

Bangladesh Bank
Monetary Policy Statement
July 13, 2006

Executive Summary

Background: This second half-yearly issue of the Monetary Policy Statement (MPS) presents for general information the monetary policy stance that the Bangladesh Bank (BB) will maintain over the coming quarters, based on its assessment of the real sector and monetary developments in the preceding quarters and the outlook for the near future.

Objective, targets and instruments: Monetary policies pursued by the BB aim at maintaining price stability while supporting the highest sustainable growth of domestic output. The price stability target is a moderate CPI inflation level realistically attainable/maintainable without unduly depressing output. Reverse repo, repo interest rates are the routinely employed policy instruments, Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) for banks are also used sparingly as instruments. Annual monetary programs based on the targeted inflation and projected GDP growth rates employ Reserve Money (RM) and Broad Money (M2) as intermediate targets, while also tracking other credit and deposit aggregates.

Growth outcome and outlook: Estimated at 6.7 percent, real GDP growth in FY06 has touched the higher end of the 6.3-6.8 percent projection reported in the January 06 MPS. The 4.5 percent growth in agriculture reflected good post-flood rebound, the 9.6 percent growth in industry and 6.1 percent growth in services were underpinned by robust domestic and export demand. The growth momentum is expected to sustain or strengthen further in FY07 in industry and services, while agriculture sector growth may ease down somewhat towards its trend level. Overall, FY07 real GDP growth is projected to be in the 6.5-6.8 percent range.

Inflation outcome and outlook: Annual average CPI inflation in Bangladesh was on slow upward creep throughout FY06, staying slightly above seven percent from December 05 onward (7.14 percent in May 06). External trade is steadily drawing domestic consumer prices closer to global prices. Growing export of perishable consumer items such as vegetables and fish are pitching their domestic prices towards the higher export prices. Higher import prices of major production inputs have cumulated to a sustained upward pressure on domestic consumer prices, despite partial shielding of pass-through of higher oil prices. This pressure being likely to persist in the second half of 2006 (April 2006 issue of *WEO*, IMF does not project significant easing of global commodity prices before 2007), monetary policies in FY07 will continue to target the containment of annual average CPI inflation within 7.0 percent, with possibility of some downward revision for the first half of 2007 based on review of developments in the second half of 2006.

Policy stance: The cautious, restrained monetary stance pursued in the preceding quarters with steadily rising policy interest rates has thus far impacted only modestly on excess demand from inflation expectations. Year on year growth of credit to the private sector has slowed to 17.1 percent in May 06 against 18.0 percent in May 05, but overall domestic credit growth has risen to 21.6 percent in May 06 from 17.8 percent of May 05 (mainly from the higher debt overhang of the state owned BPC due to incomplete pass-through of higher oil import costs to consumers). Persistent rise in consumer prices is causing public disquiet in Bangladesh and neighboring countries; and while this need be addressed also on the supply side including measures to curb market manipulation, it will clearly be important to continue for the time being the tightened bias of monetary policy towards demand containment. As before, credit needs of productive sectors not adequately served by the credit market will continue to receive specific policy attention to ensure adequate and smooth credit flow.

1. Introduction

World output is projected to grow by 4.9 percent in 2006 (*WEO*, IMF, April 2006), which will be the third successive year in above-trend growth of global output. The consequent narrowing of global output gap(spare capacity) showing up initially in rising commodity prices and asset prices has eventually surfaced also in rising consumer prices, both in developing and developed economies. To maintain stability, central banks everywhere

are responding by tightening monetary policy with tightened liquidity and rising interest rates. The high and rising global prices of oil and other commodities are particularly challenging for countries like Bangladesh that are mainly processors/users rather than producers of primary commodities. The balancing act now facing macro economic management in Bangladesh is delicate. Laxity in policies will escalate inflation intolerably with buildup of excess demand, erosion of external sector viability and eventual sharp slowdown; sudden sharp tightening on the other hand will risk the growth momentum being choked off. For stable progress, mutually supportive well coordinated monetary and fiscal policies as also the needed sectoral structural reforms will need to proceed on a steady course, avoiding knee jerk response.

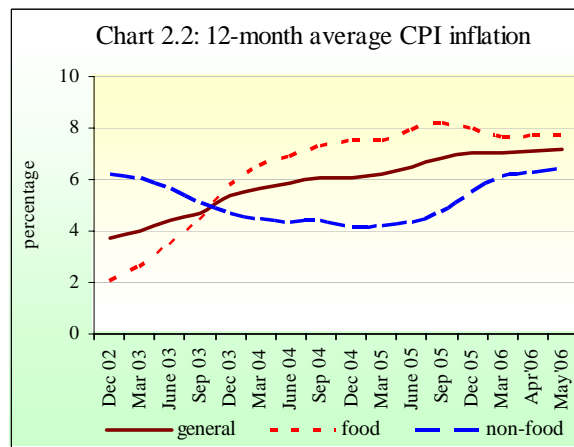
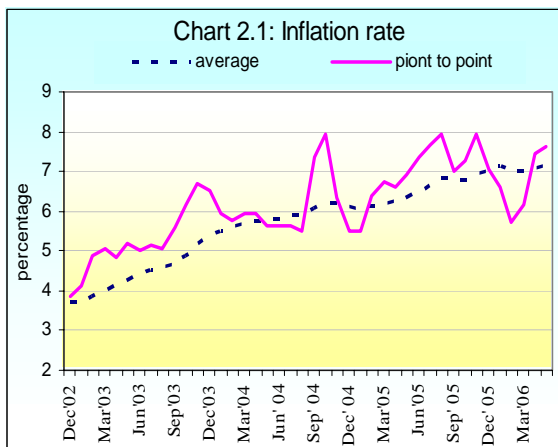
2. Macroeconomic developments in FY06, outlook for FY07

2.1. Growth: Following the slowdown to 5.9 percent in FY05 due to the adversities of floods, MFA expiry and sudden sharp oil price like, real GDP growth rebounded to an estimated 6.7 percent in FY06, with agriculture, industry and services sectors growing by 4.5, 9.6 and 6.5 percent respectively. The 4.5 percent growth in agriculture was substantially above trend, reflecting strong recovery in benign climate from flood damages of the preceding year. Benign conditions continued in FY06 both for the crop and non-crop sub-sectors, there was no incidence of pandemics like bird flue in burgeoning poultry farming. The 9.6 percent industry sector growth was broad based, spread across sub-sectors supported both by domestic demand (evidenced in strong credit growth) and export demand (with competitiveness bolstered by the 8.6 percent depreciation of Taka against US Dollar). Robust output activities in the agriculture and industry sectors supported the 6.5 percent FY06 growth in the services sector.

Conditions continue to remain favorable in FY07 in the agriculture sector, but it may be unrealistic to expect growth to be sustained at the high post-flood rate of FY06. Growth in agriculture in FY07 is likely to ease down somewhat towards the trend level. In the industry sector, new capacity addition trends continue to be strong, particularly in textiles/apparels and telecommunications. Trends of variables such as import of production inputs and capital machinery, new orders in the books of apparels exporters, growth of domestic credit etc indicate that industry sector growth will sustain or strengthen further in FY07. The services sector is likewise expected to be in buoyant growth in FY07, supported by activities in the agriculture and industry sectors and also by the steady additions of new capacities in medical, hospitality, education and logistics services. Overall, real GDP growth in FY07 is projected to be in the 6.5–6.8 percent range, in line with projections in the Medium Term Macroeconomic Framework (MTMF) in the National Strategy for Accelerated Poverty Reduction (NSAPR).

2.2. Inflation: Annual average CPI inflation was on slow upward creep throughout FY06 (charts 2.1, 2.2), and from December 05 onward breached (but also stayed quite close to) the seven percent ceiling targeted in the January 06 issue of the MPS. It will be seen in chart 2.2 that the food component of average CPI had higher upward bias than the non-food component in FY05, and also that both components were on upward trend in the fourth quarter of FY06.

The rising food prices in FY05 were largely attributable to crop losses and supply disruptions caused that year by the floods; it is harder to attribute the more recent uptrend in food and non-food prices substantially to domestic factors. No major disruption to domestic output or distribution activities, climatic or otherwise, occurred in FY06; and while complaints voiced in the media about manipulations by major market players and about extortions in the supply chains need attention, these distortions are long standing rather than newly appearing influences on consumer prices. The alleged cost push effect of tighter monetary policy by way of higher borrowing interest rates wouldn't yet be significant either, weighted average lending interest rate of banks has so far risen much slower than the rise in the BB's policy interest rates (chart 3.1).



The recent pressures on consumer prices are emerging mainly through the external trade channels. Growing exports of daily consumer necessities such as vegetables and fishes are steadily pulling their domestic prices towards the higher export prices. Rising import prices of food items, other consumer items and production inputs are feeding promptly and fully into domestic prices, except for partial shielding/subsidy by the government in some fuel oil and fertilizer prices. Depreciation of Taka associated with balance of payment pressure from rising import prices has also to some extent added to the uptrend in consumer prices.

Easing of consumer price pressure in Bangladesh will therefore be contingent upon significant easing of global commodity prices, not expected before 2007 in the projections of April 06 issue of *WEO*, IMF. Bangladesh Bank's monetary stance for the coming quarters will accordingly continue with the previous 7.0 percent target ceiling for average CPI inflation, with possibility of downward revision based on subsequent review of developments in the first half of FY07.

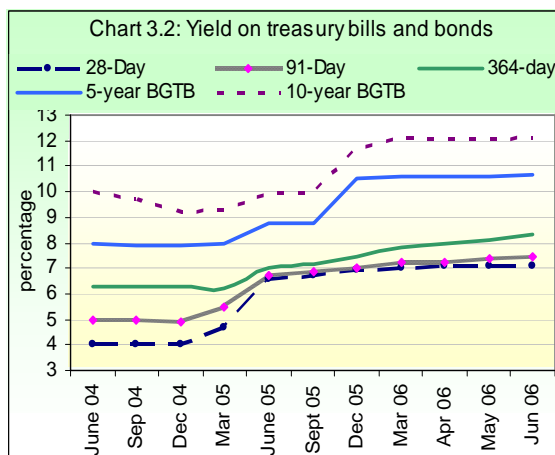
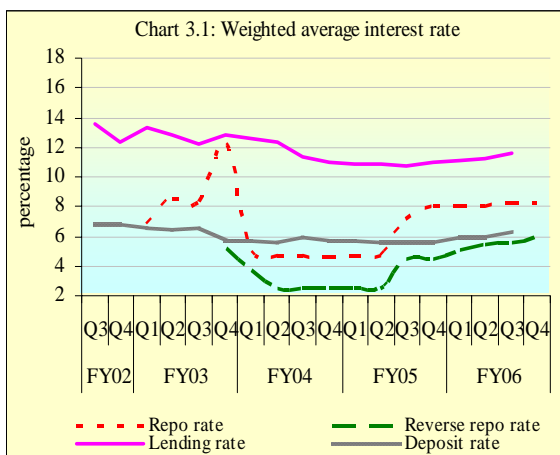
2.3. External sector: Sharp import growth in FY05 caused the current account of balance of payments to swing into deficit of about half a billion US Dollars, after three previous years in surplus. Depreciation of floating exchange rate of Taka, coupled with tightened monetary policy brought about a prompt turnaround to current account surplus by July 05, slowing down import growth to sustainable level and stimulating strong

growth in export and workers' remittances from abroad. Improvement in overall balance was somewhat slower, because of overhang of some deferred liabilities for oil and other imports of FY05. By April 06 however, overall balance has also turned around to positive, putting the foreign exchange reserves back on growth path. The floating exchange rate of Taka and the appropriately cautious monetary policy stance should retain the balance of payments in FY07 on a viable path, with continuing improvement in foreign exchange reserves as cushion against unforeseen future shocks.

2.4. Fiscal deficit and financing: Overall deficit in the government's FY06 revised budget amounted to Taka 161.90 billion or 3.9 percent of GDP, funded by Taka 24.76 billion in foreign grants, Taka 55.74 billion in foreign borrowing, and Taka 81.40 billion in domestic borrowing including Taka 49.11 billion from the banking system. Actual outturn in bank borrowing is likely to be close to the budgeted level, save an exceptional Taka 10.0 billion in government bonds issued to Sonali Bank in partial adjustment of its overdue loans to state owned BPC relating to petroleum imports. The government's FY07 budget projects an overall deficit of Taka 171.98 billion or 3.7 percent of GDP, to be funded by Taka 25.08 billion in foreign grants, Taka 58.56 billion in foreign loans and Taka 88.34 billion in domestic borrowing including Taka 54.34 billion from the banking system. The bank borrowing projected in the FY07 budget is within normal trends and should pose no major issue for monetary policy. The huge overdue debt of BPC to the nationalized commercial banks (accumulating at the rate of about one percent of GDP per annum), resulting from incomplete pass-through of petroleum import costs to consumers, is an important issue for banking system liquidity as well as for smooth conducting of monetary policy. The nationalized commercial banks burdened with large overdues from the BPC are being unable to take up new issues of treasury bills and bonds in sufficient volumes in the auctions, causing high accumulation of government's debt to the central bank. The debts of BPC need to be sorted out expeditiously, adjusting the overdue stock with explicit subsidy from government budget and stemming the flow of new overdues with a suitable mix of revision of retail prices and tariffs on fuel oils.

3. Monetary policy stance

3.1. Policy stance in FY06 and outturn: Monetary policies have been on a cautious, restraining stance from the second half of FY05, with a view to curbing excess demand from inflationary expectations. Early in FY06 (in October 05), CRR and SLR were raised from 4.5 and 16.0 percent respectively to 5.0 and 18.0 percent of time and demand liabilities of scheduled banks, towards slowing down the growth of domestic credit and its component sub-aggregates. Reverse repo, repo interest rates and treasury bill/bond yield rates have been maintained on sustained uptrend (table 3.1, charts 3.1, 3.2). The cautious monetary stance together with exchange rate flexibility has served well to protect external sector viability by bringing back import growth to sustainable level, stimulating export growth and turning around the eroding net foreign assets back to growth path. Excess demand from inflationary expectations remains yet to be fully eliminated however, as indicated by the 19.9 percent year on year deposit growth in May 06 significantly lagging the 21.6 percent growth in domestic credit, with the later far higher than the nominal GDP growth rate in FY06. Excess demand from inflationary



expectations is evidenced further by broad money and domestic credit being on significantly higher growth paths than projected in the FY06 monetary program (charts 3.3, 3.4, table 3.2). It may be noted from Table 3.2 that credit to the private sector (three fourth of total domestic credit) was also on a higher growth path than the program projections, above seventeen percent in March 06 and May 06, belying fears of the private sector credit needs being crowded out by monetary tightening. The high growth in credit to the public sector (about one fourth of total domestic credit) in FY06, essentially from increased BPC debt, arose from the government's desire to partially shield the private sector economic agents and households from adverse effects of escalating world prices of fuel oil.

3.2. Monetary policy stance for FY07: The review in the foregoing sections has identified lingering persistence of excess demand from inflationary expectations, warranting the continuation of the cautious, tightened bias of monetary policies in FY07. Policy interest rates and other instruments will be used as needed with the objective of limiting annual average CPI inflation within the targeted seven percent ceiling in FY07.

Table 3.1: Interest rate developments

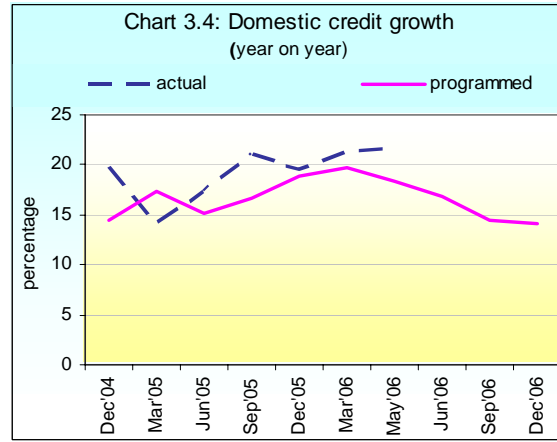
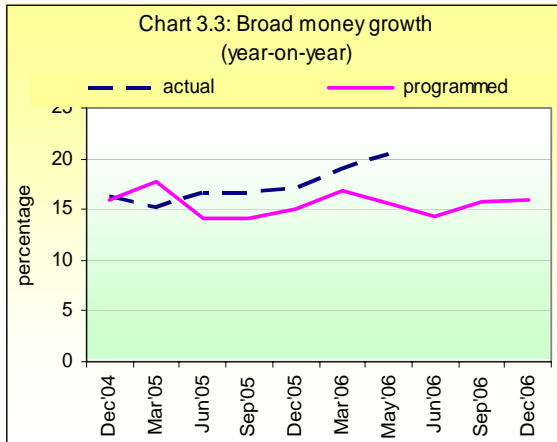
Period	Treasury Bills					BGTB		Repo		Reverse Repo		Call Rate	Lending Rate*	Deposit Rate*
	28-Day	91-Day	182-Day	364-Day	2-Year	5-Year	10-Year	1-2 Day	3-9 Day	1-2 Day	3-11 Day			
FY 05														
Jul	4.04	5.00	5.99	6.30	7.00	...	...	5.31	...	2.48	2.58	4.82	...	...
Sep	4.05	4.94	5.88	6.29	6.91	...	...	4.75	...	2.60	2.62	5.17	10.90	5.68
Dec	4.05	4.91	5.78	6.23	6.76	7.87	9.21	...	...	2.53	2.77	7.62	10.83	5.56
Mar	4.71	5.45	5.78	6.18	6.70	...	...	7.22	8.00	4.50	4.03	13.49	10.74	5.58
Jun	6.60	...	6.75	7.00	7.18	8.75	9.93	...	...	4.50	4.63	6.71	10.93	5.62
FY 06														
Jul	6.64	6.70	6.80	7.03	7.25	...	...	...	...	4.56	4.95	5.42	...	...
Sep	6.72	6.85	6.98	7.13	7.45	...	...	...	...	5.02	5.47	6.09	11.15	5.90
Dec	6.96	7.02	7.20	7.45	7.75	10.50	11.65	...	8.00	5.50	5.72	8.40	11.25	5.90
Mar	7.05	7.25	7.49	7.85	8.70	...	...	...	8.25	5.60	5.95	17.15	11.60	6.26
Jun	7.10	7.43	7.75	8.30	9.07	10.65	12.10	...	...	6.04	6.29	10.84	...	...

Source: MPD, FRTMD, Statistics Department, Bangladesh Bank

* Weighted Average rate of all banks.

Table 3.2 : Bangladesh: Monetary Program, December 2004-June 2007

	Dec.-04		Mar.-05		Jun.-05		Sept.-05		Dec.-05		Mar.-06		Jun.-06		Sept.-06	Dec.-06	Mar.-07	Jun.-07
	Prog.	Actual	Prog.	Actual	Prog.	Actual	Prog.	Actual	Rev.Prog.	Actual	Rev.Prog.	Actual	Rev.Prog.	Prog.	Program for FY - '07			
<i>period: in billions of taka)</i>																		
Net foreign assets	183	192	184	194	179	186	187	180	181	185	183	192	203	215	232	235	239	242
Bangladesh Bank	135	147	134	148	128	130	134	121	122	132	126	142	140	153	169	171	173	174
Commercial banks	48	45	50	46	51	55	53	59	60	53	56	49	63	62	63	65	66	68
Net domestic assets	1,219	1,213	1,255	1,216	1,302	1,328	1,337	1,377	1,435	1,460	1,466	1,488	1,528	1,536	1,569	1,638	1,680	1,781
Domestic credit	1,300	1,313	1,341	1,337	1,402	1,431	1,439	1,495	1,562	1,571	1,600	1,619	1,675	1,674	1,710	1,782	1,828	1,933
Net credit to central government	214	209	222	201	240	237	236	246	259	254	277	247	302	296	302	309	327	360
Credit to other nonfinancial public sector	73	68	76	71	76	86	78	104	109	126	111	126	112	112	115	118	121	124
Credit to private sector	1,011	1,037	1,043	1,065	1,086	1,107	1,125	1,145	1,194	1,191	1,212	1,246	1,261	1,267	1,294	1,355	1,380	1,449
Other items, net	-81	-100	-86	-121	-100	-102	-103	-119	-127	-110	-134	-131	-147	-138	-141	-144	-148	-152
Broad money (M2)	1,402	1,406	1,439	1,410	1,481	1,514	1,524	1,557	1,617	1,645	1,649	1,680	1,730	1,751	1,802	1,873	1,918	2,023
Currency in circulation	-	170	-	176	194	185	183	-	201	-	206	-	209	-	-	-	-	-
Deposits	-	1,236	-	1,234	1,303	1,329	1,341	-	1,417	-	1,443	-	1,521	-	-	-	-	-
<i>(Year-on-year percentage change)</i>																		
Net foreign assets	17.4	23.2	17.7	24.1	10.0	14.2	0.2	-3.4	-5.8	-3.8	-6.0	-1.5	9.2	15.7	28.9	29.7	30.5	12.5
Net domestic assets	15.7	15.2	17.6	14.0	14.8	17.1	16.5	20.0	18.3	20.4	20.6	22.4	15.0	15.7	14.0	14.1	14.6	15.9
Domestic credit	14.5	19.8	17.3	14.2	15.1	17.4	16.6	21.1	18.9	19.6	19.7	21.2	16.9	17.0	14.4	14.1	14.2	15.5
Net credit to central government	17.5	24.6	24.2	20.6	18.2	16.9	24.8	30.4	24.4	21.6	38.1	22.8	26.5	24.6	22.4	19.0	17.8	21.7
Credit to other nonfinancial public sector	19.7	10.8	19.7	13.7	10.6	25.8	14.6	51.8	60.9	85.7	56.8	78.9	29.4	29.4	10.6	8.3	9.0	10.7
Credit to private sector	13.5	18.0	15.8	19.4	14.8	17.0	15.2	17.2	15.2	14.9	13.8	17.0	13.9	14.5	13.0	13.5	13.9	14.4
Other items, net	-32.5	68.5	2.0	16.0	19.2	22.0	17.7	36.1	26.6	10.4	11.3	9.0	41.5	34.8	19.0	13.8	10.3	10.1
Broad money (M2)	16.0	16.3	17.7	15.3	14.2	16.7	14.2	16.7	15.0	17.1	16.9	19.1	14.3	15.7	15.7	15.9	16.3	15.5
Memorandum items:																		
Broad money multiplier	5.54	5.62	5.61	5.40	5.57	5.53	5.60	5.56	5.38	5.28	5.35	5.35	5.44	5.41	5.39	5.39	5.35	5.42
Broad money velocity	2.52	2.49	2.52	2.55	2.52	2.43	2.52	2.65	2.44	2.39	2.45	2.41	2.40	2.37	2.37	2.35	2.37	2.30



Monetary policy actions in FY07 will also aim at retaining key monetary aggregates (broad money, domestic credit and its components) along growth paths projected in the monetary program (at table 3.2) based on real GDP growth of 6.8 percent and inflation of 7.0 percent.

4. Conclusion

To recapitulate, monetary developments under the policy stance conveyed by the BB's January 06 MPS have been positive; better balance between demand and supply has been attained, productive activities and growth in the economy have been well supported and external sector viability has strengthened. The targeted seven percent ceiling for annual average CPI inflation has however been breached, albeit by small margin, because of lingering excess demand from inflationary expectations. These factors along with continuing uptrend of global prices of oil and other commodities posing additional risk of further worsening domestic inflation imply that tightened bias of monetary policy will need to continue in FY07 as appropriate policy response towards maintaining macroeconomic stability and containing inflation. Monetary developments are under constant monitoring and continuous review, and the policy stance will be appropriately adjusted promptly responding to any major unforeseen change in the unfolding domestic and external economic realities.