Monetary Policy Statement

January-June 2014

Chief Economist's Unit and Monetary Policy Department

Bangladesh Bank

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Monetary policy statement (January-June 2014: H2FY14)

Executive Summary

This issue of the Bangladesh Bank (BB) half yearly Monetary Policy Statement (MPS) outlines the monetary policy stance that BB will pursue in H2 FY14 (January-June 2014), based on an assessment of global and domestic macro-economic conditions and outlook. This MPS was preceded by productive consultations with key stakeholders and web-based comments were also received.

The last MPS (July 2013) was based on certain key assumptions and policy directions. A review of developments over the past six months suggests that most of these key assumptions materialized and solid progress was made towards the key goals. The July 2013 MPS explained that policy rates were being kept unchanged due to the risks of inflationary pressures stemming from wage increases and supply-side disruptions. The last MPS also aimed to contain reserve money growth to 15.5% and broad money growth to 17.2% by December 2013. It also predicted that actual private sector credit growth may not use up all the space provided in the monetary program in the lead-up to the national elections. Latest data for H1FY14 shows that reserve money growth and growth of net domestic assets of Bangladesh Bank remained within program targets, despite a surge in Net Foreign Assets (NFA) arising from robust exports and sluggish import growth. Broad money growth of 16.7% in November 2013 was close to program targets. BB's facilitation of private sector trade credit from abroad led to some switching to lower cost overseas financing with overall private sector credit growth, from both local and foreign sources, amounting to 13.8% in November 2013. Domestic retail interest rates declined during these six months with the spread between lending and deposit rates dipping below 5% and its trend indicating that lending rates have declined faster than deposit rates.

Adherence to the monetary program along with sluggish aggregate demand due to countrywide shut-downs in recent months led to non-food point-to-point inflation falling from 7.40% in July 2013 to 4.88% in December 2013. However supply bottlenecks along with rising food prices in India led to point to point food inflation rising from 8.14% to 9.0% during the same time period. Average inflation rose from 6.99% to 7.53% during H1FY14 driven by these higher food prices.

The last MPS aimed to preserve external sector stability, building up reserves and avoiding excessive volatility of the exchange rate. Improved external balances are reflected in the accumulation of international reserves of about USD2.5 billion during H1FY14 with gross reserves of over USD 18 billion at the end of December 2013, sufficient to cover about 5.5 months of projected imports. The Taka: USD nominal exchange rate remained stable in H1FY14 and BB's interventions in the foreign exchange market have significantly limited the loss of external competitiveness by stemming the appreciation of the Taka.

The July 2013 MPS also sought to strengthen credit and debt markets by taking steps to improve corporate governance, supervisory capacity and stimulate higher demand for government securities, minimizing devolvement. Latest data shows that there was a reduction in devolvement from 34% of all government securities in FY13 to 26% in H1FY14. BB's supervision capacity has been strengthened through greater automation with information from the new e-monitoring system used to take prompt remedial action (e.g recently for Inland Bill recovery). Stringent financial improvement plans have been

set with the four SOCBs and Basic Bank which includes differential ceilings on loan growth. However despite these steps, gross NPLs rose in the banking sector from 11.9% at end FY13 to 12.8% at end Q1FY14, due to the 'over-hang' of earlier scams and the difficulties businesses faced in repaying loans during the countrywide shut-downs.

The monetary stance in H2 FY14 takes these recent economic and financial sector developments into account and will target a monetary growth path which aims to bring average inflation down to 7%, while ensuring that credit growth is sufficient to stimulate inclusive economic growth. BB will use both monetary and financial sector policy instruments to achieve these goals. The persisting inflationary pressures over the past few months with the risks ahead related to the inflation outlook imply that achieving the FY14 inflation target will be challenging. As such BB has decided to keep policy rates unchanged. Moreover the ample liquidity in the banking system suggests that an easing of reserve requirement ratios is also unnecessary.

Specifically BB aims to contain reserve money growth to 16.2% and broad money growth to 17% by June 2014. BB will have a ceiling on net domestic assets as a key operating target. The space for private sector credit growth of 16.5% has been kept well in line with output growth targets and is sufficient to accommodate any substantial rise in investment over the next six months. BB views these figures as indicative ceilings – banks continue to be advised to lend only to creditworthy clients for productive purposes. At the same time these ceilings are flexible and the monetary program can be recalibrated should economic growth pick up faster than projected. The monetary stance also assumes government borrowing from the banking sector will remain around the FY14 budgetary figure of 260 billion taka, and the limited borrowing of 46 billion taka in H1FY14 suggests this is realistic.

In parallel various recent initiatives to support economic growth will continue in H2FY14. In order to cushion the impact of recent domestic disruptions on businesses, BB has taken a number of important policy steps which include broadening the scope of the Export Development Fund, and reducing the borrowing costs, as well as instructing banks to offer loan rescheduling facilities to genuine borrowers facing cashflow difficulties, especially SMEs, who are temporarily affected by the recent strikes and disruptions. Moreover in order to stimulate entrepreneurship among low income rural households who have opened ten taka accounts, BB is launching a new 2 billion taka refinancing facility to be implemented by Micro-Finance Institutions.

Effective transmission of monetary policy requires strengthening credit and debt markets and this will remain a key focus for H2FY14. In order to spur secondary market activity BB has recently embarked on secondary trading in Treasury bonds and will continue to do so in H2FY14. Devolvement of these securities has also fallen from 34% in FY13 to 26% in H1FY14 and this trend is expected to continue in H2FY14. A new Islamic bond of 3 months tenure is expected in H2FY14 which will contribute to better liquidity management of Islamic banks. While not directly under the purview of BB, various monetary and financial sector related actions have contributed to stabilizing the capital market and BB will continue to collaborate with BSEC in this regard. BB will continue to encourage larger borrowers to access the capital market as banks will need to comply with the recently revised regulation on single borrower exposure limits for business groups. In order to fill the gaps in the financial landscape, BB

intends to facilitate the role of private equity / venture capital sources of finance. Revised performance agreements for SOCBs and specialized banks have set differentiated ceilings on loan growth depending on bank performance – quarterly performance targets will continue to be published on BBs website to promote public accountability. Clear progress on implementing a credible business plan is a pre-condition for sanctioning the release of additional recapitalization funds. An important development is the fact that SOCBs have reduced their exposure to State Owned Enterprises (SOEs) which is set to continue in H2FY14. Following the uncovering of high-profile financial scams by BB, banks in general are strengthening corporate governance policies, internal controls and anti-money laundering and terrorist financing activities. BB's supervision ability is being enhanced with greater automation and capacity building and the cumulative effect of these reforms will strengthen the financial sector.

This monetary policy stance also aims to preserve the country's external sector stability. BB anticipates further build-up in foreign reserves in FY14 though at a more moderate pace than FY13. While the projected decline in remittances will not adversely affect external stability in FY14, it is imperative that manpower exports resume its growth, and opportunities such as investments in government securities are marketed to NRBs, so that remittances can remain an important part of medium-term external balance. BB will continue to support a market-based exchange rate while seeking to avoid excessive foreign exchange rate volatility.

Monetary policy statement (January-June 2014)

Global context

Although global growth prospects for 2014 (3.6%) is higher than the previous two years, the road to recovery in the advanced economies is projected to remain uneven. Key trading partners, the US and the EU, are projected to grow faster in 2014 but private demand still remains very sluggish in the Euro Area. On the other hand, Emerging Market and Developing Economies (EDEs) are experiencing a multi-speed recovery process with growth projected at 4.5% in 2013 and 5.1% in 2014 – which have both been revised downwards by about 0.5% points since the July 2013 MPS (H1FY14). While China is projected to grow at around 7.3% in 2014 the Indian economy is projected to grow by 5.1% (see Table 1).

Table 1: World GDP growth

(year- on- year, in percent)

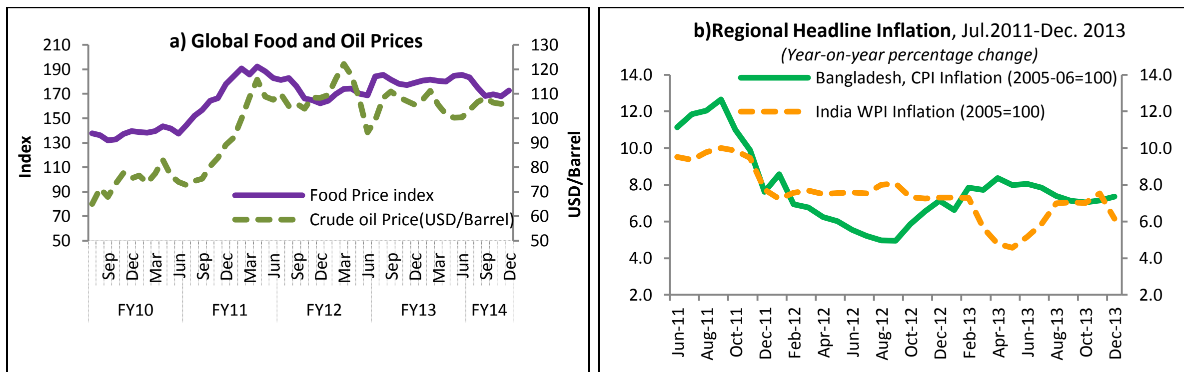
	2012	2013 (Proj.)	2014 (Proj.)
World	3.2	2.9	3.6
Advanced Economies	1.2	1.2	2.1
Other Advanced Economies	1.9	2.3	3.1
Euro Area	-0.6	-0.4	1.0
USA	2.8	1.6	2.6
Emerging and Developing Economies	4.9	4.5	5.1
China	7.7	7.6	7.3
India	3.2	3.8	5.1

Source: IMF World Economic Outlook (October 2013)

Commodity prices and regional inflation continue to pose a key country risk. Crude oil prices rose about 5% in H1FY14. The uncertainties in the Middle East may continue to persist and oil prices are therefore likely to remain volatile. On the other hand global food prices have declined somewhat over the past six months (chart 1a). FAO forecasts that global food prices are expected to remain reasonably stable over the next six months. Empirical studies show that Bangladesh's inflation is significantly correlated with India's[1] (chart 1b). Indian inflation has risen in recent months (WPI was 4.5% in June and rose to 6.2% in December 2013 while CPI was 9.9% in December 2013) and these inflationary pressures are already having knock-on effects on Bangladesh inflation, especially for food items.

[1] See Paul B and H Zaman "*When and why does Bangladesh inflation differ from India's*?" Working Paper Series WP1301, Chief Economist's Unit, Bangladesh Bank

Chart 1: Global Commodity Prices and Regional Inflation



Recent economic developments

Domestic output growth: Key indicators related to output growth in H1FY14 suggest that economic growth is likely to have slowed relative to FY13 levels. Though service sector – which comprises over half of GDP - data is available only on an annual basis, a number of proxy indicators reflect slower service sector growth during the first half of FY14. Data on bank advances show that the growth of credit (outstanding) to the trade sector declined to 12.9 percent at the end of Q1FY14 from 24.7 percent at the end of Q1FY13, while bank advances to transport and communication sector registered a negative growth of -43.54 percent. Moreover there is also evidence that retail and wholesale trade, hotel and restaurant business, transport services and tourism faced sluggish demand due to frequent national shut-downs in H1FY14. Low growth of cement production (3.16 percent) and negative growth of iron and steel production (-8.54 percent) in the first two months of FY14 indicate slowing growth of the construction sub-sector with bank credit to this sector also experiencing a low growth of 8.87 percent in Q1FY14. A sample of iron, steel and cement manufacturers reported a 50%-60% drop in sales in Q2FY14. In general manufacturing sector growth is likely to have slowed in November-December 2013 due to the nationwide shutdowns though data between July-November portray a healthy 18% growth in exports. Agricultural output data for H1FY14 suggests that thus far key targets for the cereal crops are on track (though these targets themselves imply a 2-3% growth in output relative to FY13) though the farmgate price of other produce such as vegetables, potatoes etc have fallen sharply due to the disruption in the distribution network. Therefore it is unclear whether agriculture growth will be significantly above the 2-3% range of the previous two years.

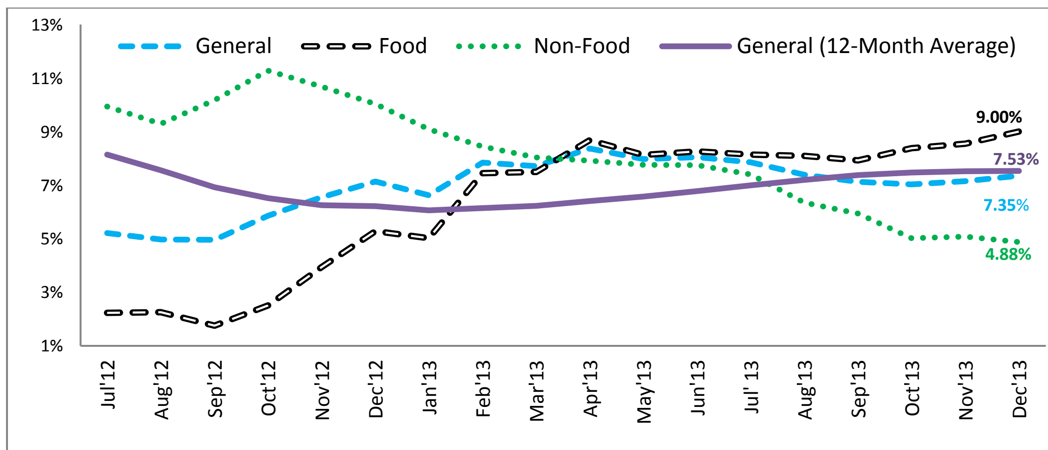
Overall the sluggish services and construction sector data along with the negative growth in remittances (- 8.4% in H1FY14 relative to the same period in FY13), suggests that aggregate demand and overall economic growth in FY14 will be lower than FY13. BBS' estimates for FY13 growth was 6.03% (using the 1995/96 base) though with the new 2005/06 base it was 6.2% (BB's forecast in December 2012 was that output growth would range from 6.1-6.4% in FY13 using the 1995/96 base and the eventual 6.03% outcome fell slightly outside this range). BB's current forecast is that output growth will pick up in

H2FY14 and this will partly make up for the losses faced in H1FY14 – overall BB's current forecast[2] for FY14 ranges from 5.8%-6.1% and should there be no major disruption to the economy, output growth could be closer to 6%. This is a slightly revised forecast relative to the 5.7%-6.0% range projected in December 2013. BB will update its forecasts on a regular basis during the course of the year and the monetary program will also be flexible to accommodate any significant change in these forecasts.

Inflation

Point to point inflation data using the 2005/06 base broadly shows that food inflation has risen steadily from 1.75% in September 2012 to 9.00% in December 2013. The reasons relate to higher distribution costs due to the frequent nationwide strikes, and the fact that Indian food inflation has also risen sharply which is also correlated with Bangladesh food inflation. On the other hand, point to point non-food inflation is steadily declining, having peaked in October 2012 at 11.28% and has declined steadily to 4.88% in December 2013. This is due to the adherence to the monetary program and the recent disruptions which caused a slowdown in economic activity and lower consumer demand (see discussion on growth above). However, the rise in food inflation is pushing up average inflation which bottomed out at 6.06% in January 2013, rose to 6.78% in June 2013 and is 7.53% in December 2013.

Chart 2: Inflation (2005/06 base)



Looking ahead, the FY14 inflation target announced in the Budget is 7.0%. Reducing average inflation from its current 7.5% level may prove challenging especially as aggregate demand is likely to pick up in H2FY14 and the recent rise in Indian inflation is also a risk for Bangladesh as shown by historical long term trends. The implications for the monetary stance are discussed later in the MPS.

[2] BB's forecasts are based on a range of estimates produced by assessing the trajectory of key economic indicators during the year and supported by modeling time-series data using standard growth-forecasting econometric methods carried out by members of the Chief Economists Unit.

The **current account balance (CAB)** recorded a surplus of USD 1384 million during July-November 2013 compared to a surplus of USD 433 million during the same period of the preceding fiscal year. The improvement in trade deficit (18% export growth along with 4.4% import growth) contributed to this and compensated for the decline in remittances relative to July-November 2012. Supported by the surplus in CAB and a small surplus in the combined capital and financial account, the overall balance recorded a surplus of USD 2040 million. This contributed to foreign exchange reserves reaching USD 18.1 billion at the end of H1FY14 compared with USD 15.3 billion at the end of FY13.

In order to protect Bangladesh's external competitiveness, Bangladesh Bank continued its interventions in the domestic foreign exchange market with a net purchase of foreign currencies amounting to USD 2.35 billion during H1FY14. Consequently, the foreign exchange market remained stable during H1FY14.

Table 2: External Balances Summary Table

Items		FY11	FY12	FY13	Jul.-Nov./Dec. FY13	Jul.-Nov./Dec. FY14
Export (% change)		41.5	6.0	11.2	4.3	18.0
Import	Shipment (% change- c&f)	52.1	2.5	0.8	-4.2	4.4
	L/Cs Opened (% change)	34.0	-4.0	-2.8	-9.7	8.8
Remittances (% change)		6.0	10.2	12.6	22.0	-8.4
FDI (in million USD)		775	1192	1300	664	673
Overall Balance (in million USD)		-656	494	5128	1752	2040
	Current Account Balance (in million USD)	885	-447	2525	433	1384
	Capital Account (in million USD)	642	482	588	190	211
	Financial Account (in million USD)	-1920	1436	2779	1870	765
Forex Reserve (in million USD, end of period)		10912	10364	15315	12751	18075
Exchange Rate (Tk./USD, end of period)		74.2	81.8	77.8	81.4	77.8

Remittance growth started slowing in H2FY13 and became negative in H1FY14. Remittance growth of 12.6% in FY13 was higher than the 10.2% growth in FY12, though this growth did slow to 4.2% during the second half of the year compared to the first half of FY13 when remittance growth was 22%. This slow-down is primarily a function of a 36% drop in the number of workers migrating in FY13.

The **capital account** shows that foreign direct investment in the first five months of FY14 is at similar levels compared with the same period of FY13 - the pattern in FY14 is likely to be dominated by reinvestment from existing firms such as for 3G upgrading, while new foreign firm entry is likely to have been limited given recent domestic uncertainties. Medium and long term loan disbursements in the first five months of FY14 were USD 741 million relative to USD 745 million during July- November FY13. Improved external balances are reflected in the accumulation of international reserves to over USD18 billion at the end of H1FY14, sufficient to cover 5.5 months of projected imports.

Avoiding excessive **exchange rate** volatility remains a key objective of BB. The nominal value of the Taka against USD barely changed in H1FY14 while real exchange rate data indicates a marginal impact on export competitiveness[3]. However, BB's interventions in the foreign exchange market have protected

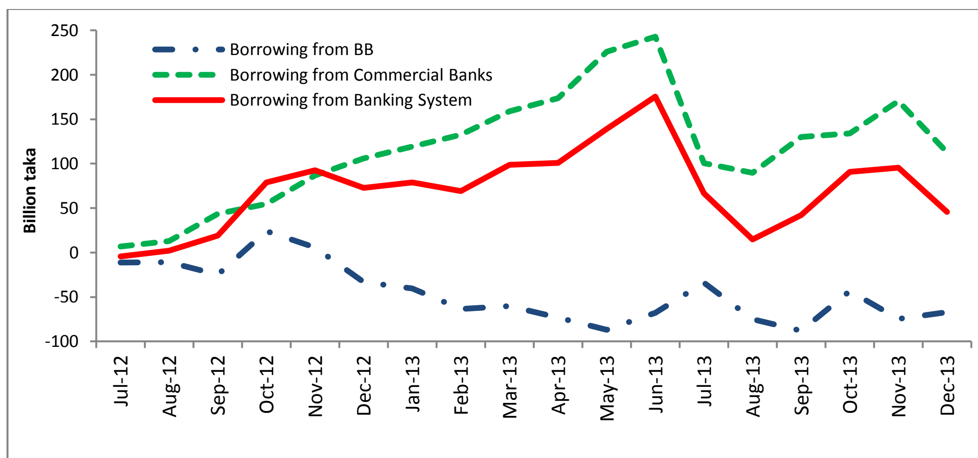
[3] For further details see IMF (2013) "Bangladesh Article IV Staff Report", Washington DC

exporters by slowing the appreciation of the Taka. Moreover by opening up working capital borrowing at lower interest rates from foreign sources to exporters in FY13, and increasing the Export Development Fund size, as well as expanding the sectors eligible for the Fund, BB is actively promoting export competitiveness.

Looking ahead to H2FY14 our balance of payments projections apprehends there will be a correction in the pace of export growth due to a possible slow-down in RMG sector orders, along with a pick-up in imports as investor confidence grows. We also project a slightly positive remittance growth in H2FY14. These assumptions along with the outcomes for H1FY14 imply that for FY14 we project overall export growth of 8%, import growth of 9% and remittance growth of -4% which will lead to a healthy balance of payment surplus. However starting from FY15 in order to retain external sector stability it will be important for remittance growth to pick-up as imports are likely to grow further following a year of import compression. This will require coordinated activities to boost manpower exports, upgrading skills of migrants and enhanced incentives to use formal channels to remit and invest funds – BB will step up its efforts in this regard.

Government borrowing (net) from the banking system was significantly lower than projected in H1FY14. Government borrowing (net) from the banking system amounted to 46 billion in H1FY14 against a budget provision of 260 billion for the whole of FY14. The relatively low borrowing levels partly relates to the slow pace of ADP implementation and this pattern appears similar to the previous year where the borrowing largely took place in H2FY13 as only 59 billion, of the total 248 billion taka borrowed, was borrowed in H1FY13. Another factor behind the low levels of borrowing from the banking sector is the fact that revenue from the sales of National Savings Certificates have risen sharply as the differential between their returns and that of bank fixed deposit rates has grown. Savings certificates sales between July-November 2013 of 33.7 billion compares with 7.72 billion for the whole of FY13. The overall net borrowing from the banking system is the sum of borrowing by the Government from Bangladesh Bank and borrowing by the Government from scheduled banks. Chart-3 illustrates how this pattern has varied. In H1FY14 government made a net repayment to BB of 67 billion taka while borrowing 113 billion from scheduled banks.

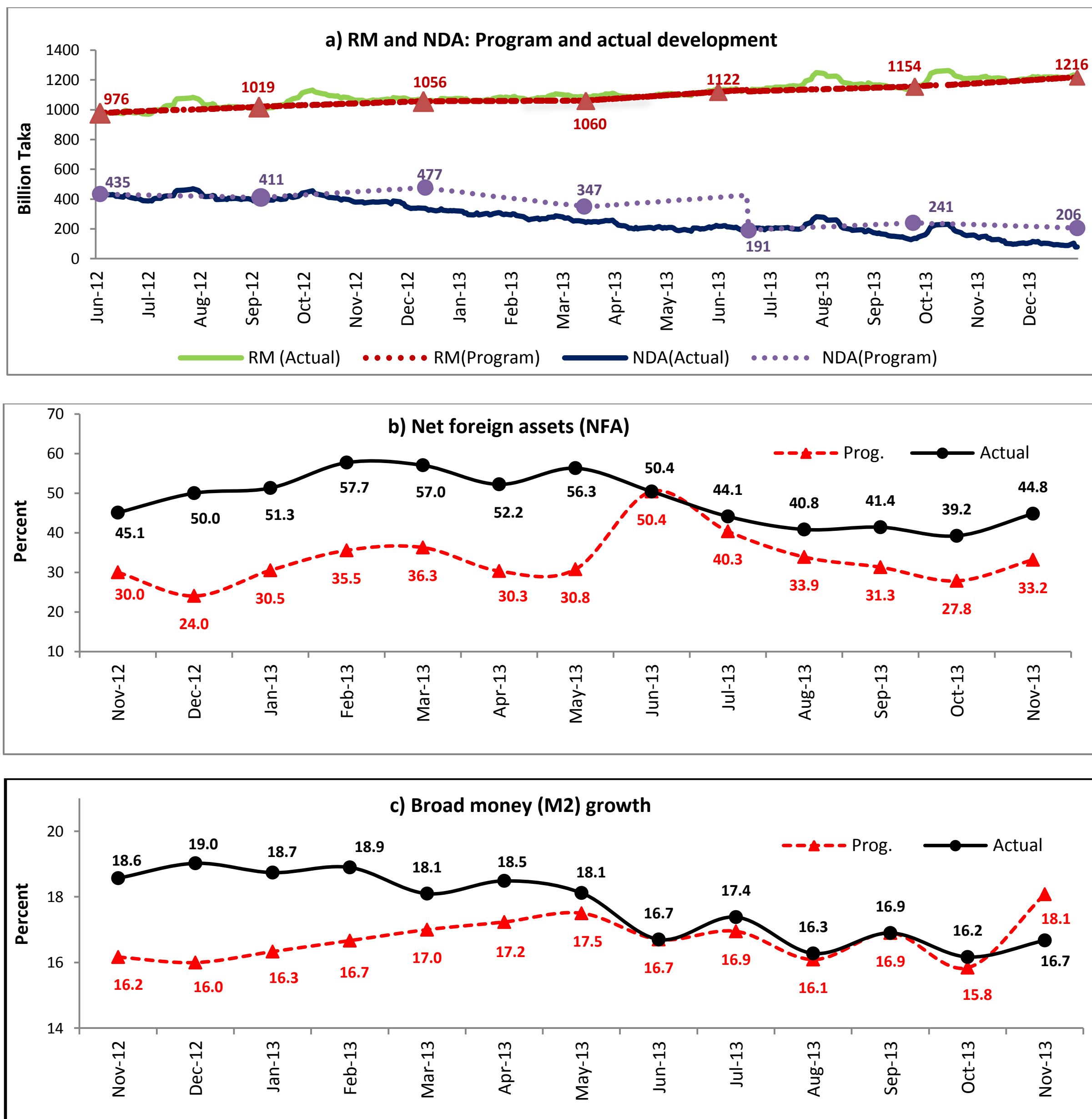
Chart 3: Net Credit to the Government from the Banking System

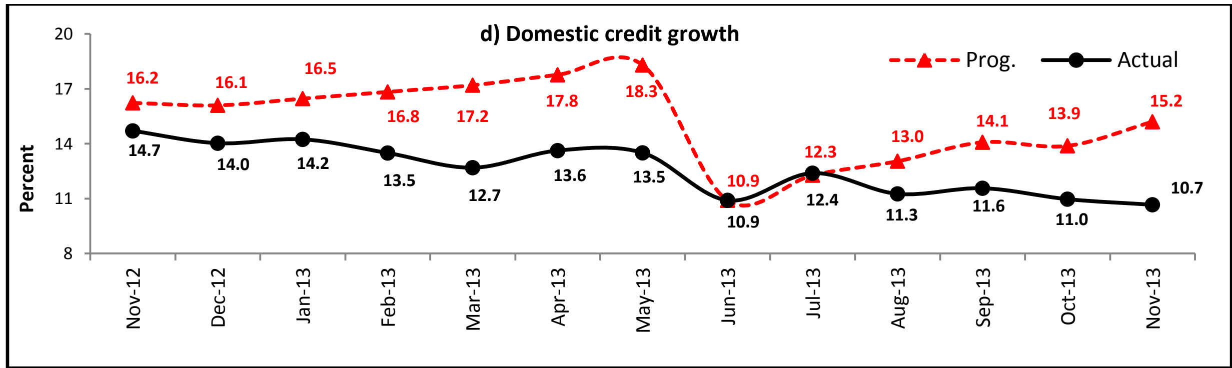


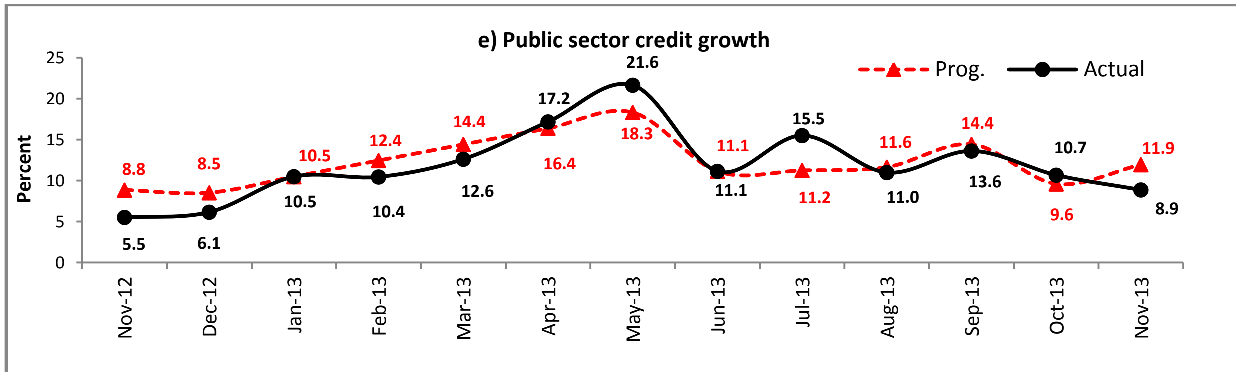
Monetary growth targets for H1FY14 stayed on track. Reserve money (RM) growth and growth of net domestic assets (NDA) of Bangladesh Bank, which are critical anchors of the monetary program, remained within program targets (see chart 4a). This was despite a surge in Net Foreign Assets (NFA) of BB (chart 4b shows NFA growth of both BB and scheduled banks) which were sterilized via reverse repo operations, selling BB bills and Islamic Bonds (see chart 5).

Broad money growth trends (chart 4c) are below the program path (16.7% growth in November 2013 compared with 18.1% target), since domestic credit growth (chart 4d) fell short of the anticipated rate due to shortfalls in both private and public sector credit growth (charts 4e and 4f).

Chart 4: Monetary Program Indicators







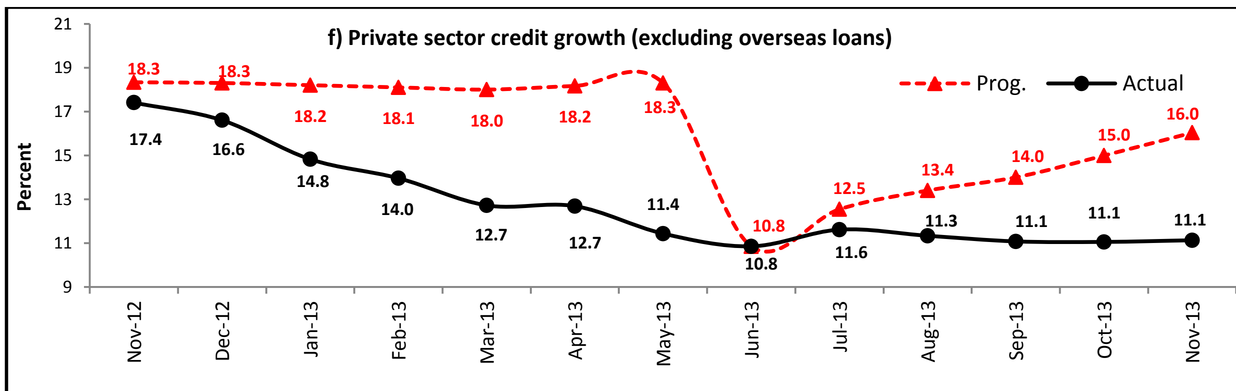
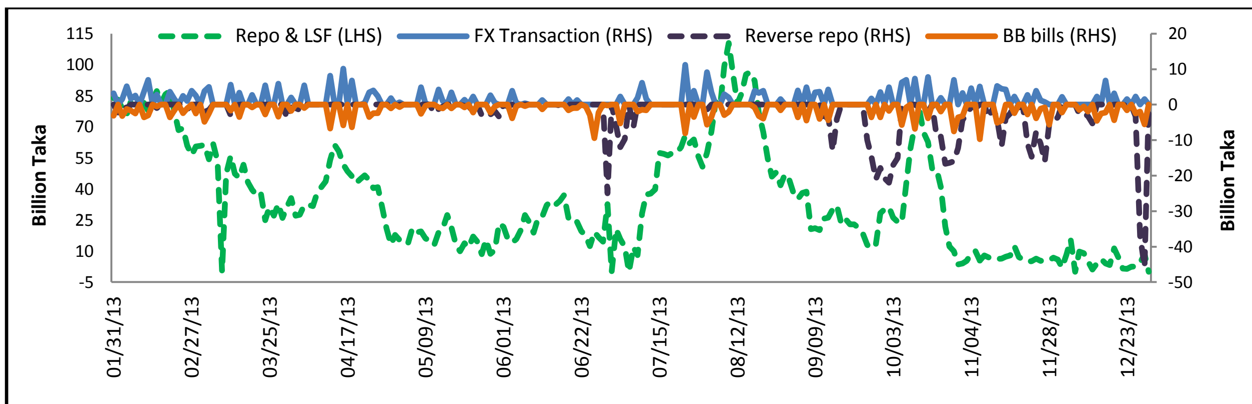


Chart 5: Liquidity Management Operations During 2013



Private sector credit growth in H1FY14 remained sluggish though borrowing by corporates overseas partly made up for this. In addition to access to credit from domestic sources, Bangladeshi corporates can tap foreign sources of financing, including two new facilities which started in FY13. Private credit growth from domestic sources slowed to 11.1% growth in end November compared with a year earlier. This slowdown is partly due to sluggish investment demand in the lead-up to the national elections, tighter lending practices by banks as well as the fact that there are two new channels through which entrepreneurs can access overseas lenders who offer lower cost financing. One existing channel is borrowing by corporates for term credit purposes with most having a maturity beyond five years – around US $534 million was approved in H1FY14 while US $1.82 billion was approved in FY13 compared with US $1 billion in FY12. In addition private capital flows to local corporates have also grown due to the addition of short term foreign currency loans for working capital purposes in the form of 'buyers credit' (which importers can avail with a tenure of upto one year) and 'discounted export bills'. The addition of external borrowing with domestic borrowing implies that total private sector credit growth for November 2013 was 13.8%.

Call money rates have leveled off and average retail interest rate spreads have fallen below 5%. Call money rates have declined since their peaks in early 2012 when they were around 20%, and also fell in H2FY13 from around 10% in January 2013 to around 7% in June 2013. They have since leveled off ranging from around 7-8% in H1FY14 (chart 6). This is also reflected in below average loan to deposit ratios. At the retail level both deposit and lending rates fell in H2FY13 and since interest rate spreads have on average fallen – from 5.13% in June 2013 to 4.97% in November 2013 – we can infer that lending rates have fallen faster than deposit rates (see chart 7). Domestic lending rates have fallen due to lower cost of funds for banks, lower demand for credit as well as due to increasing competition from overseas lenders whose lending rates are in single digits.

Chart 6: Call Money Rate and Yield on 91-Day T. Bill

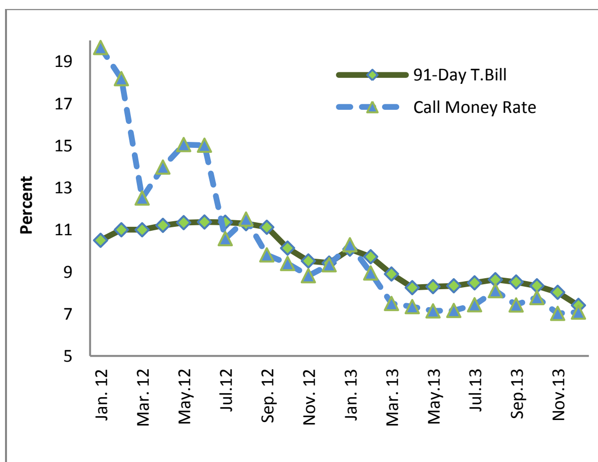


Chart-7: Interest Rate Spread

Banking sector repayment and profitability indicators have suffered for a variety of reasons. The ratio of non-performing loans (NPL), in both gross and net terms, increased at the end of Q1FY14 compared with end-Q4FY13. Gross NPL went up from 11.9 percent at the end of Q4FY13 to 12.8 percent at the end

of Q1FY14. The deterioration was across the board for all type of banks, but particularly for SOCBs and specialized banks. The reasons include having to classify loans stemming from the well-publicized scams in the banking sector as well as difficulties in loan repayment due to the economic disruptions resulting from national strikes. During Q1 FY14, capital adequacy ratio (CAR) remained at the 9.1 percent level of Q4FY13 with a slight improvement for SOCBs and PCBs but a deterioration for specialized banks. Among the profitability measures, return on asset (ROA) in the banking sector declined marginally from 0.64 percent at the end of December 2012 to 0.61 percent at the end of June 2013 primarily due to the higher interest expenditure than interest income. However, return on equity (ROE) of the banking industry remained virtually unchanged at 8.20 percent at the end of December 2012 and 8.21 percent at the end of June 2013. The steps to strengthen these indicators are outlined in the key forward-looking policy measures section later in this document.

Analysis of the economic purpose of outstanding loans to the private sector indicates that over the past year there has been a small increase in the share of loans going to the agriculture sector (from 5.2% in September 2012 to 5.4% in September 2013). The share of loans going towards trading activities has increased from 37.6% in September 2012 to 38.6% in September 2013 while there has been a reduction in the share of loans towards transport and communication (2.5% in September 2012 to 1.2% in September 2013). The share of construction loans has remained virtually unchanged (from 8.8% in September 2012 to 8.7% in September 2013) while the share of working capital financing has grown (from 13.8% to 15.0% during this period). The share of industrial term loans (19.9% in September 2013) in total outstanding credit remained unchanged compared to a year earlier.

Monetary policy stance for H2 FY14

The monetary stance in H2 FY14 takes these recent economic and financial sector developments into account and will target a monetary growth path which aims to bring average inflation down to 7%, while ensuring that credit growth is sufficient to stimulate inclusive economic growth. This would require a monetary program framework that limits reserve money growth to 16.2% and broad money growth to 17% by June 2014. BB will have a ceiling on net domestic assets as a key operating target. The ceiling for private sector credit growth of 16.5% has been kept well in line with economic growth targets. This level is sufficient to accommodate any substantial rise in investment and trade-finance over the next six months. BB views these figures as indicative ceilings – banks continue to be advised to lend only to creditworthy clients for productive purposes and whether this ceiling is reached or not depends ultimately on investor appetite and the bank's assessment of project viability. The slightly higher credit to public sector figure in percentage terms for June 2014 in the current MPS is due to the fact that the H1FY14 MPS was based on an estimated figure for June 2013 government borrowing which turned out to be higher than the actual figure. As a result due to the 'lower base effect' the public sector borrowing growth for June 2014 (22.9%) in the current MPS is higher than the previous MPS (19.5%) even though the amount in monetary terms (260 billion taka) remains the same. Similarly the relatively low NFA growth in FY14 relates to our balance of payments assumptions described earlier where we apprehend an overall negative growth in remittances for FY14 and a possible slower pace of export growth in H2FY14.

Table 3: Monetary Aggregates (Y-o-Y growth in percent)

Items	Actual			Jul'13 MPS Prog.	Jan'14 MPS Prog.
	FY11	FY12	FY13	Jun.14	Jun.14
1. Net Foreign Assets*	6.2	7.2	50.4	8.4	10.0
2. Net Domestic Assets	24.7	19.3	11.0	19.0	18.6
Domestic Credit	27.5	19.2	10.9	17.2	17.8
Credit to the public sector (incld. Govt.)	34.6	17.4	11.1	19.5	22.9
Credit to the private sector	25.8	19.7	10.8	16.5	16.5
3. Broad money	21.4	17.4	16.7	17.0	17.0
4. Reserve money	21.0	9.0	15.0	16.5	16.2

* NFA is calculated using constant exchange rates of June'11

There are a number of key policy measures, and assumptions, underlying this program:

First, BB will continue to focus on achieving its inflation targets while providing sufficient space in its monetary program for lending to activities which support broad-based investment and inclusive growth objectives. BB will use both monetary and financial sector policy instruments to achieve these goals. The persisting inflationary pressures over the past few months with the risks ahead related to the inflation outlook (described earlier) imply that achieving the FY14 inflation target of 7% will be challenging. As such BB has decided to keep policy rates unchanged. Moreover the growing liquidity in the banking system suggests that an easing of reserve requirement ratios is also unnecessary at this stage.

Second, in order to cushion the impact of recent domestic disruptions on businesses, BB has already taken a number of important financial sector policy steps which will continue during H2FY14:

- Exporters benefit from an Export Development Fund whose already concessional interest rates were further lowered in December 2013 – moreover new sectors such as leather and ceramics were explicitly included to promote export diversification and BB is willing to increase the size of the EDF if the current $1 billion fund is fully utilized (earlier in 2013, BB also set up a 1 billion taka revolving credit line to support RMG factories who require upgrading to comply with best practice safety standards).
- Banks were instructed to offer loan rescheduling facilities to genuine borrowers who were temporarily affected by the recent disruptions. Also they were given permission to restructure loans by setting up a rational repayment period while remaining within the overall provisioning and classification architecture.
- Banks were requested to be particularly aware of the difficulties SMEs are facing. Along with the above mentioned facilities, banks are also allowed to transfer such loans to blocked accounts if required.

Third, limiting Government borrowing from the banking sector is important for achieving inflation targets and providing the space for banks to lend to the private sector. The H2FY14 monetary program assumes that unanticipated spending pressures arising from the provision of 'incentive packages' to

various industries affected by recent disruptions will be accommodated within the sizeable (260 billion taka) borrowing limit. This is likely to be possible given the low borrowing levels in H1FY14. Fiscal-monetary coordination will continue among senior policymakers with regular meetings of a Coordination Council and at the operational level where one key coordinating body is the Cash and Debt Management Committee where resource inflows, domestic and external financing outlook and key operational issues related to debt management and resource mobilization are discussed.

Fourth, effective transmission of monetary policy requires well-functioning, broader and deeper credit and debt markets. This in turn has a number of dimensions:

- *Ensuring financial stability* – A number of steps were taken in H1FY14 and will continue in the coming months to ensure the stability of the financial system. An important development is the fact that SOCBs have reduced their exposure to State Owned Enterprises (SOEs) with the stock of net lending from SOCBs to the three largest SOEs falling to 24 billion taka in September 2013 from 92 billion taka in April 2012. Looking forward targets have been set to continue this trend and further reduce exposure of SOCBs to SOEs. A stringent financial improvement plan has been set with the four SOCBs and Basic Bank which includes differential ceilings on loan growth and the need to provide regular reporting to BB on a number of issues including loans beyond a certain limit, single borrower exposure, off-balance sheet items etc. SOCB boards have recently developed strengthened internal control and compliance polices which BB expects they can implement in H2FY14. Clear progress on these benchmarks will be required before any further recapitalization of these banks takes place. BB's supervision capacity has been strengthened through greater automation, use of modern tools such as stress testing (details in the recent Financial Stability Report) and staff training - these will all continue in H2FY14. For instance data from the new electronic 'dashboard' introduced in 2013 in BB was used recently to issue show-cause notices to several banks about the volume of unsettled inland bills.

- *Strengthening financial inclusion and diversification* – Following recent issuance of agent banking guidelines, BB expects that there will be greater access to banking services in under-served areas with the scaling up of various pilot initiatives in H2FY14. This will complement the growth of mobile banking services where currently by end 2013, 13 million accounts were already in use. Overall there has been a greater emphasis on providing services to rural clients by enforcing a 1:1 rural – urban new branch ratio (which was 1:4 prior to 2012) and this is reflected in a larger share of rural deposits (18% of total deposits in 2013 compared with 13% in 2010) and loans to rural areas (10% share in 2013 compared with 8% in 2010). BB is also setting up a 2 billion taka refinancing facility to provide small loans to those lower-income rural households who have set up 'ten-taka' accounts. This will be implemented through Micro-Finance Institutions starting in H2FY14. Close monitoring of SME and agricultural credit will help ensure that these loans are going to the intended clients and having their desired impact. Access to a diverse pool of financing is also important for entrepreneurs and BB will continue to encourage larger borrowers to access the capital market given single borrower exposure limits for banks. While primarily an SEC issue, BB will be supportive of the capital market through on-going deeper regulatory

coordination and policy support. Moreover in order to fill the gaps in the financial landscape, BB will facilitate the role of private equity / venture capital sources of finance.

- *Strengthening domestic debt markets* - Ensuring government borrowing from the banking system does not crowd out available liquidity for commercial banks will remain a key area of focus for BB and in H2FY14 BB expects less devolvement to commercial banks. This aims to build on the reduction in devolvement from 34% in FY13 to 26% in H1FY14. In order to spur secondary market activity BB has recently embarked on secondary trading in Treasury bonds and will continue to do so in H2FY14. The recent joint BB-MOF decision to abolish the one year lock-in period for overseas investments in government bonds is also stimulating greater secondary market activity and BB will continue to encourage PDs and overseas investors to use these opportunities in H2FY14. A new Islamic bond of 3 months tenure is expected in H2FY14 which will contribute to better liquidity management of Islamic banks[4].

Fifth, this monetary policy stance also aims to further consolidate the country's external sector stability. BB anticipates further build-up in foreign reserves in H2FY14 though at a more moderate pace than H1FY14 due to the balance of payments assumptions discussed earlier. While the decline in remittances will not adversely affect external stability in FY14, it is imperative that manpower exports resume its growth, so that remittances can be an important part of medium-term external balance. BB will continue to support a market-based exchange rate while seeking to avoid excessive foreign exchange rate volatility.

The outcomes of the monetary program and policies pursued in H2 FY14 will be reviewed in July 2014 in light of prevailing global and domestic economic conditions. In the meantime monthly Monetary Policy Committee meetings will continue in order to make necessary policy adjustments.

[4] More details about debt market development issues can be found in the 2013 Monetary Policy Review

Annex 1: Balance of Payments

In million US$

	2010-11 Actual	2011-12 Actual	2012-13 Provisional
Trade balance	**-9,935**	**-9,320**	**-7,010**
Services	**-2,612**	**-3,001**	**-3,159**
Primary income	**-1,454**	**-1,549**	**-2,315**
Secondary income	**12,452**	**13,423**	**15,009**
Of which: Workers' remittances	11,650	12,734	14,338
CURRENT ACCOUNT BALANCE	**-1549**	**-447**	**2525**
Capital account	**642**	**482**	**588**
Financial account	**1175**	**1436**	**2779**
Foreign Direct investment	775	1191	1300
Errors and omissions	**-924**	**-977**	**-764**
OVERALL BALANCE	**-656**	**494**	**5128**
Reserve Assets	**656**	**-494**	**-5128**
Bangladesh Bank	656	-494	-5128
Assets	-481	293	5196
Liabilities	175	-201	68

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

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