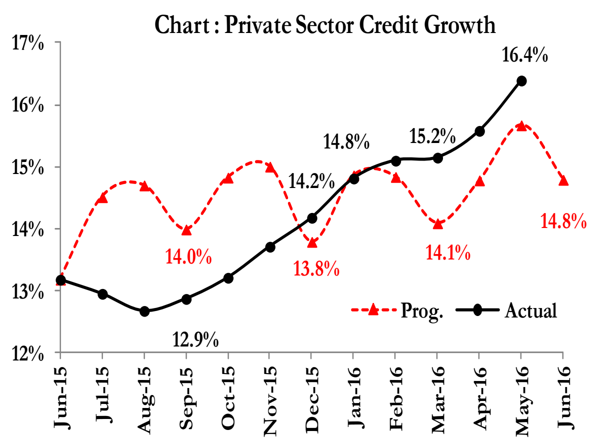
With growth supporting accommodative stance, the stock of broad money is projected to rise to Taka 10373 billion in June 2017 from Taka 8755 billion in May 2016. This stock of June 2017 comprises two figures: 1) Taka 2552 billion or USD 32.55 billion as net foreign assets (NFA) and 2) Taka 7821 billion as net domestic assets (NDA). The amount of NDA is projected to be composed of domestic credit of Taka 9275 billion and a negative figure of Taka 1454 billion against other items (net). NFA growth of 10.7 percent projected for FY 17 is much lower than the 22.1 percent growth in FY16; reflecting the expectation that the external fund inflows will be much better absorbed in the real economy in FY17 than in the preceding year, boding well for GDP growth.

Credit Growth

Bangladesh Bank has kept sufficient provisions for the government's need. The credit growth figures in the public sectors have always been very volatile based on the actual financing needs of the government. It registered a negative figure of 2.4 percent in May 2016 (Y-t-Y) in the last fiscal year whereas Bangladesh Bank projects a positive growth rate of public credit at 15.9 percent in June 2017.



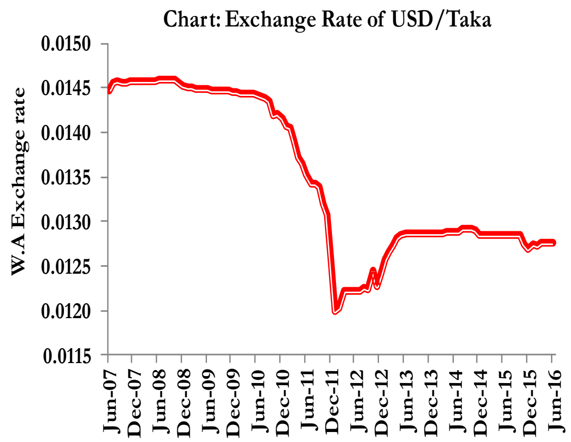
Private sector credit growth has shown an uptrend at the end of the FY16. While it was 10.8 percent in June 2013, private credit growth reached as high as 16.4 percent in May FY16. The target of 16.5 percent private credit growth appears to be adequate to support output growth ranging from 7.1 to



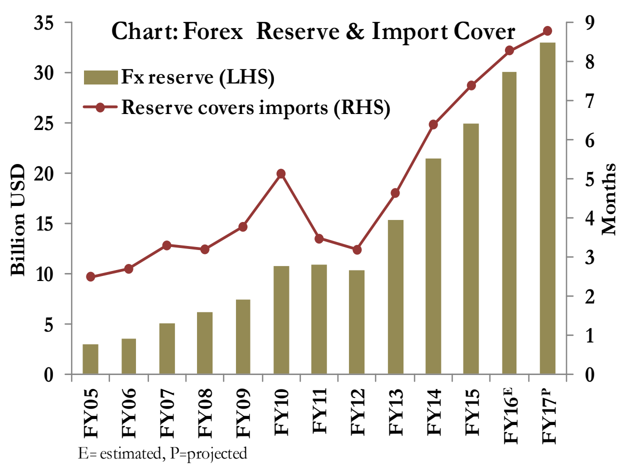
7.3 percent – Bangladesh Bank forecasts for the FY17 where the government's 7.2 percent output growth target nicely fits in.

Exchange Rate and Foreign Reserves

The central bank exercises a managed float to maintain exchange rate stability by ironing out day-to-day fluctuations. Bangladesh Bank kept on buying foreign currencies to prevent Taka from appreciating. Preserving that stability is an integral part of monetary policy although infrequent adjustments to market pressures have been carried out in the past. That policy stance helped Bangladesh Bank to maintain exchange rate stability for almost three years since early 2013.



Bangladesh Bank's foreign exchange reserves have grown fast to reach an adequately comfortable level. Reserves of USD 30 billion met almost 8 months' import bills in June 2016. At the end of FY17, foreign exchange reserves are expected to reach a record high of 33 billion dollars which will be adequate to meet import bills for 9 months. Large and persistently growing current

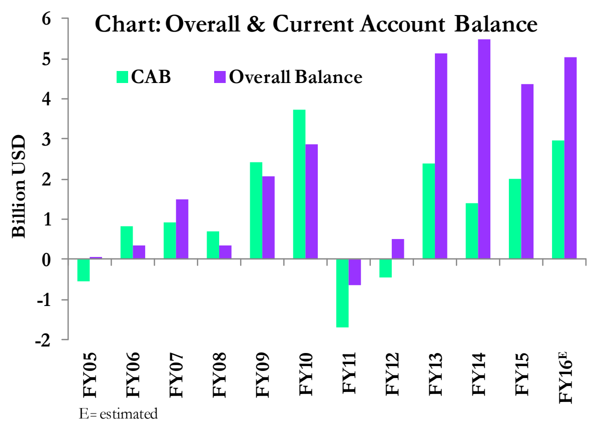


account surpluses signify some sluggishness in the external economy. As remedial efforts, the government may speed up implementation of large projects, using up the surpluses and eventually crowding in new private sector investments in the linked sectors.

Partly due to subdued price levels in global commodity markets, import growth in FY16 remained slow and lagging in absorbing the inflows from growing exports, worker's remittances, and FDI. Worries persist over appreciation of Taka's REER being hurtful for export competitiveness, but support mechanisms like low cost Export Development Fund (EDF) financing for input imports and cash incentives are working well to compensate exporters; as evidenced by sustained export growth amid global slowdown.

Balance of Payments

At the end of the last fiscal year 2016, current account surplus is estimated to reach USD 3 billion from almost USD 2 billion in

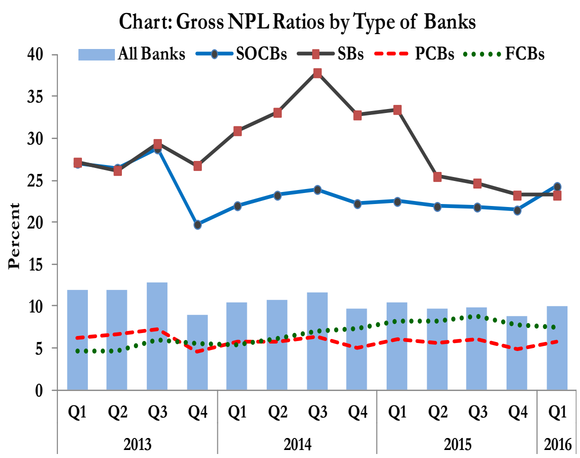


June 2015. This current account surplus helped reach an overall balance to the tune of USD 5.1 billion which contributes to the buildup of net foreign assets.

We have achieved 9.7 percent growth in exports and 6.0 percent growth in imports in FY16. Remittance growth, however, ended up with a negative growth of 2.5 percent at the end of the same fiscal year. The import coverage of nine months by foreign reserves in FY17 leaves us much ahead of many developing economies in this respect.

Addressing Nonperforming Loans for Intermediation Efficiency

Persistent higher nonperforming loans (NPL) levels in Bangladesh than in her peer group countries is a major reason keeping intermediation costs and lending rates downward sticky. Ongoing remedial efforts will be intensified during FY17 in the backdrop of pick up in lending activities. Risk management and corporate governance practices of banks have been brought under closer supervisory scrutiny, inter alia placing Bangladesh Bank observers in boards of many of the state owned and private banks.

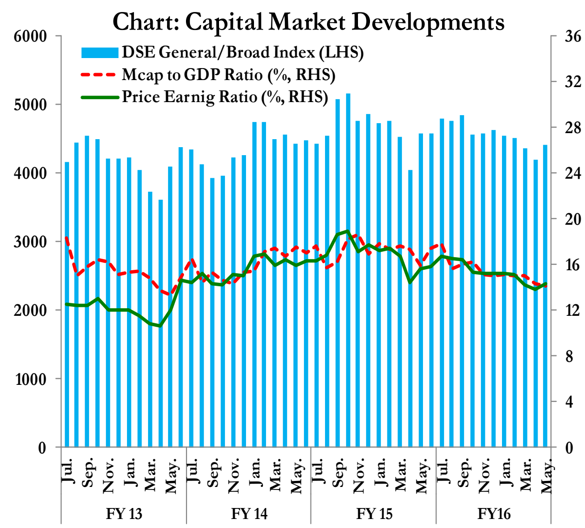


IT based online supervision is helping quicker identification of fraudulent lending practices, followed up by faster, sterner action by law enforcement authorities.

Trends in Capital Markets

Stock markets in Bangladesh have stabilized by now after the 2010 bubble creation and the subsequent collapse. Bangladesh Bank proactively lent hand in stabilizing the capital market, at the same time reining in banking sector's capital market exposures within global best practice norms linked to their capital bases.

The capital market in Bangladesh was largely stable during the FY16 as reflected in the DSE broad index (DSEX), market capitalization, and the price-earnings ratio. The DSEX index stood at 4507.6 at the end of June 2016 which is slightly lower than the level of 4583.1 in June 2015. The market capital to GDP ratio declined to 14.68 percent



at the end of May 2016 from 15.04 percent in January 2016. The price earnings ratio of the DSE also declined to 14.33 in May 2016 from 15.22 in January 2016. Attention of capital market authorities now needs to focus on further streamlining processes and bringing down costs in equity issuance, facilitating access of corporates to capital markets for raising finance.

The government has recently taken up an initiative of introducing long term pension savings schemes for general citizenry, to be supervised by a new Pension Funds Regulator. Successful introduction of such schemes will help the financial and capital markets greatly in mobilizing long term savings for long term investments.

Way Forward in Improving Intermediation Efficiency

There are however substantive issues yet to be fully addressed for enhancing monetary policy effectiveness. Financial institutions and markets constitute the transmission channels through which monetary policies translate into desired inflation and other outcomes.

The government and Bangladesh Bank are working with the World Bank toward putting in place Enterprise Resource Planning (ERP) and core banking IT platforms in the state owned banks and financial institutions, introduction of pension funds for general citizenry, and crop insurance schemes. Lengthening the maturity spectrum of the yield curve with issuance of new treasury bonds for 25 and 30 year tenors is being contemplated. The government is also working with Asian Development Bank to activate primary and secondary markets in corporate bonds.

Quite a few banks and financial institutions have by now accumulated substantial portfolios of mortgage backed housing loans. Promoting issuance of mortgage backed securities against these housing loan assets would be a convenient step toward corporate bond market activation. The state owned housing finance institution, HBFC, can be shored up to take up underwriting and market making in mortgage backed securities, like Freddie Mac and Fannie Mae in the US. For securities backed by other assets, some entity like the state owned Investment Corporation of Bangladesh can take up similar underwriting and market making roles.

Monetary Policy Formulation Approaches to Changing Needs

As monetary policy transmission channel progresses with the above outlined reform steps and as external openness of the economy widens further, Bangladesh Bank's monetary policy approach will need to evolve from the current mainly money-stock-based targeting toward a mainly market-interest-rate targeting based approach. Money stock targeting works for underdeveloped economies with limited external openness. Control on money stock growth will be lost as the growing economy opens up further and its financial sector integrates more fully with the global markets. Domestic money stock tightening efforts will then be negated by inflows attracted thereby, and vice versa. Work on chalking up a transition path of Bangladesh Bank's monetary policies toward the needed new approach over the medium term is already underway at Bangladesh Bank.

Financial Stability

Following the global financial crisis, financial stability concerns attained a high priority in Bangladesh. Stress testing exercises are now routine practices in Bangladesh as diagnostic and supervisory tools. Bangladesh Bank and all other financial sectors, capital markets, the insurance sector, and regulatory authorities in Bangladesh hold regular quarterly consultations toward policy coordination upholding financial stability. A heightened attention to improve digital safety measures for international reserves has been on the agenda in the wake of the Bangladesh Bank's reserve heist that happened in early 2016.

Substantial segments of the financial sector remain beset with asset quality impairments due to institutional weaknesses in their risk management and corporate governance practices. Financial markets remain insufficiently developed, particularly at the longer term end. Remedial efforts are being pursued in earnest; financial sector regulation and supervision practices are steadily being upgraded toward the full convergence with (BIS, Basel based) international best practice standards. Risk based Basel II capital adequacy regime is already in place. Work is underway towards adoption of the Basel III capital, liquidity; and leverage disciplines. Stress testing capabilities in banks and in Bangladesh Bank's supervisory departments are being strengthened.

New Initiatives for Growth Supportive Inclusive Financing

To activate banks in utilizing idle liquidity in productive lending to farm and nonfarm MSMEs, Area Heads of Bangladesh Bank offices are engaging in field visits with bankers in search areas of economic activities. Potential client groups are still to be drawn into the financial sector's inclusive financing initiatives. With Bangladesh Bank's field level guidance and encouragements, banks are more proactively exploring new financing opportunities in diverse new areas of output activities of new agricultural and SME clientele segments. These initiatives will hopefully create more productive credit demand and new employment opportunities in the economy.

New Financing Windows Supporting Output Activities

In FY17, inputs import financing support from Bangladesh Bank's Export Development Fund (EDF) window will continue; longer term financing line in foreign exchange for manufacturing undertakings from a USD 300 million WB credit will also continue. A medium term lending window in foreign exchange for 'greening' initiatives in the textiles and leather sectors from Bangladesh Bank's own funds is expected to commence operation soon.

Bangladesh Bank's attention toward promoting inclusive, environmentally sustainable financing is not in any way impairing its core price stabilization objective, as evident from the sustained spell of Bangladesh's inflation moderation and macroeconomic stability. Bangladesh Bank's attention to promoting inclusive, environmentally sustainable financing is already paying off by upholding buoyancy of domestic demand and growth dynamism.

Annexure: Balance of Payments

In million US$

Particulars	Actuals				Estimation	Projection
	2011-12	2012-13	2013-14	2014-15[R]	2015-16	2016-17
Trade balance	**-9,320**	**-10,004**	**-6,794**	**-6,277**	**-5,515**	**-5,984**
Export f.o.b.(including EPZ)	23,989	26,567	29,777	30,768	33,752	36,621
Import f.o.b (including EPZ)	33,309	36,571	36,571	37,045	39,268	42,605
Services	**-3,001**	**-3,162**	**-4,099**	**-4,628**	**-4,135**	**-4,787**
Receipts	2,694	2,830	3,115	3,017	3,319	3,561
Payments	5,695	5,992	7,214	7,645	7,454	8,348
Primary income	**-1,549**	**-2,369**	**-2,635**	**-2,995**	**-2,889**	**-3,333**
Receipt	193	120	131	74	73	73
Payments	1,742	2,489	2,766	3,069	2,962	3,406
Of which: Official interest payments	*373*	*476*	*427*	*404*	*500*	*450*
Secondary income	**13,423**	**14,928**	**14,934**	**15,894**	**15,498**	**15,885**
Official transfers	106	97	83	74	150	300
Private transfers	13,317	14,831	14,851	15,820	15,348	15,585
Of which: Workers' remittances	12,734	14,338	14,116	15,170	14,791	15,161
CURRENT ACCOUNT BALANCE	**-447**	**-607**	**1406**	**1994**	**2958**	**1781**
Capital account	**482**	**629**	**598**	**483**	**500**	**520**
Capital transfers	482	629	598	483	500	520
Financial account	**1436**	**2770**	**2855**	**2934**	**1453**	**620**
Foreign Direct investment	1191	1726	1474	1830	2100	2150
Portfolio investment	240	368	937	618	250	300
Other investment	5	676	444	486	-897	-1830
Net aid flows	750	1179	1386	1562	1750	1560
MLT loans	1539	2085	2404	2472	2650	2750
MLT amortization payments	789	906	1018	910	900	1200
Other long term loans	79	-150	477	-33	-378	-450
Other short term loans	242	-193	-838	-161	-575	-750
Trade credit	-1118	-250	-340	-1684	-1664	-1956
Commercial Bank (DMBs & NBDCs)	52	90	-241	802	-30	-430
Assets	443	396	898	86	-120	180
Liabilities	495	486	657	888	-150	-250
Errors and omissions	**-977**	**2336**	**624**	**-1038**	**144**	**0**
OVERALL BALANCE	**494**	**5128**	**5483**	**4373**	**5055**	**2715**
Reserve Assets	**-494**	**-5128**	**-5483**	**-4373**	**-5055**	**-2715**
Bangladesh Bank	-494	-5128	-5483	-4373	-5055	-2715
Assets	293	5196	5933	4249	5155	2865
Liabilities	-201	68	450	-124	100	150
Memorandum items:						
Export growth rate (percent)	6.2	10.7	12.1	3.3	9.7	8.5
Import growth rate (percent)	2.4	9.8	0.0	1.3	6.0	8.5
Remittance growth rate (percent)	9.3	12.6	-1.5	7.5	-2.5	2.5
Gross official reserves (million US$)	10,364	15,315	21,508	25,021	30,176	33,041
(In months of imports of goods)	3.2	4.3	6.4	7.4	8.3	8.8

Source: Statistics Department, Bangladesh Bank, EPB and the Ministry of Finance. R = Revised

Monetary Policy Flowchart

Developments/Information

- ✓ GDP growth & inflation
- ✓ Growth of monetary aggregates
- ✓ Liquidty Situation
- ✓ Short-term interest Rates
- ✓ Foreign Reserves & Exchange Rates

Policy Decision

Based on market information and judgment of the policy makers

Instruments

- ✓ Open market operations (Repo, Reverse Repo and BB bill auctions)
- ✓ Variation in reserve ratios

Targets

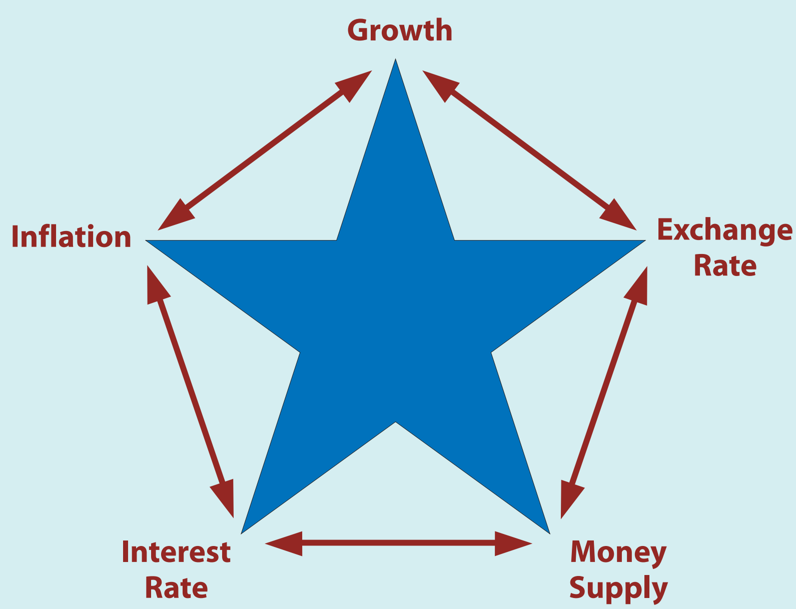
i) Operating Target
- ✓ Reserve Money

ii) Intermediate Target
- ✓ Broad Money
- ✓ Interest Rates

Goals

Moderate Inflation

Sustainable Growth



THE STAR MODEL OF MONETARY POLICY