Macroeconomic Performance, Near and Medium Term Prospects

Global Economic Outlook, Impact on Bangladesh Economy

1.1 During FY10, global economic recovery proceeded broadly as expected on two-track pace, with generally high robust output growth in emerging and developing economies and lower, rather jittery growth in many of the mature developed western economies beset by lingering financial sector weaknesses impeding lending (particularly to small businesses) and job creation, slow demand recovery in households deleveraging debt burdens. This was compounded further by concerns of markets about high public debt levels of some of the western developed economies. Successive issues of IMF's World Economic Outlook (WEO) have reiterated the near term forecast of two track recovery, but with heightening caveats about downside risks. Table 1.1 reproduces the output growth, trade and inflation outlooks in the October 2010 issue of the WEO. The projections forecast somewhat lower output growth rate for 2011 than that of 2010, global inflation is projected to remain moderate in 2010 and 2011. The IMF recommendations for restoration of global economic balance include continued easy monetary conditions with low interest rates in flagging developed economies constrained in fiscal stimulus by their heavy public debt burdens; and stimulation of domestic consumption in the fast growing emerging and developing economies, including interalia by allowing their domestic currencies to appreciate.

Table 1.1 Overview of the World Economic Outlook projections

(Annual percentage change)

	2008	2009	2010*	2011*
World output	**2.8**	**-0.6**	**4.8**	**4.2**
Advanced economies	0.2	-3.2	2.7	2.2
United States	0	-2.6	2.6	2.3
Japan	-1.2	-5.2	2.8	1.5
Germany	1	-4.7	3.3	2
United Kingdom	-0.1	-4.9	1.7	2
France	0.1	-2.5	1.6	1.6
Italy	-1.3	-5	1	1
Canada	0.5	-2.5	3.1	2.7
Newly industrialised Asian economies	1.8	-0.9	7.8	4.5
Emerging and developing economies	6	2.5	7.1	6.4
Developing Asia	7.7	6.9	9.4	8.4
China	9.6	9.1	10.5	9.6
ASEAN-5	4.7	1.7	6.6	5.4
World trade volume (goods and services)	**2.9**	**-11**	**11.4**	**7**
Imports				
Advanced economies	0.4	-12.7	10.1	5.2
Emerging and developing economies	9	-8.2	14.3	9.9
Exports				
Advanced economies	1.9	-12.4	11	6
Emerging and developing economies	4.6	-7.8	11.9	9.1
Commodity prices (U.S. dollars)				
Oil	36.4	-36.3	23.3	3.3
Nonfuel	7.5	-18.7	16.8	-2
Consumer prices				
Advanced economies	3.4	0.1	1.4	1.3
Emerging and developing economies	9.2	5.2	6.2	5.2

Source : World Economic Outlook, October 2010, IMF.
*=Projection

1.2 The two-track global growth outlook bears important implications for near and medium term growth prospects and strategies for the Bangladesh economy. Rapid switchover from export led growth strategy to a strategy based largely on domestic demand driven output growth is impractical in low income developing economies like Bangladesh, because income levels of the population cannot rise abruptly to generate consumption or investment demand. Bangladesh therefore needs to continue substantial reliance on export led growth. But recovery of exports to pre-crisis trend growth levels can no longer count wholly on demand recovery in traditional western markets in North America and Europe; new markets in the fast growing emerging and developing countries need to be explored and accessed quickly. Broadening of the export basket with new items to reduce the current heavy dependence on apparels is also important. The government has accordingly introduced some incentives for exports to new destinations, and also for some new export items. Proactive trade diplomacy with bilateral and regional negotiations leading to lower tariff and non-tariff barriers in developed and fast growing developing economies in Asia is important. Hosting manufacturing bases for items with favoured access to markets in regional trade partner countries would be a convenient mode of expanding output, employment and exports; successful inroads into fast growing Chinese and Indian markets alone may more than make up for slacks in exports to North America and Europe. Thriving higher income economies in Latin America and Africa also hold promises for substantial export growth for Bangladesh.

1.3 The near term global growth outlook would also mean slower manpower exports to traditional host countries seeking to protect job openings for their own nationals. Prospects of accessing online work outsourcing from western developed economies have also slackened; an area where positive promise of Bangladesh was shown by her ranking as the seventh most favoured global outsourcing destination out of top ten, in a recent global survey. For manpower export and outsourced online work Bangladesh therefore, needs to explore and exploit newer destinations and sources in the fast growing labour deficient economies.

1.4 The Government's fiscal outlays for current and development expenditure, including the stimulus packages and the expanding social safety net for the poor and vulnerable, are playing due role in increasing the internal demand driven components of growth. Bangladesh Bank's initiatives for broader, deeper financial inclusion of under-served/unserved population segments and economic sectors are also contributing to internal demand driven growth; supporting both output increase on the supply side and income-led consumption increase on the demand side.

Developments in the Bangladesh Economy

1.5 Continuing her resilient response to the global economic slowdown, the Bangladesh economy maintained growth momentum, with some slowdown in export growth and in new investment activities. Impact of the slowdown on Bangladesh economy showed up with some lags from early FY09, with downturns in exports, imports and new investment activities. Outlays from national budget provided support to the affected sectors and extended the social safety net to uphold domestic demand and economic activities. BB maintained a financial inclusion focused growth supportive monetary policy stance to help maintain momentum in economic activities. Supported by these policy measures, real GDP, estimated by Ministry of Planning, grew by 5.8 percent in FY10 against 5.7 percent growth in FY09. Agriculture sector output growth is 4.7 percent, industry sector output growth is 6.0 percent and service sector output growth is 6.4 percent in FY10 against 4.1, 6.5 and 6.3 percent growth in these sectors respectively in FY09. Output growth attained in FY10 was largely internal demand driven, weak external demand slowed down FY10 export growth to modest single digit level of 4.1 percent against 10.3 percent growth of FY09. The slower industry sector output growth in

FY10 than that of FY09 is attributable to weaker export demand, as also to disruptions in output activities due to acute shortages in power and gas supplies. Weak export demand and the scarcities in energy supply slowed down new investment activities. Growth of remittances from the expatriate Bangladeshi workers slowed somewhat in FY10 to 13.4 percent, against 22.4 percent growth in FY09. The domestic money market remained flush with liquidity, however, the double digit growth in remittance inflows and weak 5.5 percent growth in imports leaving substantial fund surpluses in the market despite weak export growth. Point to point CPI inflation kept creeping up from 2.3 percent of June 09 peaking at 9.06 percent in February 10, easing down somewhat thereafter. 12-month average CPI inflation continued creeping up, and was 7.31 percent at the close of FY10. The uptrend of Bangladesh inflation in FY10 was attributable partly to remittance inflow driven high monetary growth (22.4 percent M2 growth, against 19.2 percent of preceding FY 09) and partly to spill over effects from high food and non food inflation levels in neighbouring India. Besides consumer prices, real estate and stock market prices in Bangladesh were under high inflows driven upward pressure in FY10, raising concerns about second round impact on CPI inflation, as also about risk of possible collapse of asset price bubbles.

Growth Performance

1.6 The 5.8 percent real GDP growth in FY10 was underpinned, on the supply side, by overall robust growth in agriculture and service sectors, with a modest growth in industry. The Government's broad-based support for agriculture with timely and adequately delivery of inputs, disbursing large amount of agricultural loan and subsidy, providing electricity and fuel in the dry season helped to attain robust growth of 4.7 percent in FY10 from 4.1 percent in FY09. The crops and horticulture sub-sector attained higher output growth in FY10 (5.1 percent). Forestry and related services, animal farming and fishing sub-sectors achieved a slightly lower growth rate of 5.6, 3.3 and 4.0 percent in FY10 as compared with 5.7, 3.5 and 4.2 percent respectively in FY09 .

Table 1.2 Sectoral GDP Growth rate

(at FY96 constant prices)

	FY91-FY00 (Average)	FY01-FY10 (Average)	FY09	FY10P
I. Agriculture	3.2	3.4	4.1	4.7
a) Agriculture and forestry	2.1	3.6	4.1	4.9
i) Crops and horticulture	1.8	3.2	4.0	5.1
ii) Animal farming	2.5	4.5	3.5	3.3
iii) Forestry and related services	3.6	5.1	5.7	5.6
b) Fishing	8.2	2.7	4.2	4.0
2. Industry	7.0	7.4	6.5	6.0
a) Mining and quarrying	6.0	8.4	9.8	10.1
b) Manufacturing	6.9	7.4	6.7	5.7
i) Large and medium scale	7.0	7.3	6.6	5.5
ii) Small scale	6.8	7.7	6.9	6.3
c) Power, gas and water supply	5.5	7.0	5.9	6.9
d) Construction	7.5	7.4	5.7	5.9
3. Services	4.5	6.1	6.3	6.4
a) Wholesale and retail trade	5.7	6.7	6.2	6.1
b) Hotel and restaurants	5.5	7.3	7.6	7.6
c) Transport, storage and communication	4.6	7.5	8.0	7.2
d) Financial intermediation	4.8	7.9	9.0	8.4
e) Real estate, renting and other business activities	3.5	4.6	3.8	3.8
f) Public administration and defence	6.8	7.0	7.0	9.6
g) Education	6.1	7.3	8.1	9.3
h) Health and social works	4.0	6.4	7.2	8.1
i) Community, social and personal services	2.8	3.6	4.7	4.8
GDP (at FY96 constant market prices)	4.8	5.8	5.7	5.8

1.7 The industry sector grew by 6.0 percent in FY10 slightly lower from 6.5 percent growth in FY09 mainly due to sluggish growth in manufacturing sub-sector for lagged effect of global economic recession. The manufacturing sector grew by 5.7 percent in FY10 compared with 6.7 percent growth in FY09. The growth in power, gas and water supply sub-sector increased to 6.9 percent in FY10 compared with 5.9 percent in FY09 due to new investment in this sector. The growth in the construction sector also rebounded because of higher demand in the housing sector. Construction sector grew by 5.9 percent in FY10 compared with 5.7 percent in FY09.

1.8 Growth in the service sector increased to 6.4 percent in FY10 from 6.3 percent in FY09, with strong growth in different sub-sectors as hotel and restaurants, public administration and defence, education, health and social services. However, the growth in trade, transport and communication and financial intermediations declined in FY10 compared with FY09.

1.9 On the demand side, real domestic demand increased by 6.8 percent in FY10, compared with 6.0 percent in FY09. Of the two components of domestic demand, consumption increased by 7.1 percent in FY10 from 5.9 percent in FY09. The rise in consumption is driven by remittance induced demand as well as subsidised sales of food grains and other social safety net spending by the government. Investment demand grew by 5.8 percent in FY10 compared with 6.2 percent in FY09. The social safety net expenditure of the government and SME credit programmes supported by Bangladesh Bank refinance underpinned buoyancies of the domestic demand.

Savings and Investment

1.10 Available data indicate that domestic savings-GDP ratio decreased from 20.1 percent of FY09 to 19.8 percent in FY10, and investment-GDP ratio increased from 24.3 percent in FY09 to 25.0 percent in FY10 (Chart 1.1). The domestic savings-investment gap as a percentage of GDP, increased from 4.3 in FY09 to 5.97 percent in FY10. However, national savings-GDP ratio recorded at 28.8 percent in FY10 for a glut inflow of net factor income from abroad which is yet to be utilised.

Chart 1.1

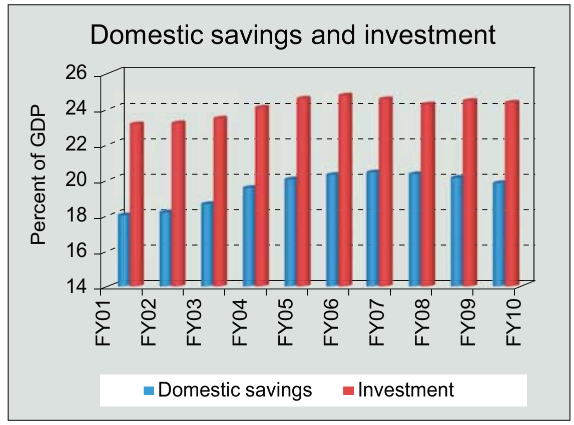


Chart 1.2

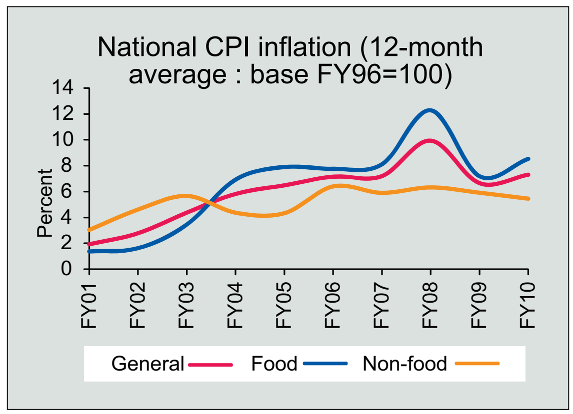
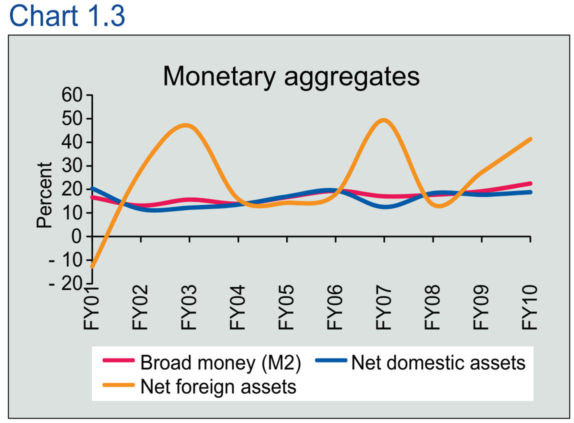


Chart 1.3



Price developments

1.11 Inflation rate maintained upward trend and reached to 7.3 percent in FY10 from 6.7 percent in FY09. Inflation rose mainly due to increase of domestic food grains' prices along with rising prices of imported essentials in the international markets particularly those of neighbouring markets, inflow of remittances which accumulates high foreign exchange reserve caused higher than targeted growth of money supply. Mainly rise of food inflation to 8.5 percent in FY10 from 7.2 percent in FY09 contributed to the rise in overall inflation, while non-food inflation declined to 5.5 percent in FY10 compared with 5.9 percent in FY09. On the other hand, point to point basis CPI inflation rose to 8.7 percent in FY10 from 2.3 percent in FY09. The Government and the Bangladesh Bank continued to take measures to contain inflation by imposing ban on rice export, issuing agricultural credit cards to farmers for inputs, loans and subsidies, open market sale of rice in Dhaka and adjoining districts and introducing fair price cards for the ultra-poor. Bangladesh Bank raised the interest rates on government securities, resumed 30-day Bangladesh Bank bill to curb excess liquidity of the banks. It revised CRR and SLR upward by 0.5 percentage points. Bangladesh Bank has also directed all commercial banks to cap interest rate at 12 percent on import finance for essential items.

Money and Credit Developments

1.12 Bangladesh Bank pursued accommodative monetary policy stance in FY10 to support investments and productive economic activities as also to uphold domestic demand in the backdrop of recessionary global environment. Sharp decline in credit to public sector and soaring remittance inflows led to large liquidity surpluse in the banking system. To engage in market operations towards managing market liquidity, BB resumed auction of 30-day BB bills and from October 09, it resumed reverse repo auctions after lowering the repo and reverse repo rates by 200 basis points respectively to 4.5 and 2.5 percent levels closer to the then call money rates. Pursuing commitment of BB towards

Chart 1.4

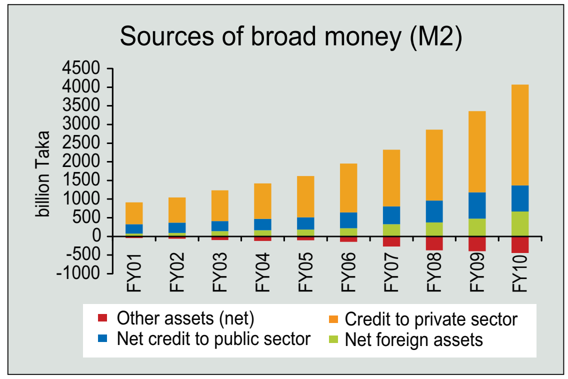


Chart 1.5

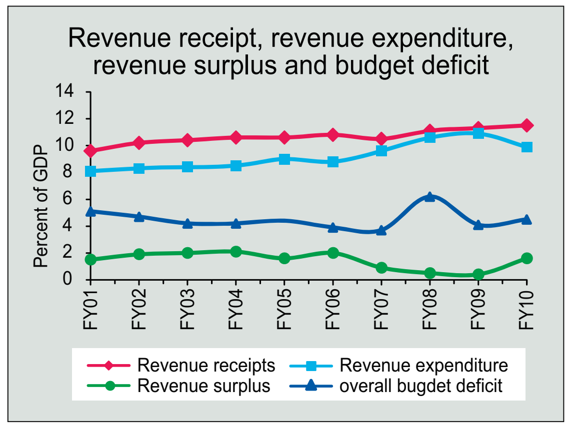
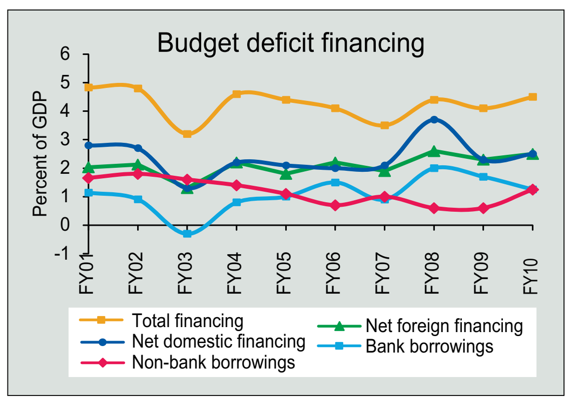


Chart 1.6



broadening and deepening of financial inclusion, special attention was paid to ensure adequate credit flows to productive and environment friendly economic activities including agriculture, SMEs, renewable energy and effluent treatment projects; with refinance support lines kept available from BB. On the other hand, policy pronouncements in BB's monetary policy statements discouraged undue expansion of credit for unproductive ostentation, conspicuous consumption and speculative purposes.

1.13 Broad money (M2) growth stood at 22.4 percent in FY10, which is higher than the 19.2 percent growth recorded in FY09 and also higher than the target under the programme. The growth in broad money was mainly driven by higher growth in net foreign assets. Net foreign assets of the banking system increased notably by 41.3 percent in FY10 resulting from robust growth in remittance inflows with the target of 27.9 percent and previous year's increase of 27.2 percent. The credit to public sector declined sharply by 5.2 percent in FY10 compared with projected growth of 11.9 percent and actual growth of 20.3 percent in FY09 due to downward revision of ADP, higher revenue collection and inflow of foreign assistance. Credit to the private sector grew by 24.2 percent in FY10, which is higher than the 14.6 percent growth in FY09 and also higher than the programme level of 16.7 percent for FY10 reflecting the positive attitude of the investors as the global economy begins to recover from recession.

1.14 Of the components of broad money on the liability side, growth of the currency and demand deposits (32.4 percent) was much higher than that of time deposits (19.5 percent). This was consistent with the decline in the income velocity of money. The income velocity of money declined to 1.90 in FY10 from 2.07 in FY09, reflecting increased monetisation in the economy.

1.15 The declining trend of interest rates that persisted over a couple of years till FY05 reversed in FY06 which continued in FY07. Thereafter, weighted average interest rate on bank advances started creeping up during

Chart 1.7

Chart 1.8

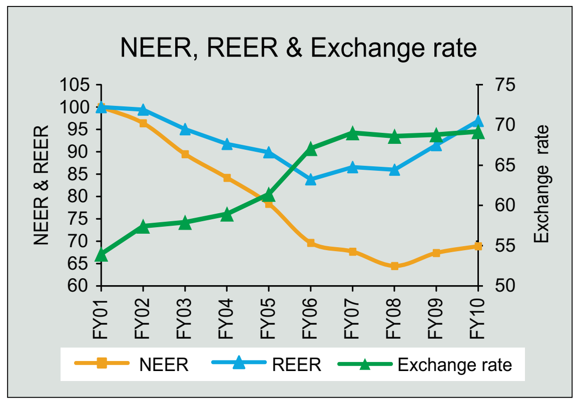
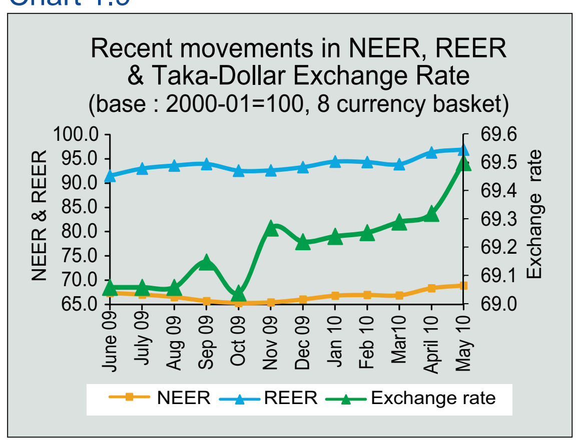


Chart 1.9



FY08 and FY09, but again on a decreasing trend following central bank policy measures recorded a decrease to 11.23 percent as of end June 2010 from 11.9 percent as of end June 2009, while the deposit rate decreased to 5.96 percent as of end June 2010 from 7.0 percent as of end June 2009.

Public Finance

1.16 Revenue receipts grew by 14.9 percent in FY10 against 14.3 percent growth in FY09 and in GDP percentage it rose to 11.5 percent of FY10 GDP from 11.2 percent of FY09 GDP. A heartening feature of FY10 revenue growth is the robust 22.3 percent increase in income tax receipts, a progressive turn in the revenue regime still largely reliant on regressive indirect taxes.

1.17 Public expenditure in FY10 grew by 17.4 percent, against 0.6 percent growth in FY09 and in GDP percentage it rose to 16.0 percent of FY10 GDP from 15.3 percent of FY09 GDP. Public expenditure allocations in FY10 featured stimulus package for economic sectors affected in the global slowdown and extended social safety net for the poor and vulnerable, besides the usual poverty reduction focused pattern of high share of pro-poor social sector outlays, and input subsidies and other support measures for agricultural and other productive activities. The success of FY10 fiscal measures for upholding economic activities and domestic demand is reflected in sustenance of the economy's growth momentum.

1.18 Continued liquidity glut in the domestic financial market kept interest rates on bank deposits at low levels in FY10, while the higher interest rates on government's NSD instruments remained unchanged. Net sales of NSD instruments available on tap soared as a result by high 219 percent, driving net government borrowing from the banking system to negative. This meant ample fund availability in the banking system for private sector borrowing, but high, above market borrowing cost for the government. Downward revision of NSD interest rates has reversed this trend early in FY11.

1.19 Overall budget deficit increased to 4.5 percent of GDP in FY10, from 4.1 percent of FY09 GDP. Domestic financing of the deficit increased to 2.5 percent of GDP in FY10, from 2.3 percent of FY09 GDP; foreign financing covered the remainder of the deficit. The outstanding stock of domestic public debt decreased to 16.9 percent of GDP as of end June 2010 from 17.7 percent of GDP as of end June 2009.

External Sector

1.20 Following growth at double digit rate in FY09, exports suffered some decline in H1 FY10; but turned around to positive growth path in H2 FY10, attaining modest 4.1 percent overall growth for FY10. Exports of key items like ready-made garments, frozen foods and chemical products declined reflecting the lagged impact of the global recession. Among the RMG export items, woven garments and knitwear grew only by 1.6 percent and 0.84 percent respectively. Export of primary products experienced a negative growth of 0.90 percent, while manufacturing product rose by 4.34 percent. Downward pressures on prices of export items continued as the price index for primary products rose by 4.86 percent and manufacturing products declined by 0.63 percent. The volume index of primary products rose by 0.10 percent and of manufacturing products by 5.17 percent. The robust export growth rates of the later months of FY10 have continued subsequently, portending strong recovery for FY11.

1.21 Like exports, imports were also in decline in the initial months of FY10, turning around to positive growth from February 10 and attaining overall modest 5.5 percent growth for FY10, marginally higher than the 4.1 percent growth of FY09. The low FY10 import growth was attributable partly to lower international prices of food grains, fuel and other import commodities, partly to lower input import needs of manufacturer exporters facing weak demand, and partly also to slack in real sector investments facing energy supply constraints. As proportion of GDP, export earnings declined from 17.4 percent in FY09 to 16.2 percent in FY10, while import payments declined from 25.2 percent in FY09 to 23.8 percent in FY10. Hearteningly, as for exports, the strong positive import growth rates of the later months of FY10 have continued subsequently, portending strong recovery for FY11.

1.22 Despite moderate growth of workers' remittance inflows to 13.4 percent in FY10 from the high 22.4 percent of FY09, BOP current account balance registered a surplus of USD 3.73 billion; substantially higher than the FY09 surplus of USD 2.42 billion. With deficits in service, income and trade accounts, the FY10 current account surplus was attributable entirely to inflows of workers' remittances, rising to USD 10.99 billion in FY10, from USD 9.69 billion of FY09.

1.23 The overall balance of FY10 BOP stood in surplus at USD 2.87 billion, against USD 2.06 billion of FY09. Gross foreign exchange reserves held by the Bangladesh Bank rose by USD 3.28 billion to USD 10.75 billion at the end of FY10, comprising about 5.1 months of import cover.

1.24 The domestic foreign exchange market was stable during FY10 with ample inflows driven liquidity, as in the preceding year. Bangladesh Bank's interventions in the market were aimed at ensuring market order and stability, with liquidity at appropriate levels. The interventions moderated the appreciation pressures on Taka, helping protect competitiveness of exports facing weak external demand and incentive for inflows from expatriate workers. The nominal exchange rate of Taka depreciated by 0.56 percent to Taka 69.45 per US dollar as of end June 2010, from Taka 69.06 per US dollar as of end June 2009. In nominal effective term against a trade weighted eight currency basket (base: 2000-01=100), Taka appreciated by 2.24 percent in FY10, while the real effective exchange rate of the Taka appreciated by 7.09 percent.

1.25 Outstanding external debt of Bangladesh increased to USD 21.79 billion as of end June 2010, from USD 20.86 billion as of June 2009. However, as ratio of GDP the outstanding external debt declined to 21.9 percent of GDP as of end June 2010, against 24.3 percent of GDP as of end June 2009.

Financial Sector Stability

1.26 Following the global financial crisis and economic downturn, financial sector stability is being monitored with heightened priority as a key requisite for macro stability. In the Bangladesh economy with limited, regulated openness in the external sector, the financial system remained free of contagion from toxic assets of markets in developed economies afflicted by the crisis. The banking sector remained stable and liquid during and after the global financial crisis; assessment and stress testing by an IMF FSAP update mission in Q1 FY10 reported positively on the resilience of the banking sector in Bangladesh and the improvements in its capital base and other fundamentals. Recent measures adopted by BB in bolstering stability of the financial sector include mandatory implementation of the Basel II capital regime (with standardised approach for credit and market risks, and basic indicators approach for operational risks) from 2010, with the attendant shoring up of risk management

Box 1.1

The response of Bangladesh Bank to the global financial crisis

The rapid and divergent eruption of the severe global financial crisis that started in the last quarter of 2008 has extensively affected all categories of economies ranged from the most developed to emerging and developing economies, leading to the deterioration in demand for exports as well as business and consumer confidence in different degrees . Like many other central banks, Bangladesh Bank (BB) needed to take monetary and exchange rate measures in an attempt to limit the damage to the economy from spreading distress in financial markets. Although various arguments have been raised for and against it, Bangladesh's monetary policy to counter the adverse shock to the economy enacted in the crisis period, has in end been judged a success.

Given its fundamental policy objective of maintaining price stability and difficulty of applying fiscal policy as a short-term adjustment policy, owing to long –term fiscal objectives as well as political factors, Bangladesh has to rely heavily on monetary policy in controlling its macroeconomic situation. In addition, monetary policy has some additional responsibilities in situations of unconvertible Taka in capital account and flexible exchange rate management; taking into account these situations, Bangladesh Bank (BB) have used various devices to achieve macroeconomic stability.

As in the other countries, the main monetary policy. Measures employed in Bangladesh an open market operations involving short –term and long-term treasury bills and bonds and BB bills – these primary measure are used to adjust money supply. BB is also using changes in the reserve requirements and rediscount policies as means of controlling the money supply. As we look at BB's policy tools, money supply and interest rates levels are of primary importance.

Significant features of monetary response

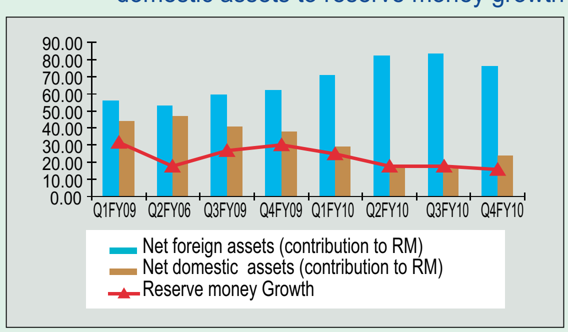
The fundamental goals of monetary policy of BB in the global financial crisis period were to restrain inflationary pressures and rising excess liquidity in the banking system brought about by remittance inflows and within the framework of a developing private sector , control the macro economy by monetary and exchange rate policies. The basic monetary policy method employed by BB was open market operations involving repo and reverse repo markets, established in 2003. In March, 2009 BB raised the daily requirement of cash reserve requirements(CRR) from 4% to 4.5% while CRR remained unchanged at 5% of commercial banks total demand and time deposits on bi-weekly average basis . In addition to these policies, BB tried to exert regulatory influence over bank loans. In April 2009, BB requested that all commercial banks to reschedule without mandatory down payment of default loans on the banker-customer relationship basis for affected export oriented industries up to 30 September, 2009. BB also directed the commercial banks to reduce their rate of interest to lower and fix to a maximum at 13 % on loan financing in agriculture, term and working capital loans to large and medium scale industries , housing loans and trade financing . BB also increased the rates of export subsidies/cash incentives for selected products during the crisis period.

Now we look at the ends to which the Bangladesh Bank had applied the monetary policy tools described above.

Monetary Policy as a means of countering expanding foreign assets

When global financial crisis affected Bangladesh economy, it reflected on the assets side of BB's balance sheet as a change in international reserves (foreign assets), and on the liabilities side as a fluctuations in money supply. BB's intervention using monetary measures described above was to prevent the money supply from fluctuation excessively and thus maintaining macroeconomic stability through stabilization policy. As BB cannot control net foreign assets; we can determine its monetary policy stance by looking at the relationship between the changing rate of reserve money, which BB can control

Figure 1 : Contribution of net foreign assets and net domestic assets to reserve money growth

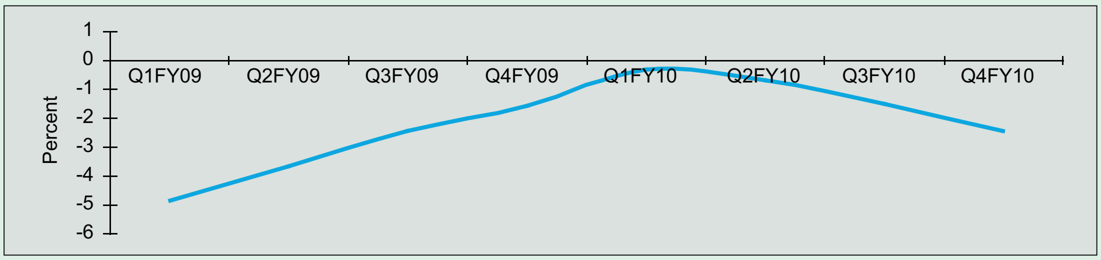


Box 1.1

The response of Bangladesh Bank to the global financial crisis *(Contd.)*

directly, and the growth rate of net domestic assets. The monetary policy stance, as interpreted from this viewpoint, is seen graphically in Figure-1. The graph indicates the year-on year changes in reserve money during the crisis period and the contribution ratios of BB's net foreign assets and net domestic assets to these changes. During the whole crisis period net foreign assets contributed more to the growth in reserve money than did net domestic assets; net domestic assets were cut down to limit the growth of reserve money to stay at stable rates, averaged 23 percent. Another index of monetary policy stance is interest rate trends. Real interest rate on savings deposits (which allowed for measuring confidence on banking system) was basically negative but gradually improved in the crisis period. (See Figure-2). Overall, during the global financial crisis period, BB invoked monetary policy to restrain growth in the money supply arising out of increased foreign assets. Furthermore, given the improvement of real interest rate, BB's policy can be considered accommodative but essentially cautious.

Fiqure 2 : Savings deposits interest rate (deflated by CPI)

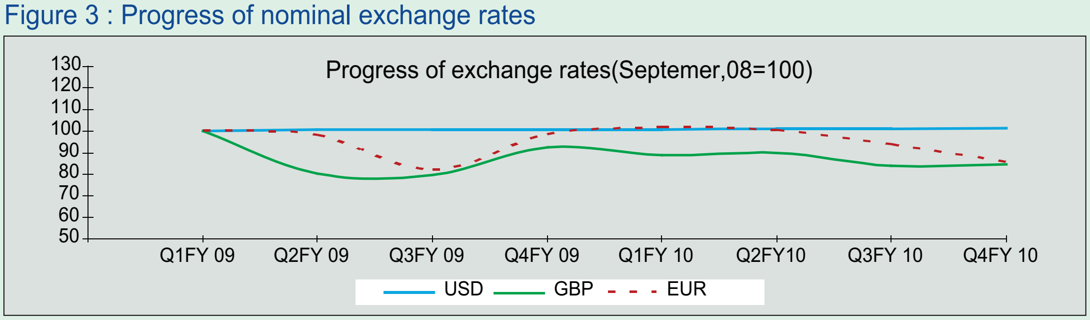


Exchange rate policy

During the global financial crisis period, BB's exchange rate policy was to keep the nominal exchange rate against the Dollar stable and use this to stabilize the country's economic management. Such a stance was possible apparently because there was no need to depreciate the nominal exchange rate as a means of promoting external demand because of relatively low inflation during this period.

In exchange rate policy, as noted above, BB broadened the intervention in the exchange market in the crisis period in an attempt to reduce, as much as possible, the amount of domestic currency to be supplied by BB in return for purchase of foreign currency. The Taka was remarkably stable against US Dollar in the crisis period. The exchange rate of Taka/US$ was 68.51 in September , 2008, remained at 68.93 in December 2008, 69.03 in March 2009, 69.06 in June 2009, 69.06 in September 2009, 69.27 in December 2009, 69.24 in March 2010 and 69.44 in June 2010. However, against EURO , while beginning in September 2008 the value of Taka was 98.99, starting fell rapidly to 81.08/EURO in March 2009, remained at 91-98/ EURO for the next two quarters and bottoming out at 103.30/EURO in November 2009 and than appreciated to 99.33 in December 2009, 92.88 in March 2010 and 84.66 in June 2010. (see Figure 3). The exchange rate of Taka against U.K. Pound Sterling also strengthened over the same period. The exchange rate of Taka/ GBP was 123.93 in September , 2008, 99.36 in December 2008, 98.52 in March 2009, 114.42 in June 2009, 110.20 in September 2009 , 111.34 in December 2009, 104.00 in March 2010 and104.62 in June 2010. Thus with its practice of maintaining an essentially stable exchange rate, monetary policy was in fact functioned effectively as a means of restraining inflation and managing the macro economy during the period of global financial crisis.

Figure 3 : Progress of nominal exchange rates



structures and practices that these will entail. Mandatory periodical stress testing routines in banks have also been introduced, to bring out early warnings about their vulnerabilities. BB's supervisory surveillance on the financial sector has been strengthened, including on their compliance with prudential regulatory ceilings on their exposures in the capital market. State owned and private sector banks are being regulated and supervised on the same bases with the same yardsticks.

Near and Medium Term Outlook for the Bangladesh Economy

1.27 The financial crisis driven global growth slowdown impacted Bangladesh with some lags, noticeably slowing down exports, imports and new investment from around the close of FY09. With limited, regulated external exposure keeping the financial sector free of toxic assets and contagion, the impact of global slowdown on Bangladesh economy turned out to be relatively moderate and short lived. Despite weakened exports, the economy retained firm footing in growth path, and indications of robust bounce back in external trade came out clearer by close of FY10. Growth outlook in agriculture remain good for FY11, with generally benign climatic conditions and proactive attention of the agriculture ministry and BB in ensuring access to necessary inputs and financing. Internal demand led manufacturing activities have maintained pace, supported inter alia by social safety net expenditures and BB's financial inclusion thrust for adequate financing of micro, small and medium scale enterprises. On positive growth trend from H2 FY10, exports have rebounded with 30 percent y-o-y increase in Q1 FY11, including significant uptrend in exports to newer markets. Incremental export prospects from waivers of tariffs and import bans on many export items of Bangladesh promised recently by China and India may more than make up for the demand slack in North America and Europe. In view of these internal and external sector developments, the 6.7 percent real GDP growth targeted in FY11 national budget looks well within reach, positioning the economy well for launch to growth trajectory of eight percent or higher over the medium term, as envisaged in the government's proposed sixth five year plan.

1.28 The main near term risk to this upbeat outlook is in the persistent shortages of power and gas supplies, disrupting production in installed capacities and slowing down investments for new capacities. Near and medium term growth prospects for the economy now hinge crucially on the implementation of the Government's plan for eliminating energy shortages, adding as fast as possible new generation capacities with private and public sector outlays.

1.29 Significant external sector risk factors to medium term growth outlook include the recent declining trends in FDI and manpower exports. Foreign direct investment inflows are likely to pick up in step with global growth recovery, but can be hastened by forging closer trade and investment ties with fast growing economies in East and South Asia, bilaterally as well as regionally. Recovery from decline in manpower exports may prove more challenging. Major host countries of Bangladeshi workers, including even those not in growth slowdown, are reportedly shedding foreign workers to protect employment for their own nationals. Fewer of the employment contracts of Bangladeshi workers in these countries are being renewed; and the returning jobless migrants will pose significant employment challenge in the domestic job market. They will need to be assisted effectively in finding new employment in new host markets abroad; as also in self employment initiatives in setting up SMEs locally.

Box 1.2

Need for introducing Environmental Risk Management

Environmental Risk is defined as an actual or potential threat of adverse effects on living organisms and environment by effluents, emissions, wastes, resource depletion, etc. arising out of an organisation's activities. Climate Change Risks is often referred to as "global warming"- generating huge challenges to the environment and to the world economy. The manifestations of climate change include higher temperature, altered rainfall patterns and more frequent or intense extreme events such as heat-waves, drought and storms. So environmental and climate change risks are interlinked with each other and these risks are some of the most significant emerging risks facing the world today.

The state of environment in Bangladesh is deteriorating significantly. The key areas of deterioration include land degradation, water pollution and scarcity, air pollution, biodiversity resources and impacts of natural disasters. Rapid population growth, improper use of land, poor resource management and uncontrolled discharge of pollutants are the major causes. In addition, Bangladesh is one of the most climate change vulnerable countries in the world. Floods, tropical cyclones, storm surges and droughts are likely to become more frequent and severe in the coming years. Banks/Financial Institutions (FIs) in Bangladesh need to protect their financing from the risks arising out of the deteriorating environmental scenario and climate change. Banks/FIs must need to adopt environmental and climate change risk management techniques and procedures. They are required to play an effective role in responding to this grave environmental challenge and also to ensure that their own financial assets are adequately protected from environmental and climate change impacts and associated risks. BB as the supervisory authority has rightly been involved in this timely event and prepared a guideline on Environmental Risk Management in consultation with IFC-SEDF, banks and FIs. Banks and FIs will have a chance to use these guidelines for both equity and debt management. However, there is a need to bring the Securities and Exchange Commission to consider environmental risks in a formal manner in terms of the information being furnished to the investing public. The main determinant of environmental risk is the nature of a borrower’s business activity. Credit rating agencies should be encouraged to integrate environmental risk considerations into their models and approaches in delivering ratings of individual borrowers/promoters. The systems in place for CAMELS rating should also integrate environmental risks. This will include integrating environmental risks in the checklists, audit guidelines and reporting formats. All of these will help mainstream Environmental Risk Management further by providing a weightage in the overall periodic evaluation of the banks/FIs. On receiving the proposal for lending, banks/FIs should now conduct a preliminary environmental risk review using Environmental Due Diligence (EDD) checklists. Possible sources of Environmental Risk such as Land use, climate change related events (cyclone, drought), animal diseases/pathogens such as avian influenza, solid waste including waste feed, animal waste, carcasses, sediments, wastewater discharges, hazardous materials, etc will be reviewed under EDD checklists. The detailed Environmental Risk Review will be required for all projects, which are identified in the Red Category under the Environmental Conservation Rules (ECR), 1997 being implemented by the Department of Environment. When presenting the credit risk rating of the proposal for lending, the Environmental Risk Rating (EnvRR) should also be provided.

The guideline on Environmental Risk Management has been forwarded to the concerned departments of BB, Association of Bankers Bangladesh Limited (ABB) and some banks for vetting. Department of Environment has been requested to make comments on the said guidelines as well. BB is continuing the consultative approach and will issue circular to all scheduled banks and financial institutions for introducing the guidelines after the vetting is completed.

1.30 CPI inflation remained at higher single digit level in H2 FY10 breaching the 6.5 percent ceiling targeted in FY10 for 12-month average CPI. In Q1 FY11 point to point inflation has eased slightly. The 12-month average CPI continues creeping up however due to the higher base effect in averaging, but will begin declining towards the 6.5 percent level targeted in FY11 monetary program from Q2 onward unless there is new sharp upsurge in p-to-p inflation. No looming near term risk of such upsurge is apparent right now in the external or domestic front. With the global economy on two track path of recovery from slowdown, forecasts by IMF and other sources report no near term likelihood of sudden sharp spike in overall global inflation, despite possible sporadic price volatility in individual food or non food commodities. No major near term domestic factor likely to cause sharp spike in CPI inflation in Bangladesh is apparent either; with labour unrests resolved in the RMG sector and with no pronouncement of government intent of any immediate upward revision of administered energy prices. . The overheated capital and real estate markets continue to pose risk of second round worsening effect on CPI inflation over the medium term; besides first round disruption risks to the economy from price bubble collapse. Overheating of the asset markets not being primarily credit driven, impact of monetary and credit policy steps on asset price trends are unlikely to be extensive. Nevertheless BB has taken feasible cautionary measures; including strict enforcement of regulatory limits on capital market activities of banks, requiring fire-walling between their banking and capital market businesses, higher provisioning requirements on capital market assets, prohibition of bank lending for land purchase, prior BB review and clearance requirement on real estate acquisition proposals of banks, and discontinuation of refinance against loans for apartment purchase.

1.31 The BB in recent revisit of its strategic goals and objectives in a strategic planning workshop in H1 FY10 has opted to enhance comprehensive thrust for deeper, broader financial inclusion, in support of GOB's goal of rapid poverty reduction with faster inclusive growth. BB's multifaceted financial inclusion initiatives are getting banks increasingly engaged in financial services to the under-served and unserved economic sectors including agriculture; micro, small and medium scale enterprises; renewable energy and effluent treatment projects. In these initiatives innovative partnerships between banks, microfinance institutions, mobile phone and smart card based IT platforms for efficient and cost effective client service are being encouraged and supported. These initiatives are stimulating incremental output of goods and services on the supply side, and incremental income and purchasing power on the demand side, contributing to progress in attainment of the country's poverty reduction with inclusive growth goals.