Monetary Policy Statement

July-December 2013

Chief Economist's Unit and Monetary Policy Department

Bangladesh Bank

www.bb.org.bd

<u>Monetary policy statement (July-December 2013: H1FY14)</u>

<u>Executive Summary</u>

This issue of the Bangladesh Bank (BB) half yearly Monetary Policy Statement (MPS) outlines the monetary policy stance that BB will pursue in H1 FY14 (July-December 2013), based on an assessment of global and domestic macro-economic conditions and outlook. This MPS was preceded by productive consultations with a range of key stakeholders and web-based comments were also received.

In FY12 the economy was faced with the challenges of rising inflation and balance of payments pressures stemming largely from a sudden surge in oil imports. In order to address these challenges BB pursued a more restrained monetary policy stance which, along with other policy measures, helped curb inflationary pressures and significantly strengthened foreign exchange reserves. In FY13 the economy faced a different set of challenges. Robust foreign remittance and export growth along with sluggish import growth led to a sharp growth of Net Foreign Assets (NFA) which needed to be sterilized. Moreover declining inflation and concerns over a slowdown in growth created space for a 50 basis point rate cut by BB in January 2013 with the aim of influencing bank lending rates downwards. At the same time the January 2013 MPS set out a monetary program consistent with bringing average inflation down to the targeted 7.5% level.

Data for the second half of FY13 suggests that solid progress was made towards these key objectives. Reserve money growth and growth of net domestic assets of Bangladesh Bank remained within program targets, despite the aforementioned NFA surge. Broad money growth was also close to program targets. Average inflation measured using the 1995/96 base year continued its decline and in June 2013 it reached 7.70% from 8.40% in January, though core inflation (non-food, non fuel) is on a rising trend since April 2013 reflecting aggregate demand pressures. Retail interest rates also 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. Frequent strikes in H2FY13 contributed to general investor uncertainty which along with more stringent lending practices by domestic banks led to a slowdown in domestic private sector credit growth. The introduction of new foreign currency borrowing facilities by BB partially compensated for this as some consumers switched to lower cost overseas financing with overall private sector credit growth, from both local and foreign sources, amounting to 13.6% in May 2013. GDP growth in FY13 is estimated to be 6.03% by BBS, slightly short of BB's FY13H2 MPS forecast of 6.1-6.4%.

Improved external balances are reflected in the accumulation of international reserves to over USD 15 billion at the end of FY13, sufficient to cover 4.9 months of projected imports. Key underlying drivers included double digit remittance and export growth coupled with sluggish imports. The Taka: USD nominal exchange rate appreciated by 2.6% in H2FY13 and real exchange rate data suggests that there has been a marginal loss in export competitiveness – though BB's interventions in the foreign exchange market have limited this significantly by slowing the appreciation of the Taka in keeping with the goal of avoiding excessive exchange rate volatility. Moreover by opening up working capital borrowing at lower interest rates from foreign sources to exporters in FY13, and increasing the size of the Export Development Fund (EDF), export competitiveness is being actively supported.

Looking ahead to FY14, the inflation target announced in the Budget is 7.0% using the 1995/96 base. The equivalent target using the 2005/06 base could be in the range of 6.0-6.5%. The risks to the inflation target stem partly from likely wage increases in both the public and private sectors which will further add to existing aggregate demand pressures. Another risk to food inflation in particular stems from possible supply-side disruptions if prolonged nationwide strikes take place, recent increases in food inflation in India and as in all years risks due to weather related factors affecting agriculture. BB's current growth outlook for FY14 is that output growth is unlikely to deviate significantly from the last ten year average of 6.2%. This is based on current and projected trends of a number of variables including global growth, exports, investment, imports, remittances etc. 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.

The monetary stance in H1 FY14 takes these recent economic developments into account and will target a monetary growth path which aims to bring average inflation down to 7% (using the 1995/96 base), while ensuring that credit growth is sufficient to stimulate inclusive economic growth. Specifically we aim to contain reserve money growth to 15.5% and broad money growth to 17.2% by December 2013. The space for private sector credit growth of 15.5% for December 2013 and 16.5% in June 2014 has been kept well in line with economic growth targets and higher than the average of 'emerging' Asian economies. This level is sufficient to accommodate a substantial rise in demand for credit if it materializes though actual private credit growth may not use up all the space in the monetary program as it will depend on the investment climate in the lead-up to the national elections. The monetary stance also assumes government borrowing from the banking sector will remain around the FY14 budgetary figure of 260 billion taka.

The decision to keep repo rates and reserve requirement ratios unchanged following the fifty basis point rate cut in January 2013 was based on a number of factors. The growing inflationary pressures over the past several months along with the prospects of wage pressures, possible supply-side disruptions and rising regional inflation imply that achieving the FY14 inflation target of 7% will be a challenge. 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.

Effective transmission of monetary policy requires strengthening credit and debt markets and this will remain a key focus for H1FY14. Overall there is a greater focus on improving corporate governance in banks as well as using automation and capacity building to strengthen BB supervision. Specific actions within performance agreements (MOUs) for SCBs and specialized banks including Basic Bank include ceilings on loan growth and the need to provide regular reporting to BB on a number of issues including large loan approvals, single borrower exposure, off-balance sheet items etc. Clear progress on these benchmarks will be important before any recapitalization of these banks.

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. BB will continue to support a market-based exchange rate while seeking to avoid excessive foreign exchange rate volatility.

Monetary policy statement (July-December 2013)

Global context

Although global growth prospects for 2014 (3.8%) is higher than the 3.1% for the previous two years, the road to recovery in the advanced economies is projected to remain uneven and these projections reflect recent downward revisions by the IMF. 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 5.0% in 2013 and 5.4% in 2014. While China is projected to grow at around 7.7-7.8% the Indian economy is projected to grow by 5.6% in 2013 with a projected recovery to around 6.3% in 2014 (see Table 1).

Table 1: World GDP growth
(year- on- year, in percent)

	2012	2013 (Proj.)	2014 (Proj.)
World	3.1	3.1	3.8
Advanced Economies	1.2	1.2	2.1
Other Advanced Economies	1.8	2.3	3.3
Euro Area	-0.6	-0.6	0.9
USA	2.2	1.7	2.7
Emerging and Developing Economies	4.9	5.0	5.4
China	7.8	7.8	7.7
India	3.2	5.6	6.3

Source: IMF World Economic Outlook (July 2013)

Commodity prices continue to represent a key country risk. Global food prices have been relatively stable over the past six months (chart 1a). FAO forecasts that global food prices are expected to fall due to bumper harvests in the coming months. It is also clear that trends in Indian inflation are correlated with Bangladesh[1] (chart 1b). While the Indian 'headline' wholesale price index (WPI) fell from 7.25% in January 2013 to 4.72% in May, there are indications that inflationary pressures are once again on the rise with higher numbers for June (WPI was 4.89% and consumer price index was 9.9%). These inflationary pressures are likely to have knock-on effects on Bangladesh inflation, especially for food items. Crude oil prices have come down in the last few months following fluctuations throughout FY13. The uncertainties in the Middle East may continue to persist and oil prices are therefore likely to remain volatile.

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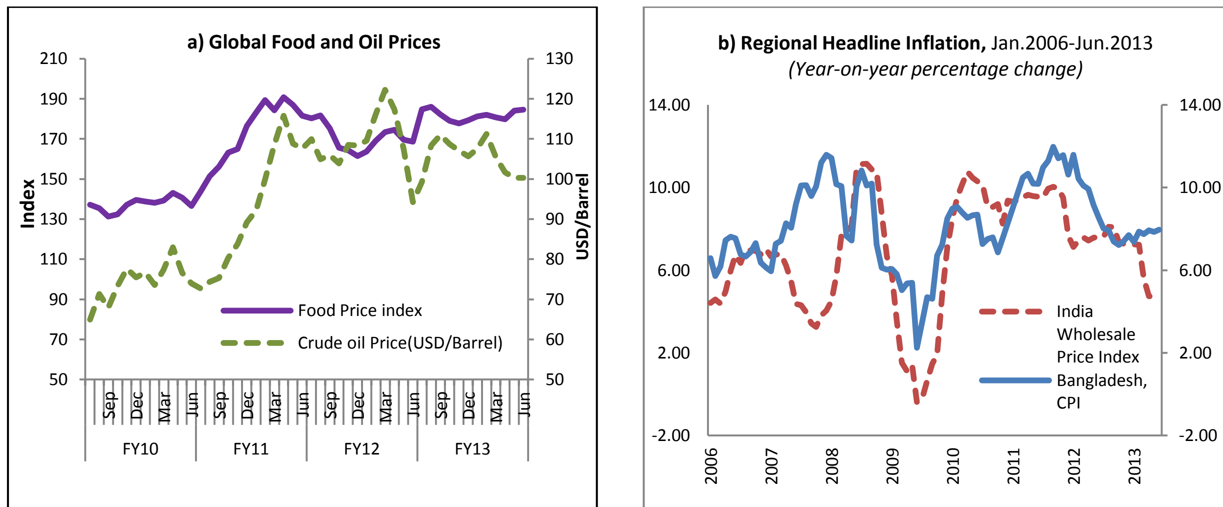
[1] See Paul B and H Zaman "*When and why does Bangladesh inflation differ from India's*?" Working Paper Series WP1301, Chief Economist's Unit, Bangladesh Bank

Chart 1: Global Commodity Prices and Regional Inflation



Recent economic developments

In FY12 the economy was faced with the challenges of rising inflation and balance of payments pressures stemming largely from a sudden surge in oil imports. In order to address these challenges BB pursued a more restrained monetary policy stance which along with other policy measures helped curb inflationary pressures and reversed foreign exchange reserve depletion. At the same time sufficient funds for private sector development was ensured with private sector credit growth at 19.7% at the end of FY12. In FY13 the economy faced a different set of challenges. A sharp increase in foreign remittances and negative import growth for much of the year led to a sharp growth of Net Foreign Assets (NFA) which needed to be sterilized. Moreover declining inflation and concerns over a slowdown in growth created space for a 50 basis point rate cut by BB in January 2013. Frequent strikes in H2FY13 which dampened investor sentiment, and tighter loan sanctioning procedures following recent financial sector scams, led to lower domestic private sector credit growth though the introduction of new foreign currency borrowing facilities by BB contributed to overall private sector credit growth amounting to 13.6% in May 2013.

Domestic output growth: BBS' preliminary estimates for FY13 growth came to 6.03% (see table 2). The average GDP growth in developing countries was 5.0 percent in 2013 so while on the one hand Bangladesh's growth rate remains respectable, it is lower than the previous five year average of 6.2% growth. A key factor behind this was slower growth in agriculture which according to these provisional numbers has slowed from 3.11% in FY12 to 2.17% in FY13. This is largely due to the base effect of two consecutive years of record growth, lower output due to the falling price of paddy/rice and also due to weather-related disruptions. Yet industrial growth, which is the sector most affected by access to timely credit, is estimated at 8.99% in FY13, higher than the 8.90% in FY12 driven in large part by faster growth of construction and small scale industries which increased from 7.57% and 6.45% in FY12 to an estimated 8.05% and 6.76% in FY13 respectively. The construction sector is likely to have benefitted from higher remittance growth and a significant increase in public investment compared to FY12. However the investment climate suffered for parts of H2FY13 due to a series of national strikes and consequent

disruptions to the supply chain. As such growth of services slowed down to 5.73% in FY13 from 5.96% in FY12 as the retail and wholesale trade sectors were particularly affected.

Table2: GDP growth at Constant Market Prices by Broad Industry Sector

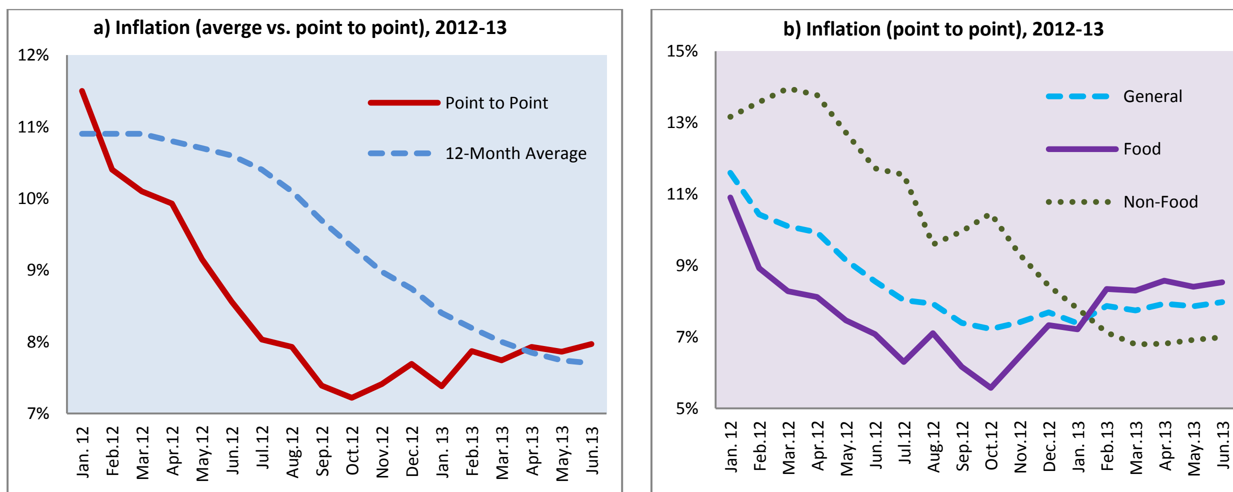
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13(p)
1.Agriculture	**3.20**	**4.12**	**5.24**	**5.13**	**3.11**	**2.17**
2.Industry	**6.78**	**6.46**	**6.49**	**8.20**	**8.90**	**8.99**
a) Manufacturing	7.21	6.68	6.5	9.45	9.37	9.34
of which small scale	7.10	6.90	7.77	5.84	6.45	6.76
b) Construction	5.68	5.7	6.01	6.51	7.57	8.05
3.Services	**6.49**	**6.32**	**6.47**	**6.22**	**5.96**	**5.73**
GDP at constant market prices	**6.19**	**5.74**	**6.07**	**6.71**	**6.23**	**6.03**

Source: BBS, (P)-Provisional

Looking ahead to FY14, BB's current forecast is that output growth is unlikely to deviate significantly from the last ten year average of 6.2%. This is based on current and projected trends of a number of variables including global growth, domestic and foreign investment, exports, imports, remittances etc. 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.

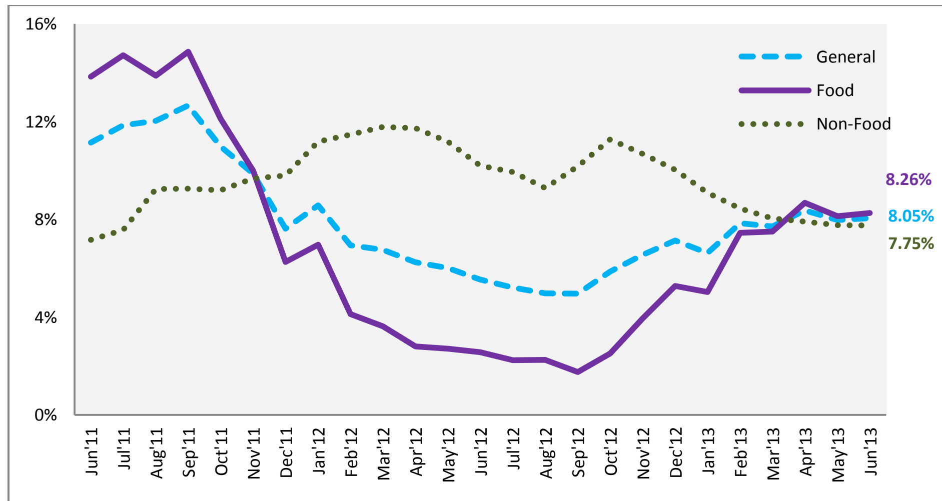
Inflation: Average inflation, using the 1995/96 base year, has been declining steadily over the past fifteen months, from a peak of 10.96% in February 2012 to 7.70% in June 2013. This decline was driven by a steady fall in point to point food and non-food inflation until October 2012 when food inflation bottomed out at 5.57%. Since then food inflation began to rise and in June 2013 is 8.53%. Non-food inflation fell from a peak of 13.96% in March 2012 to 6.79% a year later. However, point to point non-food inflation has increased to 6.99% in June 2013 (see chart 2) and core inflation (non-food, non-fuel) has also increased since March 2013.

Chart 2: Inflation (1995/96 base)



Point to point inflation data using the 2005/06 base broadly shows similar trends to the pattern using the 1995/96 base though the absolute numbers differ (see chart 3). Using the 2005/06 base, point to point food inflation has risen from 1.75% in September 2012 to 8.26% in June 2013. Point to point non-food inflation is steadily declining, having peaked in October 2012 at 11.28% to 7.75% in June 2013. The rise in food inflation is pushing up average inflation which bottomed out at 6.06% in January 2013 and has risen to 6.78% in June 2013. As such both the old and new inflation base data indicate that inflation remains a key challenge.

Chart 3: Inflation (2005/06 base), point to point



Looking ahead, the FY14 inflation target announced in the Budget is 7.0% using the 1995/96 base. The equivalent target using the 2005/06 base could be in the range of 6.0-6.5%. The risks to the inflation target stem partly from likely wage increases in both the public and private sectors which will create aggregate demand pressures. The FY14 Budget includes a sizeable provision for a public sector wage rise and in the private sector the Wage Board for the garments industry has been established which will in turn have implications for the rest of the economy. Another risk to food inflation in particular stems from possible supply-side disruptions if prolonged nationwide strikes take place and as in all years risks due to weather related factors affecting agricultural produce. Finally the recent rise in Indian inflation could also transmit to Bangladesh as shown by historical long term trends.

While **the current account has registered a larger surplus of USD2004 million in FY13 the slow-down in imports is of some concern** (see Table 3 and Annex 1). In the external sector, the current account balance (CAB) continued to be in surplus reflecting the increasing inflows of remittances bolstered by continued export expansion and declining imports. Import growth was sluggish in FY13, partly reflecting the significant fall in food import demand, lower petroleum imports as well as slower demand for imports related to manufacturing output. However the new L/C opening trend, especially for capital goods which recorded a growth of 31.5% between July-May FY13 compared to the same period in FY12, suggests that import growth will be higher in the coming months.

Table 3: External Balances Summary

Items		FY11	FY12	July- May FY12	July -May FY13
Export (% change)		41.5	6.0	7.0	10.7
Import	Shipment (% change- c&f)	52.1	2.5	8.2	-0.4
	L/Cs Opened (% change)	34.0	-4.0	-6.4	-1.6
Remittances (% change)		6.0	10.2	10.9	13.9
FDI (in million USD)		775	1192	1112	1150
Overall Balance (in million USD)		-656	494	11	4429
Forex Reserve (in million USD, end of period)		10912	10364	9520	14531
Exchange Rate (Tk./USD, end of period)		74.2	81.8	81.9	77.8

Remittances have been buoyed by larger numbers of Bangladeshi workers moving abroad in FY12 as well as real wage growth in the Middle East following the 'Arab Spring' events. Remittance growth of 12.6% in FY13 is 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 a function of a 34% drop in the number of migrant workers between July-April FY13 relative to the same period in FY12.

The **capital account** shows that foreign direct investment is projected to have increased from USD1.2 billion in FY12 to USD1.3 billion in FY13. Medium and long term loan disbursements rose from USD1.5 billion in FY12 to USD1.7 billion in FY13 and net aid flows increased from USD671 million to USD841 million during the same period. Improved external balances are reflected in the accumulation of international reserves to over USD15 billion at the end of FY13, sufficient to cover 4.9 months of projected imports.

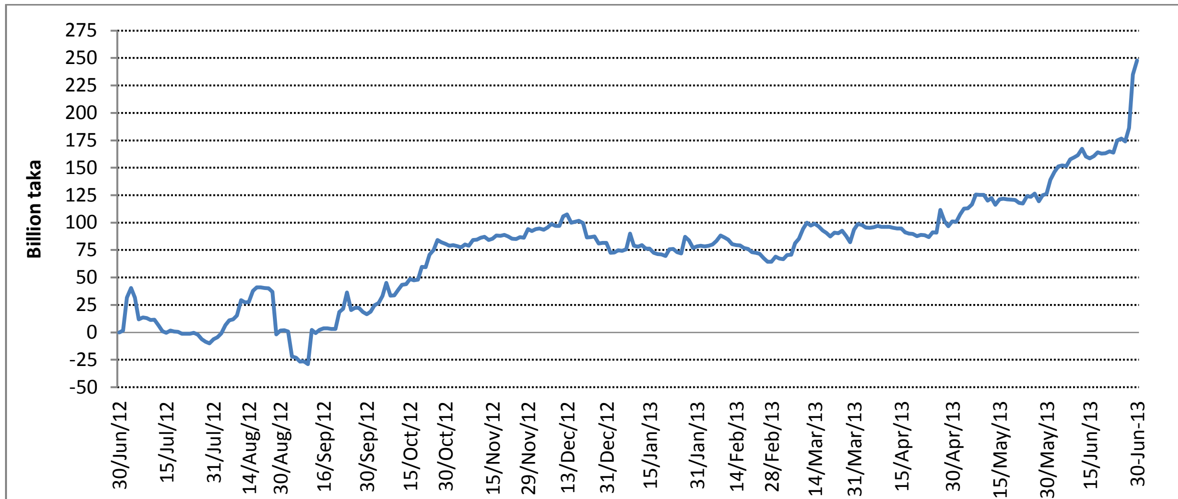
Avoiding excessive **exchange rate** volatility remains a key objective of BB. The Taka appreciated by 2.6% between January 1st-June 30th 2013 and real exchange rate data indicates a marginal impact on export competitiveness. However, BB's interventions in the foreign exchange market have limited this loss significantly 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, BB is actively promoting export competitiveness.

Looking ahead to FY14 our balance of payments projections assumes an export growth of 11%, import growth of 9% and remittance growth of 11%. The remittance growth expectations are contingent on some bilateral arrangements between the Government of Bangladesh and other countries (e.g. Malaysia) leading to the increased manpower exports which were envisaged in the agreements. These assumptions, along with others relating to the capital account, contribute to a projected overall reserve build-up of about USD1 billion in FY14.

Government borrowing (net) from the banking system rose in H2FY13 but remained within budget targets. Government borrowing (net) from the banking system amounted to 248 billion taka in FY13, short of the revised budget figure of 285 billion Taka. The borrowing largely took place in H2FY13 as only

59 billion was borrowed in H1FY13 – as chart 4 shows there was a large surge in the last two weeks of June 2013. However the ample liquidity position in the banking sector suggests that this increase in government borrowing did not crowd out private sector credit. In FY12 government borrowing was 185 billion taka.

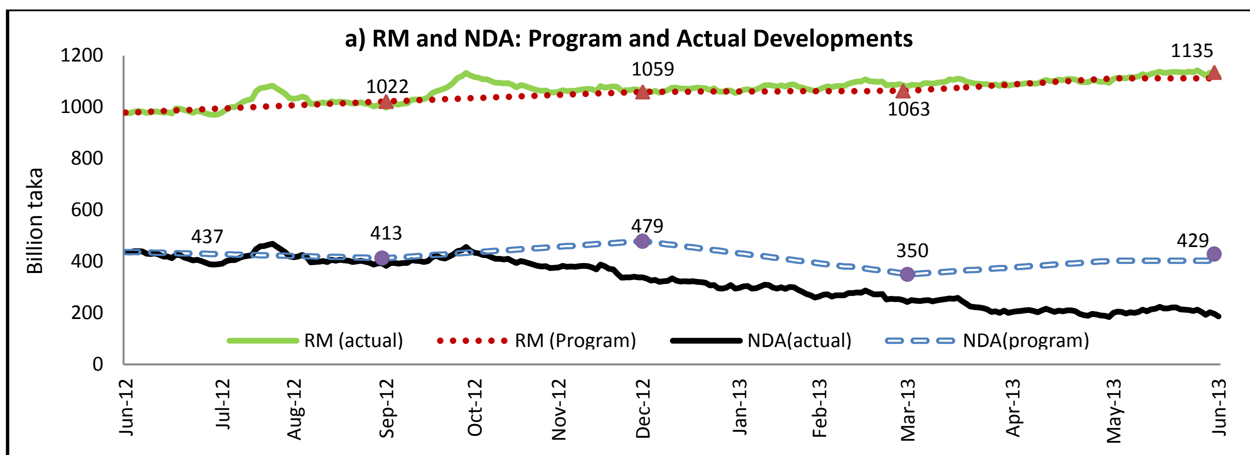
Chart-4: Govt. Borrowing (Net) from the banking system in FY13

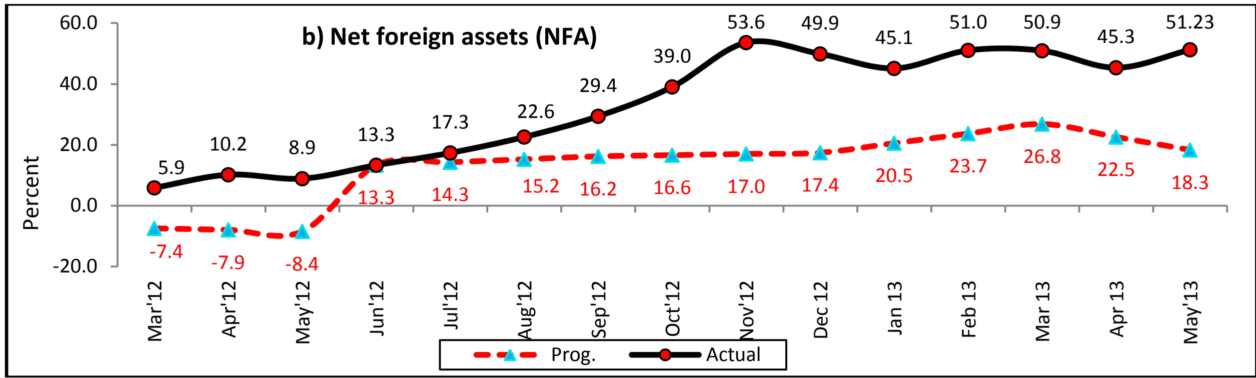


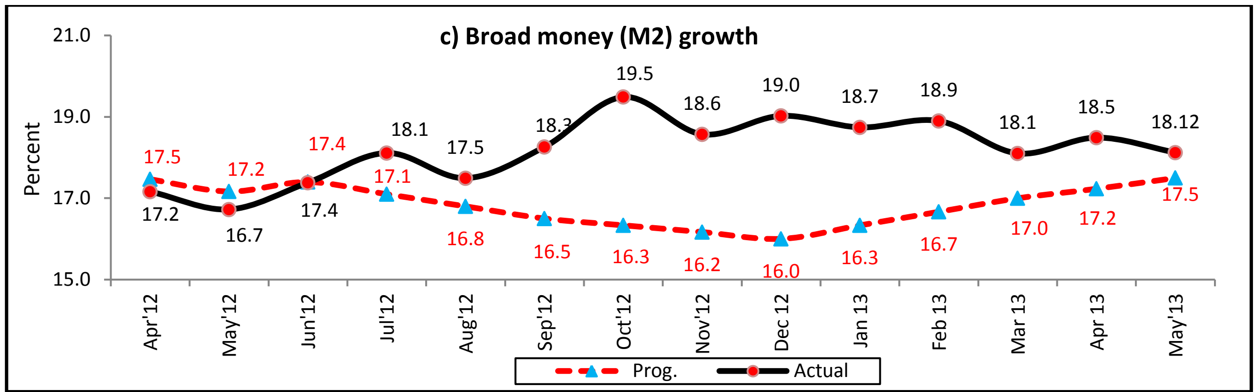
Monetary growth targets for FY13 stayed on track establishing the credibility of the stance taken in the previous Monetary Policy Statement. Reserve money growth and growth of net domestic assets of Bangladesh Bank remained within program targets (see chart 5a). This was despite a surge in Net Foreign Assets (NFA) of BB, which rose sharply as foreign exchange reserves of about USD4.5 billion were built up in FY13. This stance was achieved through open market operations, selling BB bills and Islamic Bonds.

Broad money growth trends (chart 5c) are above the program path (18.1% growth in May 2013 compared with 17.5% target), due to high NFA growth, while domestic credit growth (chart 5d) fell short of the anticipated rate due to shortfalls in private sector credit growth.

Chart 5: Monetary Program Indicators




b) Net foreign assets (NFA)
Percent
60.0
40.0
20.0
0.0
-20.0
5.9
10.2
8.9
13.3
17.3
22.6
29.4
39.0
53.6
49.9
45.1
51.0
50.9
45.3
51.23
-7.4
-7.9
-8.4
13.3
14.3
15.2
16.2
16.6
17.0
17.4
20.5
23.7
26.8
22.5
18.3
Mar'12
Apr'12
May'12
Jun'12
Jul'12
Aug'12
Sep'12
Oct'12
Nov'12
Dec 12
Jan 13
Feb 13
Mar 13
Apr 13
May'13
Prog.
Actual


c) Broad money (M2) growth
Percent
21.0
19.0
17.0
15.0
17.5
17.2
17.4
17.1
16.8
16.5
16.3
16.2
16.0
16.3
16.7
17.0
17.2
17.5
17.2
16.7
17.4
18.1
17.5
18.3
19.5
18.6
19.0
18.7
18.9
18.1
18.5
18.12
Apr'12
May'12
Jun'12
Jul'12
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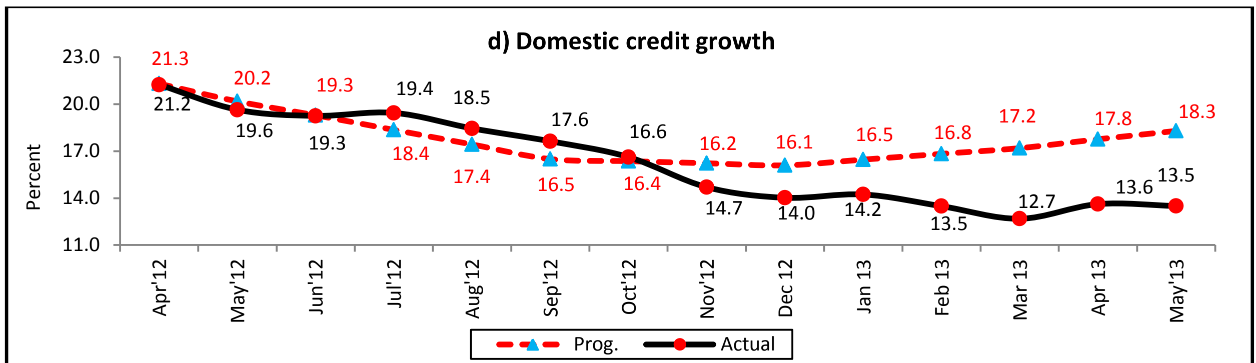
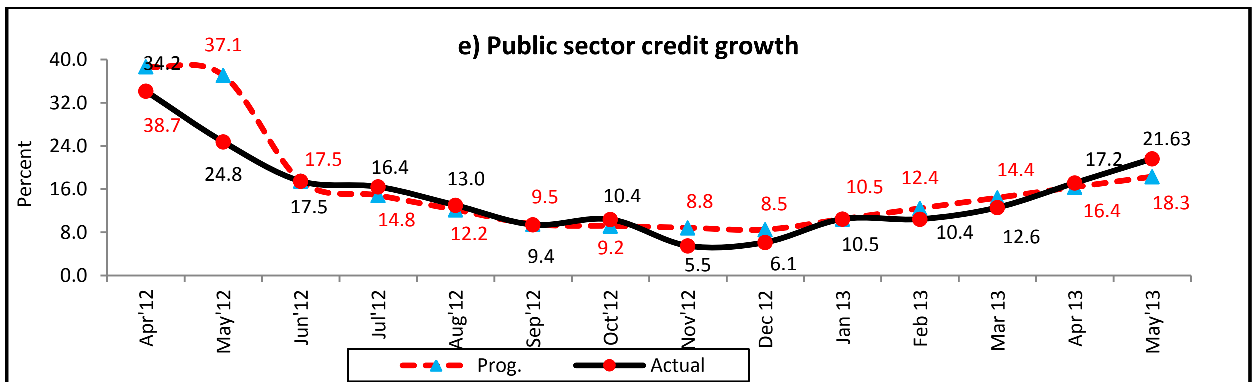
Oct'12
Nov'12
Dec 12
Jan 13
Feb 13
Mar 13
Apr 13
May'13
Prog.
Actual


d) Domestic credit growth
Percent
23.0
20.0
17.0
14.0
11.0
21.3
20.2
19.3
18.4
17.4
16.5
16.4
16.2
16.1
16.5
16.8
17.2
17.8
18.3
21.2
19.6
19.3
19.4
18.5
17.6
16.6
14.7
14.0
14.2
13.5
12.7
13.6
13.5
Apr'12
May'12
Jun'12
Jul'12
Aug'12
Sep'12
Oct'12
Nov'12
Dec 12
Jan 13
Feb 13
Mar 13
Apr 13
May'13
Prog.
Actual


e) Public sector credit growth
Percent
40.0
32.0
24.0
16.0
8.0
0.0
34.2
37.1
38.7
24.8
17.5
17.5
16.4
14.8
13.0
12.2
9.5
9.4
10.4
9.2
8.8
5.5
8.5
6.1
10.5
10.5
12.4
10.4
14.4
12.6
17.2
16.4
21.63
18.3
Apr'12
May'12
Jun'12
Jul'12
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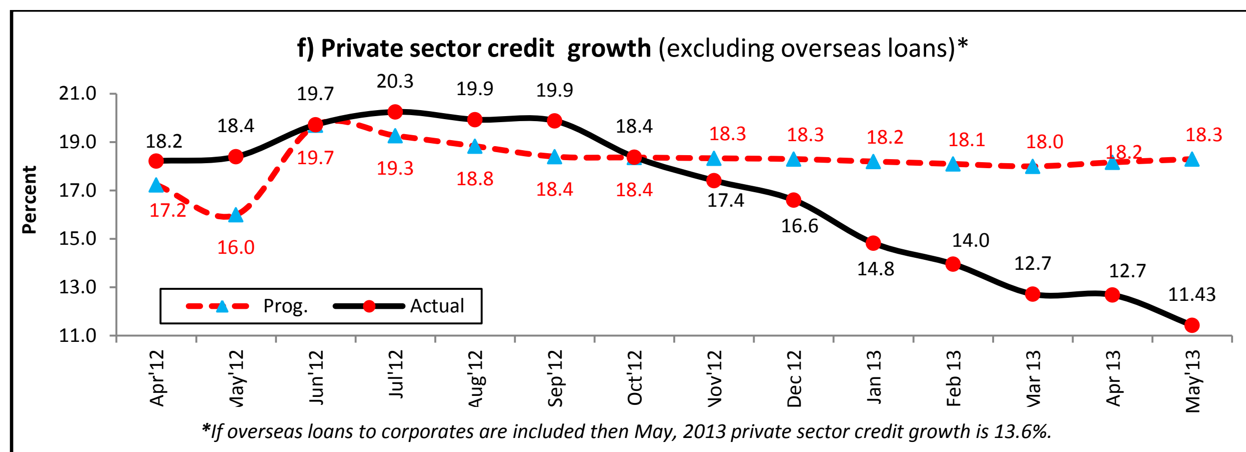
Oct'12
Nov'12
Dec 12
Jan 13
Feb 13
Mar 13
Apr 13
May'13
Prog.
Actual



Private sector credit growth in FY13 slowed in the second half of the year though borrowing by corporates overseas partly made up for this. In addition to access to credit from domestic sources, Bangladeshi corporates now also can tap foreign sources of financing. Private credit growth from domestic sources slowed to 11.4% growth in end May from 19.7% at the end of FY12. 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. One existing channel is borrowing by corporates for term credit purposes with most having a maturity beyond five years – around US $1.48 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. These newly introduced facilities in the form of ‘buyers credit’ which importers can avail with a tenure of upto one year and ‘discounted export bills’ have led to a $784 million inflow between July-May of FY13. The addition of external borrowing with domestic borrowing implies that total private sector credit growth for May 2013 was 13.6%.

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 5.1% in March 2012 to 5.5% in March 2013). As the share of the services sector in the economy has grown so too has the share of loans going towards trading activities (34.6% in March 2009 to 37.2% in March 2013), towards transport and communication (1.6% in March 2009 to 2.2% in March 2013) and towards consumer credit (5.3% in March 2009 to 6.0% in March 2013). There has been a significant rise in construction loans (6.9% in March 2009 to 9.5% in March 2013) while the share of working capital financing has fallen from 17.1% to 13.2% during this period. The share of industrial term loans (20.5% in March 2013) in total outstanding credit also fell slightly compared to a year earlier, as the growth in industrial term credit (10.3% between March 2012-March 2013) was lower than the average growth in private sector advances during that period.

The share of domestic and foreign discounted bills in total advances has fallen from 7% in January 2012 to 5% in May 2013. This is partly linked to lower trade-finance demand and also tighter monitoring over the use of these instruments given their role in recent financial sector scams.

Call money rates have declined 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 signaling further easing of liquidity pressures in the banking system (chart 6). This is also reflected in below average loan to deposit ratios (see chart 7). At the retail level both deposit and lending rates fell in H2FY13 and since interest rate spreads have on average fallen – from 5.60% in June 2012 to 4.98% in May 2013 – we can infer that lending rates have fallen faster than deposit rates (see Chart 8). 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 the single digits.

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

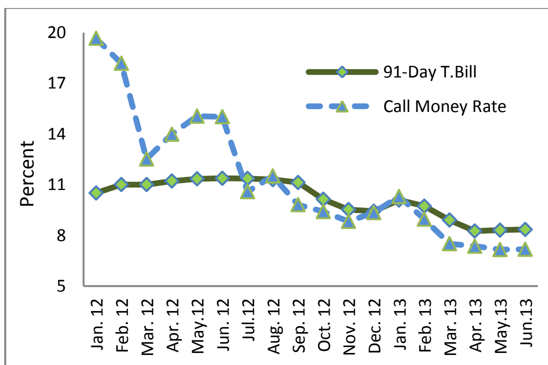


Chart 7: Advance to Deposit Ratio,
Jun. 2006- Jun.2013

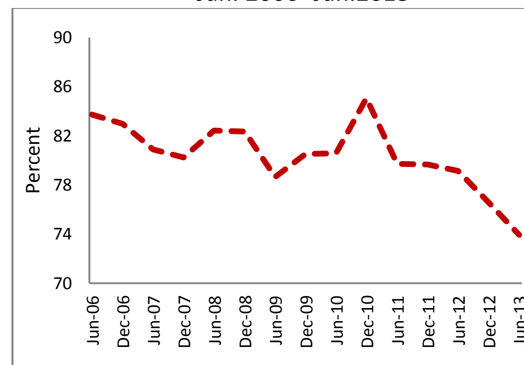
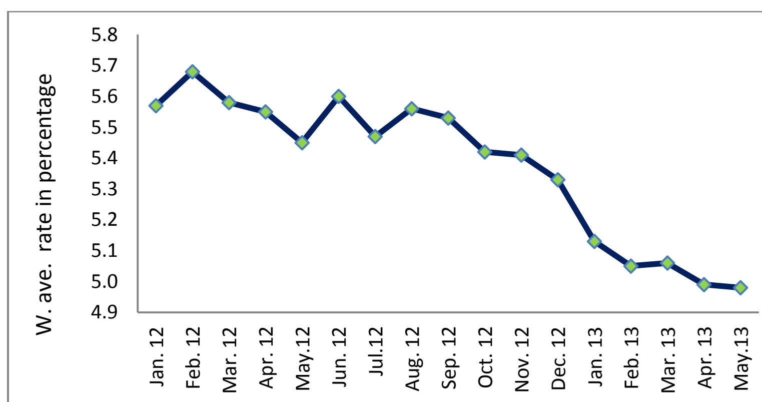


Chart-8: Interest Rate Spread



The use of anonymous consumer surveys has increased the incentives for accurate reporting of interest rates and other data by banks. In addition to the routine inspection visits, BB piloted the use of anonymous consumer surveys as an additional tool to verify the accuracy of reported data by banks. One study assessed the actual deposit interest rates being offered to customers taking a random sample of branches for each bank[2]. BB has published the list of banks who offered rates to customers which were different than what they reported to BB and also sent warning letters to the relevant bank management.

[2] Islam E et al (2013) "A quick analysis of deposit interest rates offered by consumers" Policy Note P1301, Chief Economist's Unit (CEU), Bangladesh Bank

The monetary stance in H1 FY14 takes these recent economic developments into account and will target a monetary growth path which aims to bring average inflation down to 7% (using the 1995/96 base), or 6.0-6.5% (using the 2005/06 base), while ensuring that credit growth is sufficient to stimulate inclusive economic growth. Specifically we aim to contain reserve money growth to 15.5% and broad money growth to 17.2% by December 2013. BB will have a ceiling on net domestic assets as a key operating target. The space for private sector credit growth of 15.5% has been kept well in line with growth targets and higher than the average of 'emerging' Asian economies. This level is sufficient to accommodate a substantial rise in investment and trade-finance though actual private credit growth may not use up all the space in the monetary program as it will depend on the demand for credit in the lead-up to the national elections. The monetary stance also assumes government borrowing from the banking sector will remain around the FY14 budgetary figure of 260 billion taka. The relatively high credit to public sector growth projection for December 2013 is due to the "low base effect" for December 2012 since only 59 billion taka was borrowed in FY13H1. Similarly the relatively low NFA growth in FY14 relates to our balance of payments assumptions described earlier where we anticipate higher import growth and a smaller overall external balance.

Table 4: Monetary Aggregates (Y-o-Y growth in percent)

Items	Actual				Program	
	FY10	FY11	FY12	May 13	Dec.13	Jun.14
1. Net Foreign Assets	41.0	6.2	13.4	51.2	19.3	8.4
2. Net Domestic Assets	19.0	24.7	18.1	12.5	16.8	19.0
Domestic Credit	17.5	28.2	19.3	13.5	19.3	17.2
Credit to the public sector (incld. Govt.)	-4.2	38.3	17.6	21.6	33.7	19.5
Credit to the private sector	24.2	25.8	19.7	11.4	15.5	16.5
3. Broad money	22.4	21.4	17.4	18.1	17.2	17.0
4. Reserve money	18.1	21.0	9.0	21.0	15.5	16.5

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

First, the decision to keep repo rates and reserve requirement ratios unchanged following the fifty basis point rate cut in January 2013 was based on a number of factors. The growing inflationary pressures over the past several months along with the prospects of wage pressures, possible supply-side disruptions and rising regional inflation imply that achieving the FY14 inflation target of 7% will be a challenge. 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.

Second, limiting Government borrowing from the banking sector is essential for achieving inflation targets and providing the space for banks to lend to the private sector. The recent move to remove the lock-in period for foreign investors, and the consequent inflow of foreign funds into domestic debt instruments, reduces the private sector crowding-out risk to a certain extent. Fiscal-monetary coordination is therefore important and takes place at various levels. Among senior policymakers it is ensured with regular meetings of a Coordination Council chaired by the Minister of Finance. At the operational level a key coordinating body is the Cash and Debt Management Committee where

representatives from Bangladesh Bank and Ministry of Finance meet regularly to discuss resource inflows, domestic and external financing outlook and key operational issues related to Treasury auctions and foreign resource mobilization.

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

- *Ensuring financial stability* – BB monitors key financial stability ratios closely and there have been clear improvements on reducing non-performing loan ratios (which has more than halved in the last decade from 28% in 2002 to around 12% currently) and raising capital adequacy standards. However recent scams have led to greater scrutiny over the internal controls, management and governance in the banking industry as well as the supervision capacity of BB. In response a stringent financial improvement plan has been set with the four SCBs 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. A 'special diagnostic exam' on the SCBs was completed in June 2013 and on that basis the performance plans will be further amended in H1FY14. Clear progress on these benchmarks will be important before any recapitalization of these banks. Board accountability has been enhanced through a new monthly reporting form related to internal control and compliance which has to be co-signed by the board audit committee chair and the Managing Director. BB's supervision capacity has been strengthened through greater automation, use of modern tools such as stress testing (details in forthcoming Financial Stability Report) and staff training - these will all continue in FY14.

- *Strengthening access to loans for a broad range of credit-worthy borrowers* – Use of a new 'large loan monitoring software' launched in H1FY13 will be stepped up to monitor exposure to large business groups and ensure that there is an equitable distribution of credit for all industry sizes. Close monitoring of SME and agricultural credit will help ensure that these loans are going to the intended clients and having their desired impact. Interest rates are an important determinant of broadening credit access and BB reduced repo rates in January 2013 so that retail interest rates follow suit. As the decline in interest rate spreads shows this repo rate reduction, along with other factors, has led to a reduction in customer lending and deposit rates. BB's new policies to permit borrowing by corporates from overseas were also designed to put downward pressure on interest rates. Liquidity pressures in the financial sector have been eased reflected in inter-bank interest rates. Moreover interest rate spreads will be closely monitored and publicly disclosed on BB's website in order to promote a more competitive banking sector. Financial inclusion policies which strengthen access to banking services to those previously excluded will continue to remain a key pillar of BB's activities.

- *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 FY14 we expect less devolvement to Primary Dealer Banks. In addition, in order to reduce the overdrafts held by GOB with BB, additional treasury bills will be issued each month starting in H1FY14, and the auction calendar will accordingly be adjusted. The recent joint BB-MOF decision to abolish the one year lock-in period for overseas investments in government bonds is likely to stimulate greater secondary market activity in H1FY14.

Fourth 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. 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 H1 FY14 will be reviewed in January 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.

Annex 1: BANGLADESH BALANCE OF PAYMENTS

In million US$

	2010-11 Actual	2011-12 Provisional	2012-13 Estimation
Trade balance	**-9,935**	**-9,317**	**-7,344**
Services	**-2,612**	**-2,723**	**-3,453**
Primary income	**-1,454**	**-1,508**	**-2,267**
Secondary income	**12,452**	**13,699**	**15,069**
Of which: Workers' remittances	11,650	12,843	14,461
CURRENT ACCOUNT BALANCE	**-1549**	**151**	**2004**
Capital account	**642**	**469**	**535**
Financial account	**514**	**785**	**2347**
Foreign Direct investment	775	1192	1300
Errors and omissions	**-263**	**-911**	**0**
OVERALL BALANCE	**-656**	**494**	**4886**
Reserve Assets	**656**	**-494**	**-4886**
Bangladesh Bank	656	-494	-4886
Assets	-481	293	4951
Liabilities	175	-201	65

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