



**RESEARCH REPORT ON
MONEY MARKET AND MONETARY POLICY**

00737

BBA

Letter of Transmittal

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To

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Subject: Submission of the Report Work.

Dear Sir,

I have worked my way through to complete this report on "Money and Monetary system of Bangladesh." I have observed the use of this money and monetary system in Bangladesh and tried to implement new ideas.

I have gone through some extensive research for this project, especially in secondary level. I came up with my findings related to my topic and therefore moved onto a conclusion regarding the effectiveness of monetary system in Bangladesh. I also have recommended some ideas in my paper.

I am anticipating your appreciation in this regard.

Regards

Samina Akhter

Samina Akhter

2003-2-10-203

TABLE OF CONTENT

Introduction	1
Origin of the Report	1
Objective of the Report	1
Scope	1
Source of Information	2
Methodology	2
Limitations	2
An Overview	3
Money & its Kind	3
Money is a "medium of exchange"	4
Exchange	4
Direct and Indirect Exchange	4
What Should Be Used As Money?	5
Historical Perspectives	7
The Era of Metal-Based Money	7
The Monetary Base Today	7
Base Money Flows	8
The Role of the Central Bank	8
Reserve Ratio Requirements	9
Monetary Policy	10
Monetary Policy	10
History of Monetary Policy	11
Role of Monetary Policy	13
Monetary Policy Framework	14
Bangladesh Perspectives	17
Total	17
Focus on Past Financial Performance	18
Financial System	19
Activities of Bangladesh Bank	19
Foreign Exchange System	21
Exchange Rate Policy	22
Bank Licensing	22
Commercial Banks	23

Financial Institutions _____	24
Capital Market _____	25
1. Regulatory Bodies _____	25
2. Participants in the Capital Market _____	25
Investment Corporation of Bangladesh (ICB) _____	25
Other Institutions _____	27
Insurance _____	27
Micro Financial Institutions _____	27
Fiscal Development _____	28
Revenue Management _____	28
Public Expenditures _____	32
Money Supply and Credit Market Development _____	35
The Foreign Exchange Market _____	46
Tools of Bangladesh Bank _____	49
Control of Money Supply _____	49
Bank Rate _____	49
Reserve Requirement _____	50
Required Reserve Ratio _____	50
Open Market Operation _____	52
Recommendation _____	58
Conclusion _____	59
References _____	60



EXECUTIVE SUMMARY,

Money is a token that is widely accepted as a medium of exchange. The token can be tangible like a coin or a note, or intangible like credit in a bank deposit. If the token is convertible on demand into a commodity like an ounce of gold or a bushel of wheat, the token is known as commodity money.

All fiat money is issued by the Central Bank of the countries. Its value derives from the fact that it is the only kind of money acceptable in payment of taxes and for settling private debts in court. Those who have no tax liability have reason to acquire fiat money because it is of value to those who do. Thus fiat money can be viewed as a tax credit that is widely accepted as a medium of exchange.

Monetary policy rests on the relationship between the rates of interest in an economy, that is the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment.

A policy is referred to as contractionary if it reduces the size of the money supply or raises the interest rate. An expansionary policy increases the size of the money supply, or decreases the interest rate. Further monetary policies are described as accommodative if the interest set by the central monetary authority is intended to spur economic growth, neutral if it is intended to neither spur growth or combat inflation, or tight if intended to reduce inflation.

There are several monetary policy tools available to achieve these ends. Increasing interest rates by fiat, reducing the monetary base or increasing

reserve requirements all have the effect of contracting the money supply, and, if reversed, expand the money supply.

The primary tool of monetary policy is open market operations. This entails managing the quantity of money in circulation through the buying and selling of various credit instruments, foreign currencies or commodities. All of these purchases or sales result in more or less base currency entering or leaving market circulation.

It must now take into account such diverse factors as short term interest rates; long term interest rates; velocity of money through the economy; exchange rates; credit quality; bonds and equities (corporate ownership and debt); government versus private sector spending/savings; international capital flows of money on large scales and financial derivatives such as options, swaps, futures contracts, etc.

The financial system of Bangladesh consists of Bangladesh Bank (**BB**) as the central bank, nationalized commercial banks (**NCB**), Government owned specialized banks, Domestic private banks, foreign banks and Non-bank financial institutions. The financial system also embraces insurance companies, stock exchanges and the co-operative banks.

Capital market, an important ingredient of the financial system, plays a significant role in the economy of the country.

BB, like all other central banks uses its power to alter the money supply growth for the purpose of overall monetary management of the country. Bangladesh attempts to alter money supply growth generally through the following traditional tools such as Bank rate, Reserve requirement and Open market operation.

Economists differed on the issue of monetary management. However there is a broad consensus regarding the objectives of monetary management. Macroeconomic objective of price stability has been broadly recognized as the primary objective of monetary policy. In the recent decade, efforts are being made to improve the efficiency and soundness of the banking system through reform programs. Because efforts to improve financial sector efficiency and soundness are needed to support improved macroeconomic and monetary management.



PART ONE





PART ONE

INTRODUCTION

Origin of the Report

M Sayeed Alam, faculty, Dept of BBA, East West University, Mohakhali, Dhaka as a part of research report, orally authorized this report.

Objective of the Report

- **Primary Objective:** The primary objective of this report is to fulfill requirement of the course.
- **Secondary Objectives:**
 1. **To get acquainted and earn knowledge on the real situation of the Monetary System of Bangladesh.**
 2. **To know the current strength, weakness, future opportunity and threats in this sector.**
 3. **To recommend some measure to improve in this regard.**

Scope

This research paper is intended to provide information regarding Money and Monetary system of Bangladesh. Money, as a medium of exchange system has a vital forerunning role in the economy of any country. Therefore, in order to working the business field, it has become a must to have some working knowledge in this arena.

Efforts of making this paper have concentrated in two parts. First part covers the elementary knowledge on Money, whereas part two contains the Monetary System of Bangladesh.

Source of Information

This report is prepared basing on basically the secondary information. The information's of this report were taken from different books. However to collect information and record Data following sources were used:

- Bangladesh Institute of Development Studies (BIDS).
- Bangladesh Bank Website.
- Dhaka Stock Exchange.

Methodology

Essential steps and paths that follow the monetary system of Bangladesh constitute the theoretical section of this report. So books, periodical, Journal or any other printed materials as well as records related with the topics are the source for the conceptual part of the report.

Limitations

The major limitation in preparing this term paper is given below:

- Time constraint, as I am doing the course along with 3 other courses.
- Lack of co-operation from the officials on the concerned sectors.
- There is huge information in this aspect, so with limited and basic knowledge it becomes often difficult to filter out correct information.

AN OVERVIEW

Money & its Kind

Money is a token that is widely accepted as a medium of exchange. The token can be tangible like a coin or a note, or intangible like credit in a bank deposit. If the token is convertible on demand into a commodity like an ounce of gold or a bushel of wheat, the token is known as *commodity money*. The exchange value of commodity money can vary, but is never less than its value as a commodity. A precious metal coin is a token convertible into the bullion that comprises it, meaning the intrinsic value of the token coincides with its value as a commodity.

Money that is inconvertible is known as *fiat money*. Lacking intrinsic value, it must depend on some other mechanism to maintain a positive exchange value. All modern money systems employ fiat money. One must therefore avoid thinking of money in terms of a commodity to understand modern money. In the era of commodity money, the issuer was constrained by the need to hold a sufficient supply of the underlying commodity. There is no such constraint in the case of fiat money. The viability of a fiat money system depends on the policy and actions of the issuer, normally the central bank of a country.

All fiat money is issued by the Central Bank of the countries. Its value derives from the fact that it is the only kind of money acceptable in payment of taxes and for settling private debts in court. Those who have no tax liability have reason to acquire fiat money because it is of value to those who do. Thus fiat money can be viewed as a tax credit that is widely accepted as a medium of exchange.

Banks greatly expand the scope of fiat money by issuing credit through the act of lending. The value of bank credit money is based on the promise that it can be converted to fiat money at par. Banks must hold sufficient reserves of fiat money to accommodate such conversion on demand.

Money is a "medium of exchange"

That's all. Yet the conception of a "medium of exchange" ranks below only language (with its corollaries - speech and the written word) as the greatest intellectual discovery in history. Without language, the exchange of anything but the most rudimentary ideas is impossible. Without money, the production and exchange of anything but the most rudimentary goods and services is impossible. It is not difficult or time consuming, or inefficient, it is IMPOSSIBLE!

Exchange

Animals don't exchange (or trade) amongst one another. They are self-sufficient, or they take from each other, or they exercise the prerogative of superior strength and/or cunning. There are some human beings who get along in a very similar fashion, but the overwhelming majority recognizes the benefits of voluntary exchange. Strictly speaking, the use of the word "voluntary" in this context is redundant. The phrase "your money or your life" is not the precursor to an exchange, whether the person uttering it brandishes a gun or a government identity card.

The first rule of any **voluntary** exchange is simplicity itself. If two people are willing to exchange, each must view the results of the exchange as being beneficial. If either of them is not of that view, the exchange will not take place.

Direct and Indirect Exchange

Direct exchange, or barter, is exactly that - my good or service for your good or service. The problem is that I might want what you have to offer, but you might not want what I offer in exchange. With no "medium" of exchange, there is no deal. Indirect exchange takes place when one party has a "medium" that is always acceptable, not for what it is, but for what can be done with it. If you offer me **money**, I will accept it, because I know that I can exchange it for what I want, whenever I want it.

Indirect exchange involves the use of MONEY - the "medium" of exchange. Money is the universal key, it fits all locks. And the world it has unlocked is the world we live in today. Money has made the division of labor possible. It has made specialization possible. It has made the accumulation of wealth over periods which exceed a human lifetime possible. Perhaps most important of all, it has hugely advanced the potential for amicable interaction between people. To survive as such, and to prosper, a **rational** animal must exchange. He or she has language, to exchange ideas, and money, to exchange the fruits of ideas. From that foundation, everything else we see around us has been built.

What Should Be Used As Money?

What is money? It is a medium of exchange. What does it do? It ensures the success of exchange by being the one item on offer that is ALWAYS acceptable. Why is it necessary? Because human beings must exchange to live together in peace, and to prosper. How important was the discovery of the idea of money? Look around you.

That covers the concept or idea of money. But an idea, as such, does not exist as a physical entity. Money must be a physical entity. Neither the "electronic" money of today nor the notes and coin which circulate as cash has any official or legal connection with Gold and Silver. But they once did, and most people think that they still do. As long as that situation persists, the modern monetary system will function.

Now, how does one go about choosing **what** is to be used as money? Simple, one looks for the most tradable good, the good which is in highest demand, the good that has begun to be accepted, not as an end in it, but as a means to an end. Money is the good that people do not want to consume, but want to use to make further exchanges easier.

Human beings have lived together for more than two million years. Money in its modern form - coin of fixed weight and denomination - came into use less than three thousand years ago. It took a long time to discover the physical goods which best serves the purpose of a medium of exchange.



HISTORICAL PERSPECTIVES

The Era of Metal-Based Money

During the era of precious metals as money, the production of money was basically in the hands of the private sector. The State minted it or printed the certificates used in trade to represent it. But private enterprise mined the ore and reaped the benefits of doing so. The total amount produced was not under State control. Its relative scarcity acted to maintain its exchange value at a reasonable level.

People viewed precious metal coins as being the only "true money." The Treasury acquired a stock of the metals, which, together with coins in circulation, became the monetary base of that era. Treasury certificates were valued because they were convertible on demand into gold or silver coin. The coins were an asset to the holder and a liability to no one. Under such conditions, there was no basic need for a central bank (CB).

The Monetary Base Today

With the end of convertibility, state-issued *fiat money* took over the role of the monetary base. Fiat money replaced gold and silver coin as "true money." The State holds a monopoly on its issue. No one can legally produce it except the State. Fiat money represents a balance sheet relation, meaning it is an asset of the holder and a liability of the State. Indeed it is an IOU of the State. The State must deliver something of value when it redeems its IOUs.

Since fiat money is not convertible on demand into gold or any other commodity, it must acquire value through the promise behind it. The most compelling promise is that it will be accepted in payment of one's tax liability. As long as the State is able to enforce tax collection, its fiat money will be in demand and widely accepted as a medium of exchange. In effect, fiat money is a credit against taxes due.

Base Money Flows

All monetary base money originates with the State. The State itself must therefore provide enough to enable the private sector to pay its taxes, but not so much that the demand for it disappears. The private sector acquires base money primarily from Treasury spending. The Treasury recaptures it through taxes and the sale of its debt securities. This balanced reciprocal flow is fundamental to maintaining the value of base money. Thus, Treasury spending does not change the total amount of base money. It changes as a result of actions taken by the CB in its role as the monetary authority.

The Role of the Central Bank

The monetary base exists in two forms:

- Bank deposits at the CB and
- Cash, i.e. notes and coins.

Banks maintain accounts at the CB for check clearing which requires the interbank transfer of deposits. Each bank must hold enough reserves at the CB to cover the checks written by its own depositors. Normally the interbank lending market serves to redistribute bank reserves where they are needed. However when aggregate bank lending increases, the CB is obliged to add reserves in order to maintain the interbank lending rate on target. It does so by buying Treasury securities from the public. The selection and control of that interest rate is the primary monetary policy tool of the CB.

Cash, which is by far the largest component of the monetary base, is used primarily as street money. The amount of cash in circulation depends entirely on how the public chooses to divide its money between bank deposits and cash. Since cash is not interest bearing, the public normally holds as little as possible. However as the economy grows, there is an increasing demand for cash. Withdrawals of cash reduce a bank's reserves, forcing the CB to replenish those reserves in order to defend its interest rate target. In effect,

when the public needs more cash, it sells some of its Treasury securities to the CB.

One of the key roles of the CB is to ensure the liquidity of the banking system. For that reason the CB cannot arbitrarily control the amount of base money. It must respond to the demand for base money as needed to support bank lending and cash withdrawals.

Money plays a central role in our lives, yet no one can be totally free of misconceptions about it.

Reserve Ratio Requirements

The reserve ratio requirement limits a bank's lending to some fraction of its demand deposits. The current rule allows a bank to issue loans, i.e. create credit money, in an amount equal to 90% of such deposits, holding 10% in reserve. The reserves can be held in any combination of vault cash and deposit at the CB. There is no required reserve for other bank liabilities, such as savings accounts or certificates of deposit.

The *money multiplier* in its basic form is the reciprocal of the required reserve ratio. It is commonly thought to be a measure of how large the credit money supply will grow, given the amount of reserves created by the Fed. In truth the amount of reserves depends on the amount of bank credit issued, not the other way around, as will be explained. The money multiplier is little more than an after-the-fact observation of the multiple. Indeed the money multiplier can have no meaning in the many countries where there is zero reserve requirements on banks.



MONETARY POLICY

Monetary Policy

Monetary policy rests on the relationship between the rates of interest in an economy, that is the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate (in order to achieve policy goals). The beginning of monetary policy as such comes from the late 19th century, where it was used to maintain the gold standard.

A policy is referred to as contractionary if it reduces the size of the money supply or raises the interest rate. An expansionary policy increases the size of the money supply, or decreases the interest rate. Further monetary policies are described as accommodative if the interest set by the central monetary authority is intended to spur economic growth, neutral if it is intended to neither spur growth or combat inflation, or tight if intended to reduce inflation. There are several monetary policy tools available to achieve these ends. Increasing interest rates by fiat, reducing the monetary base or increasing reserve requirements all have the effect of contracting the money supply, and, if reversed, expand the money supply. Since the 1970s, monetary policy has generally been formed separately from fiscal policy. And even prior to the 1970s, the Bretton Woods system still ensured that most nations would form the two policies separately.

Within almost all modern nations, special institutions (such as the Bank of England, the European Central Bank or the Federal Reserve System in the United States) exist which have the task of executing the monetary policy independently of the executive. In general, these institutions are called central

banks and often have other responsibilities such as supervising the smooth operation of the financial system.

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The primary tool of monetary policy is open market operations. This entails managing the quantity of money in circulation through the buying and selling of various credit instruments, foreign currencies or commodities. All of these purchases or sales result in more or less base currency entering or leaving market circulation.

Usually the short term goal of open market operations is to achieve a specific short term interest rate target. In other instances, however, monetary policy might instead entail the targeting of a specific exchange rate relative to some foreign currency or else relative to gold. For example in the case of the USA the Federal Reserve targets the federal funds rate, the rate at which member banks lend to one another overnight. However the monetary policy of China is to target the exchange rate between the Chinese renminbi and a basket of foreign currencies.

History of Monetary Policy

Monetary policy is associated with currency and credit. For many centuries there were only two forms of monetary policy: decisions about coinage, and the decision to print paper money to create credit. Interest rates, while now thought of as part of monetary authority, were not generally coordinated with the other forms of monetary policy. Monetary policy was seen as an executive decision, and was generally in the hands of the authority with seniorage, or the power to coin. With the advent of larger trading networks came the ability to set the price between gold and silver, and the price of the local currency to foreign currencies. This official price could be enforced by law, even if it varied from the market price.

With the creation of the Bank of England in 1694, which acquired the responsibility to print notes and back them with gold, the idea of monetary policy as independent of executive action began to be established. The goal of monetary policy was to maintain the value of the coinage, print notes which

would trade at par to specie, and prevent coins from leaving circulation. The establishment of central banks by industrializing nations was associated then with the desire to maintain the nation's peg to the gold standard, and to trade in a narrow band with other gold back currencies. To accomplish this end, central banks as part of the gold standard began setting the interest rates that they charged, both their own borrowers, and other banks who required liquidity. The maintenance of a gold standard required almost monthly adjustments of interest rates.

During the 1870-1920 period the industrialized nations set up central banking systems, with one of the last being the Federal Reserve in 1913. By this point the understanding of the central bank as the "lender of last resort" was understood. It was also increasingly understood that interest rates had an effect on the entire economy, in no small part because of the marginal revolution in economics, which focused on how many more, or how many fewer, people would make a decision based on a change in the economic trade-offs. It also became clear that there was a business cycle, and economic theory began understanding the relationship of interest rates to that cycle. (Nevertheless, steering a whole economy by influencing the interest rate has often been described as trying to steer an oil tanker with a canoe paddle.)

The advancement of monetary policy as an engineering discipline has been quite rapid in the last 150 years, and it has increased especially rapidly in the last 50 years. Monetary policy has grown from simply increasing the monetary supply enough to keep up with both population growth and economic activity. It must now take into account such diverse factors as:

- ◆ short term interest rates;
- ◆ long term interest rates;
- ◆ velocity of money through the economy;
- ◆ exchange rates;
- ◆ credit quality;
- ◆ bonds and equities (corporate ownership and debt);
- ◆ government versus private sector spending/savings;

- ◆ international capital flows of money on large scales;
- ◆ financial derivatives such as options, swaps, futures contracts, etc.

A small but vocal group of people advocate for a return to the gold standard (the elimination of the dollar's fiat currency status and even of the Federal Reserve Bank). Their argument is basically that monetary policy is fraught with risk and these risks will result in drastic harm to the people should monetary policy fail.

Most economists disagree with returning to a gold standard. They argue that doing so would drastically limit the money supply, and throw away 100 years of advancement in monetary policy. The sometimes complex financial transactions that make big business (especially international business) easier and safer would be much more difficult if not impossible. Moreover, shifting risk to different people/companies that specialize in monitoring and using risk; they can turn any financial risk into a known dollar amount and therefore make business predictable and more profitable for everyone involved.

Role of Monetary Policy

The central bank is the sole issuer of banknotes and bank reserves. That means it is the monopoly supplier of the monetary base. By virtue of this monopoly, it can set the conditions at which banks borrow from the central bank. Therefore it can also influence the conditions at which banks trade with each other in the money market.

In the short run, a change in money market interest rates induced by the central bank sets in motion a number of mechanisms and actions by economic agents. Ultimately the change will influence developments in economic variables such as output or prices. This process – also known as the monetary policy transmission mechanism – is highly complex. While its broad features are understood, there is no consensus on its detailed functioning.

Long-run neutrality of money

It is widely agreed that in the long run – after all adjustments in the economy have worked through – a change in the quantity of money in the economy will be reflected in a change in the general level of prices. But it will not induce permanent changes in real variables such as real output or unemployment.

This general principle, referred to as "the long-run neutrality of money", underlies all standard macroeconomic thinking. Real income or the level of employment are, in the long term, essentially determined by real factors, such as technology, population growth or the preferences of economic agents.

Inflation – a monetary phenomenon

In the long run a central bank can only contribute to raising the growth potential of the economy by maintaining an environment of stable prices. It cannot enhance economic growth by expanding the money supply or keeping short-term interest rates at a level inconsistent with price stability. It can only influence the general level of prices.

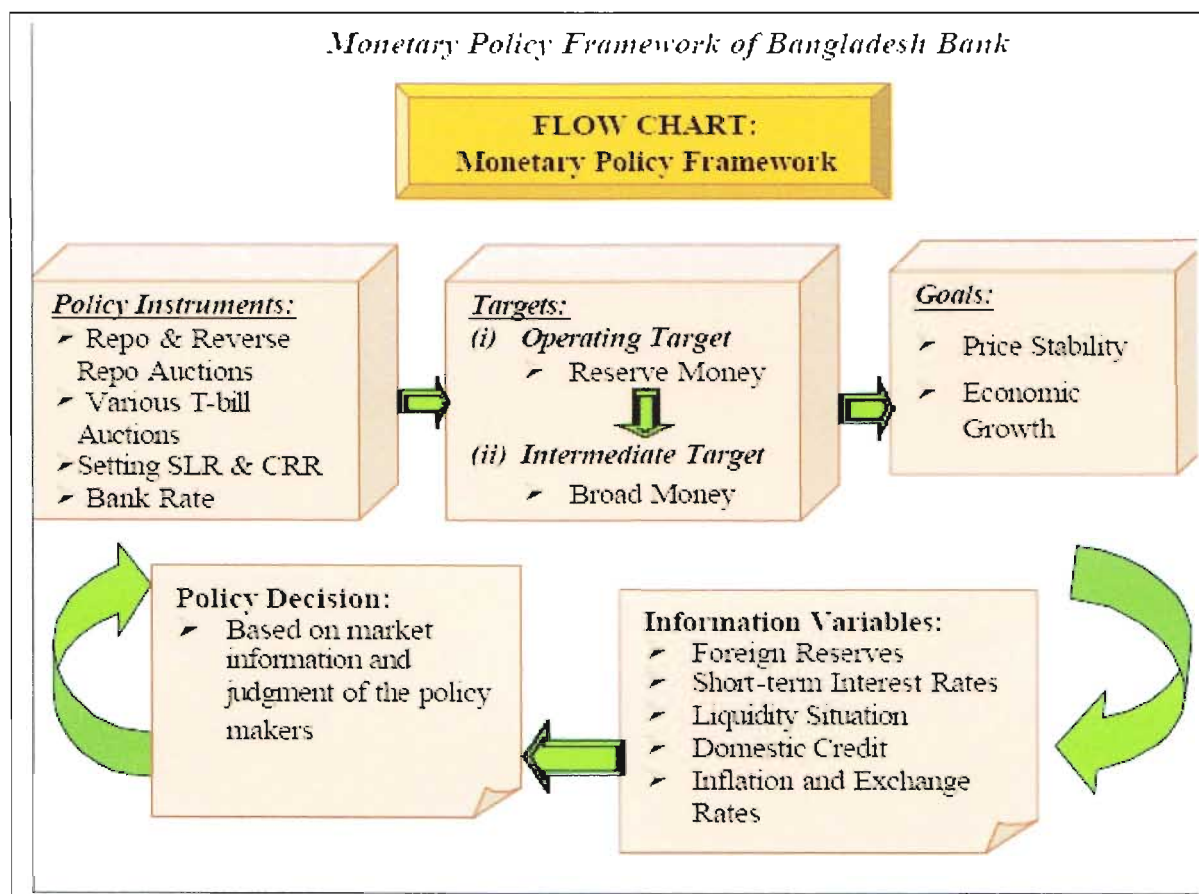
Ultimately, inflation is a monetary phenomenon. Prolonged periods of high inflation are typically associated with high monetary growth. While other factors (such as variations in aggregate demand, technological changes or commodity price shocks) can influence price developments over shorter horizons, over time their effects can be offset by a change in monetary policy.

Monetary Policy Framework

Since monetary policy goals cannot be influenced directly, like most central banks BB uses a set of indirect instruments. As noted above, the Bangladesh Bank pursues its monetary policy within a framework of monetary targeting with reserve money as the *operating target*, and broad money as an *intermediate target*. The Flow Chart on the Monetary Policy Framework provides a simple illustration.

As described above, the broad money (M) can be influenced indirectly by changes in policy instruments that target and monitor the reserve money (RM)

via the money multiplier (m). The primary mechanism employed for this purpose is the direct control of liquidity on a day-to-day basis achieved by the *ratio*, *reverse-ratio* and the weekly T-bill auctions. The latter instruments would in turn have an impact on the inter-bank call money rate for overnight transactions. While adjusting the excess liquidity in the banking system by this mechanism, BB simultaneously re-sets the ratio and reverse-ratio rates on a daily basis.



The cash reserve requirement ratio (CRR) and the statutory liquidity ratio (SLR) are effective means of announcing the monetary policy stance. In a tightening mode, BB adjusted CRR twice recently (first in the third quarter of FY' 05, and again in the first quarter of FY'06, though effective from October 1, 2005). In the latter occasion the SLR was also raised to 18 percent. Earlier reasons were cited as to why the traditional bank rate has not been effective in signaling the monetary policy stance via the adjustment of the borrowing and deposit rates in the banking system. It is also noteworthy that the Bangladesh Bank has of late encouraged the activation of the inter-bank call

money market instead of the reliance of commercial banks on the rediscount window the Central Bank. As the time lag between policy actions and the eventual impact on goals is usually several quarters long, additional information variables such as foreign reserves, short-term interest rates, liquidity situation and domestic credit growth appear handy for policy makers to adapt and revise its policy measures if and as needed. No matter how sound is the monetary program being pursued and its analytical base, the monetary authorities need to use their judgment deciding the future direction of the policy stance and communicate that rationale to the public.

PART TWO

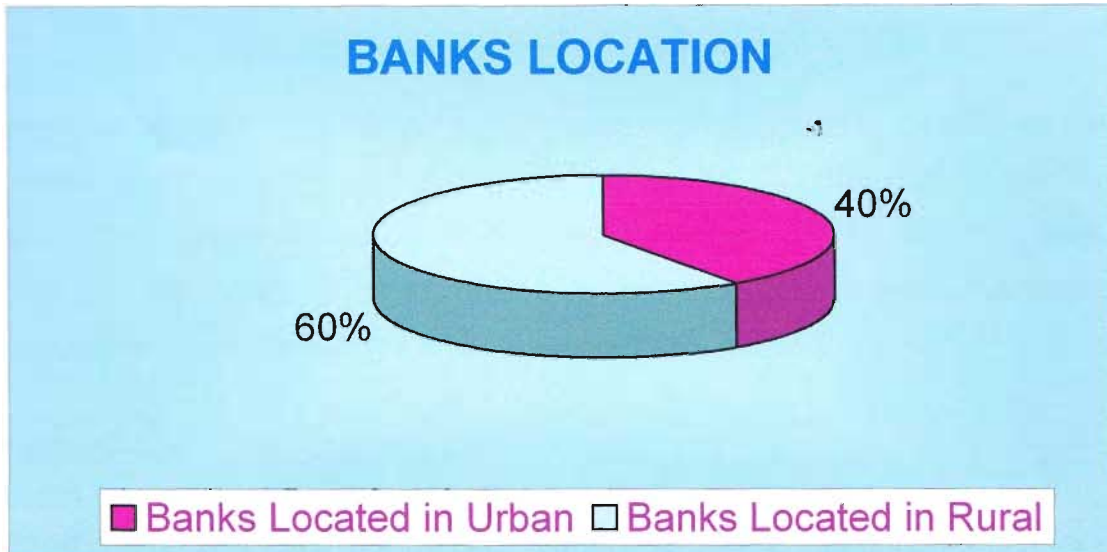


PART TWO

BANGLADESH PERSPECTIVES

After the liberation of Bangladesh, government policies were directed towards increased flow of credit to the priority sectors including agriculture. As a result, the expansion of bank was encouraged to cope with the then policy of the government. Supply leading strategy was adopted in monetary management during the 1970s. Directed lending, subsidies to various priority sectors and in some cases credit retaining was pursued as a part of monetary policy during 70's. Bangladesh bank, as central Bank of the country tried to provide adequate level of credit to support the desired growth of the priority sectors. Bangladesh Bank also played strong developmental role in the financial market through establishment of new developmental role in the financial market through establishment of new development of financial institutions and enlargement of credit through expansion of branches of various Commercial Banks. As a result, number of bank branches rose from 1447 in 1974 (end of June) to 6124 in 2000-2001. Followings are the table and graph showing various banks. It may be noted that less attention was given to contain inflation at that time which is a major macroeconomic policy objective of the economy.

SL No	Type	Number
1	Nationalized Bank Branches	3608
2	Non-nationalized Bank Branches	1268
3	Foreign Bank	34
3	Specialized Bank	1214
4	Non-Tafsili Bank (Only Type)	4
	Total	6128



Focus on Past Financial Performance

In terms of overall macroeconomic performance the decade of 1970s was the worst in Bangladesh. Money supply (M2) accelerated to 18.86% on yearly average during 1973-74 to 1979-80. Inflation rate, on yearly average basis, rose to 14.36 percent during 1973-74 to 1979-80. The yearly average credit growth was 25.82 percent while that average GDP growth was under 6.00 percent during the same period. In the subsequent decade that is during 1980 – 81 to 1989-90 the annual average rate of monetary expansion increased to 21.58 percent with a decline in inflation rate to 10.83 percent. The annual average growth in bank credit was 22.40 percent while GDP growth was under 4.00 percent during the same period. In the 90,s (up to 1996-97) the average rate of growth of broad money was 12.36 percent per annum while there was a significant drop in inflation rate to 4.33 percent, Credit growth was registered at 10.55 percent which was below the growth of money supply and the average rate of growth of GDP was 4.5 percent during the 1990s.

It may be noted here that 1970s was the decade of persistent rise in prices with volatility in money supply. In next two decades that is during 1980s and 1990s Bangladesh witnessed a moderate in inflation rate although continuous rise in money supply and credit was noticed.

Financial System

The financial system of Bangladesh consists of Bangladesh Bank (**BB**) as the central bank, nationalized commercial banks (**NCB**), Government owned specialized banks, Domestic private banks, foreign banks and Non-bank financial institutions. The financial system also embraces insurance companies, stock exchanges and the co-operative banks.

Activities of Bangladesh Bank

Bangladesh Bank (BB), as the central bank, has legal authority to supervise and regulate all the banks and is entrusted to the following responsibilities:

- To performs the traditional central banking roles of note issue and banker to the government and banks.
- To formulates and implements monetary policy manages foreign exchange reserves and supervises banks and non-bank financial institutions.

Its prudential regulations include:

- Minimum capital requirements,
- Limits on loan concentration and insider borrowing
- Guidelines for asset classification and income recognition.

BB has power to impose penalties for non-compliance and also intervene in management of a bank if serious problems arise. It also has the delegated authority of issuing policy directives regarding foreign exchange regime.

A governing body of 09 members conducts activities of Bangladesh Bank with one Governor. Its head office is located in Dhaka and having the other branches as follows:

SL No	Location	Number
1	Dhaka	02
2	Chittagong	01
3	Rajshahi	01
4	Khulna	01
5	Bogra	01
6	Sylhet	01
7	Rangpur	01
8	Barisal	01

Interest Rate Policy

Under the new interest rate policy which became effective in January 1990, all deposits rates are decontrolled. Lending rates are all freely determined by the market except for exports.

Capital Adequacy

In January 1996, BB announced new policy on Capital Adequacy along the lines recommended by the Basle Committee on banking supervision. Revised policy on capital adequacy requires scheduled banks to maintain at least 8% of off-balance sheet risk and risk in different types of assets as capital.

Loan Classification and Provisioning

Bangladesh Bank introduced new accounting policies with respect to loan classification, provisioning and interest suspense in 1989 with a view to attaining international standard over a period of time. Revised policy for loan classification and provisioning was introduced from 1st January, 1999. Revised policy calls for independent assessment of each loan on the basis of qualitative factors and objective criteria. Each loan is branded with the worst level of classification resulting from this independent assessment.

If a **Continuous Credit** or a **Demand Loan** remains non-performing for 6 months or more it is classified **Sub-standard**. It is classified as **Doubtful** if it

remains non-performing for 9 months and classified as **Loss** if non-performing for 12 months or more.

-3

In case of **Term Loan**, which is repayable within a maximum period of 5 years, if any installment is not repaid within the specified period and if the time-equivalent of such unadjusted balance is 6 months it is classified **Sub-standard**. Term loan is classified **Doubtful** and **Loss** if the time-equivalent of unadjusted balance is 12 months and 18 months respectively.

In case of a **Term Loan**, which is repayable within a period of more than 5 years, if any installment is not repaid within the specified period and if the time-equivalent of such unadjusted balance is 12 months it is classified as sub-standard. It is classified **Doubtful** and **Loss** if the time-equivalent of unadjusted balance is 18 months and 24 months respectively.

Agricultural Loan and Micro-Credit is classified **Sub-standard** if non-performing for 12 months, **Doubtful** if non-performing for 36 months and **Loss** if non-performing for more than 60 months.

Under the existing system scheduled banks are required to maintain provisions against unclassified and substandard loans in addition to doubtful and loss loans. They are allowed to book interest against classified loan only on cash basis.

Whether a credit is classified or not under the objective criteria, it is subjected to classification under qualitative judgment if any doubt arises regarding repayment of loan.

Foreign Exchange System

On March 24, 1994 Bangladesh Taka (domestic currency) was declared convertible for current transactions in terms of Article VII of the **IMF** Articles of Agreement. Consequent to this, current external settlements for trade in goods and services and for amortization payments on foreign borrowings can be made through banks authorized to deal in foreign exchange, without prior

central bank authorization. However, because resident owned capital is not freely transferable abroad (Taka is not yet convertible on capital account), some current settlements beyond certain indicative limits are subject to bonafides check.

Direct investments of non-residents in the industrial sector and portfolio investments of non-residents through stock exchanges are repatriable abroad, as also are capital gains and profits/dividends thereon. Investment abroad of resident-owned capital is subject to prior Bangladesh Bank approval, which is allowed only sparingly.

Exchange Rate Policy

Exchange rate policy of Bangladesh Bank aims at maintaining the competitiveness of Bangladeshi products in the international markets, encouraging inflow of wage earners' remittances, maintaining internal price stability, and maintaining a viable external account position. Adjustments in exchange rates are made keeping in view the trends of Real Effective Exchange Rate (**REER**) index based on a trade weighted basket of currencies of major trading partners of Bangladesh and the trends of other important internal and external sector indicators.

The inter bank foreign exchange market sets the exchange rates for customer transactions and interbank transactions based on demand-supply interplay; while the exchange rate for Bangladesh Taka in Bangladesh Bank's transactions with scheduled banks are notified by Bangladesh Bank with the consent of the Government. Bangladesh Bank notifies a trading band (presently Tk.69.50 to Tk. 70.00 per USD) within which it will undertake transactions with banks at rates agreed on a deal to deal basis.

Bank Licensing

Bank Company Act, 1991 empowers BB to issue license to carry out banking business in Bangladesh. Pursuant to section 31 of the Act, before granting license, BB needs to be satisfied that the following conditions are fulfilled

- That the company is or will be in a position to pay its present or future depositors in full as their claims accrue;
- That the affairs of the company are not being or are not likely to be conducted in a manner detrimental to the interest of its present and future depositors;
- That, in the case of a company incorporated outside Bangladesh, the Government or law of the country in which it is incorporated provides the same facilities to banking companies registered in Bangladesh as the Government or law of Bangladesh grants to banking companies incorporated outside Bangladesh and that the company complies with all applicable provisions of Bank Companies Act, 1991

Licenses may be cancelled if the bank fails to comply with above provisions or ceases to carry on banking business in Bangladesh.

Commercial Banks

The commercial banking system dominates Bangladesh's financial sector with limited role of Non Bank Financial Institution and the capital market. Banking sector alone accounts for substantial share of assets of the financial system. The banking system is again dominated by the 4 Nationalized Commercial Banks, which together, as of June 30, 2001 controlled more than 54% of deposits and operated 3612 branches (58% of the total).

Specialized Banks

Out of the 5 specialized banks, two (Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank) were created to meet the credit needs of the agricultural sector while the other two Bangladesh Shilpa Bank (**BSB**) & Bangladesh Shilpa Rin Sangtha (**BSRS**) are for extending term loans to the industrial sector.

Financial Institutions

Twenty-two financial institutions are now operating in Bangladesh. Of these institutions, ten are local and the rest twelve are established under joint venture with foreign participation. Total amount of loan & lease of these institutions are Tk. 13168 million as on 30-06-2000. To enable the financial institutions to mobilize medium and long term resources. Government of Bangladesh (GOB) signed a project loan with IDA and a project known as "Financial Institutions Development Project (FIDP)" has started its operation from February, 2000. Bangladesh Bank is administering the project. The Project has established "Credit, Bridge and Standby Facility (CBSF)" to implement the financing program with a cost of US\$ 57.00 million.

CAPITAL MARKET

Capital market, an important ingredient of the financial system, plays a significant role in the economy of the country.

1. Regulatory Bodies

Securities and Exchange Commission exercises powers under the Securities and Exchange Commission Act 1993. It regulates institutions engaged in capital market activities. On the other hand Bangladesh Bank exercise powers under the Financial Institutions Act 1993 and regulates institutions engaged in financing activities including leasing companies and venture capital companies.

2. Participants in the Capital Market

SEC has issued license to 27 institutions to act in the capital market. Out of them, 19 institutions are Merchant Banker & Portfolio Manager while 7 are only Issue Managers and 1(one) acts as Issue Manager and Underwriter.

Stock Exchanges

There are two stock exchange namely Dhaka Stock Exchange (**DSE**) and Chittagong Stock Exchange (**CSE**) dealing in the secondary capital market. DSE was established as a public Limited Company in April 1954 while CSE in April, 1995. As of 30 June 2000 total number of enlisted securities with DSE and CSE were 239 and 169 respectively. Out of 239 listed securities with the DSE 219 were listed companies, 10 mutual funds and 10 debentures.

Investment Corporation of Bangladesh (ICB)

Investment Corporation of Bangladesh was established in 1976 with the objective of encouraging and broadening the base of industrial investment. ICB underwrites issues of securities, provides substantial bridge financing programmes, and maintains investment accounts, floats and manages closed-

end & open-end mutual funds & closed-end unit funds to ensure supply of securities as well as generate demand for securities. ICB also operates in the DSE and CSE as dealers.

OTHER INSTITUTIONS

Insurance

The insurance Sector is regulated by the Insurance Act 1938 with regulatory oversight provided by the controller of Insurance on authority under the ministry of commerce. General insurance is provided by 21 companies and the life insurance is provided by 6 companies. The industry is dominated by the two large, state-owned companies--SBC for general insurance and JBC for life insurance--which together command most of the total assets of the insurance sector.

Micro Financial Institutions

A rapidly growing segment of Rural Financial Market (RFM) in Bangladesh is the member based institutions. The largest member based institution is the Grameen Bank, the only formal institution of its type. All others are Non-Government Organizations (NGOs), biggest among them are BRAC, ASA and Proshika. Most of these institutions have an explicit social agenda to cater to the needs of the poorest sections of the non-agricultural population, with women making up a majority of their clientele. Up to December 1999 all the reported Micro Finance Non-Government Organizations (MFNGOs) have disbursed Tk. 92,436.20 million and the loan outstanding is Tk. 18,692.17 million. Total active members were 9,433,974. The average recovery rate was approximately 95%. There are 87 MFIs who have outstanding loan of more than Tk. 10 million and 18 MFIs have outstanding loan of more than Tk. 50 million.

FISCAL DEVELOPMENT

The developing countries have the potential to achieve high economic growth through physical and human capital accumulation, technological progress and structural change. Availability of domestic resources is vital for accelerating the rate of physical and human capital accumulation in a developing country. In analyzing the limits and potential for domestic resource mobilization, UNCTAD (2006: 105) rightly points out that limited domestic resources availability is one of the three reasons why the rate of physical and human capital accumulation is inadequate in most of the LDCs. Higher level of domestic resource mobilization can deliver more government expenditure both in consumption and the productive capacity in the public sectors. There is no denying that the domestic resource component in the budget deficit has been increasing during the last one and half decades in Bangladesh.

Revenue Management

The level of government expenditure in the developing countries is often limited because of their low level of taxation arising from narrow access to resource rents. In general, government revenues are very low in most LDCs due to the structural constraint facing these economies. During the 1990s, the Bangladesh economy has suffered a serious structural constraint in the domestic resources mobilization efforts. Though the share of revenue (tax, non-tax and grants together) in GDP increased from 10.3 percent in FY91 to 11.2 percent in FY06, one can observe that the revenue/GDP ratio remained virtually stagnant between FY93 and FY97 as depicted in Figure 1.27 Then the revenue/GDP ratio started to decrease until FY00 and recovered considerably after that. However, Bangladesh's revenue/GDP ratio is one of the lowest in the developing world due to tax evasion especially in the agricultural and the growing informal sector. Even, the revenue receipts as a share of GDP is lower compared to its South Asian neighbors. For example, the average revenue/GDP ratio during 1991-2005 in Bangladesh was 11.1 percent, which is lower in comparison to that of India (12.1 percent), Pakistan (16.1 percent) and Sri Lanka (18.5 percent).

The tax revenue/GDP ratio is even lower in Bangladesh compared with other developing countries and developed countries. A recent calculation of tax revenue as a share of GDP indicates that it is 18 percent on average in developing countries and 38 percent in developed countries (McKinley, 2005). Although on average annual tax collection in the South Asian Region is quite low compared to other developing regions, the scenario is even worse in Bangladesh compared to its neighbours.²⁸ The average tax revenue-GDP ratio in Bangladesh during 1991- 2005 was recorded at 7.5 percent, whereas the average ratio for India, Pakistan and Sri Lanka was 9.1 percent, 12.2 percent, 16.2 percent respectively.

Total budgetary revenue in Bangladesh is mainly divided into three major parts, namely tax revenue, non tax revenue and grants from abroad. Historically, in Bangladesh, taxes contribute around 80 percent of total revenue collection in a given year. Major portions of the tax revenue are collected by National Board of Revenue (NBR), about 95 percent, and the rest is non-NBR portion.²⁹ three major items, namely VAT, customs duty and income tax dominate the tax revenue.

According to the latest available data for the period of July-June FY06, NBR registered a significant 13.7 percent growth over the corresponding period of FY05, where income tax registered 28.3 percent growth. Among other major components of NBR tax revenue, VAT registered a considerable 19.1 percent growth during this period, whereas a marginal negative growth ((-) 1.1 percent) of import duties has been observed during the same period. On the other hand, according to the Budget FY07, non-NBR tax revenue registered a growth of 15.7 percent during the July-June FY06, while non-tax revenue posted a significant growth of 16.6 percent during the same period.



(a) VAT

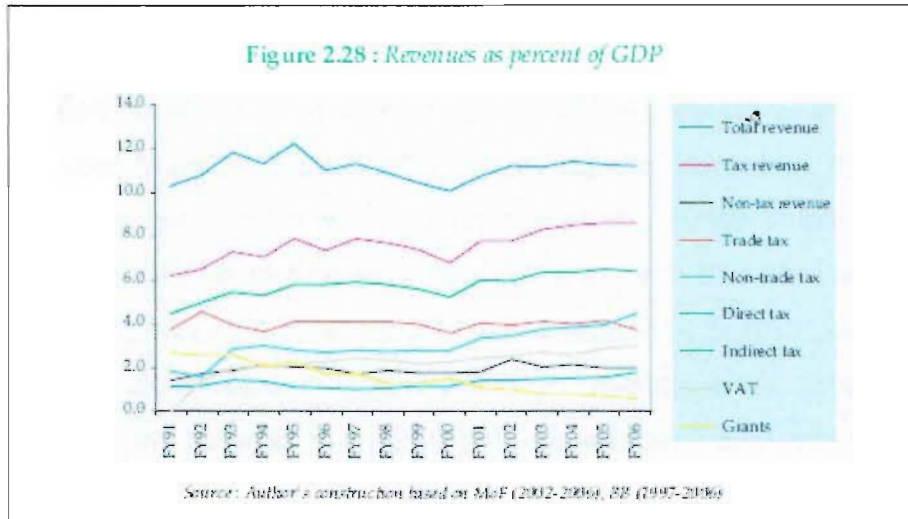
The success of the early 1990s in revenue growth was triggered by the introduction of Value Added Tax (VAT), expanding the tax base and increasing of the tax rates. VAT provided a bigger source of revenue compared to the taxes it replaced, mainly in respect of taxation of domestic production. Currently VAT contributes one-third of total tax revenue collection of the country and the share of VAT in GDP increased from 1.4 percent in FY92 to 3.0 percent in FY06, as depicted in Figure 2.28 the fall of VAT collection in the second half of 1990s was largely predicated by the devastating floods of 1998. Some recovery was, however, observed in FY01, when the total revenue collection recorded 10.7 per cent of GDP and reached its peak during the last one and half decades in FY04, when total revenue was 11.4 percent as a percent of GDP. This was possible due to some progress in meeting the revenue collection targets facilitated by on-going reforms initiated by NBR.

(b) Tax and non-tax revenues

It is observed that tax revenue as a percentage of GDP increased considerably from 6.2 percent in FY91 to 8.6 percent in FY06, whereas non-tax revenue as a percentage of GDP increased from 1.4 percent in FY91 to 2.1 percent in FY06.

Although both the components of total revenue receipts increased in terms of a percentage of GDP, their relative share in the total revenue receipts remained virtually the same, even declining a little, during the last one and half decades.

However, on average, the share of non-tax revenue in total revenue receipts increased slightly from 19.4 percent during 1991-95 to 20.1 percent during 2001-06.



(c) Trade and non-trade taxes

Tax revenue, the share of trade tax revenue in GDP remained stagnant at around 4 percent during FY91-FY06, whereas the non-trade taxes increased significantly from 1.84 percent in FY91 to 4.46 percent in FY06. This suggests that the non trade tax revenue increased its share from one third of total tax revenues to almost half of that just within one and half decades, mainly due to considerable success in VAT collection.

(d) Direct and indirect taxes 30

Although the share of both the direct tax and indirect tax revenue as a percent of GDP increased, their share in the total tax revenue remained stagnant, around 20 percent and 80 percent respectively, since the beginning of 1990s.

(e) Grants

Grants contributed significantly in reducing budget deficit during the first half of 1990s, when on average, grants recorded 2.5 percent share of GDP. However, a declining trend in grants/GDP ratio has been observed since FY96, and the share of grants in GDP remained below 2 percent during the later half of 1990s. The decline in disbursement of grants continued during the first 6 years of the new decade, when the share of grants was 0.8 percent of GDP.

Public Expenditures

In general, government final consumption expenditure in developing countries is equivalent to about 15 to 16 percent of GDP. At around 14 percent of GDP, public expenditure in Bangladesh is among the lowest in the developing countries and even in the world (Glinskaya et. al., 2005). Public expenditures as a share of GDP experienced a rise in the early 1990s from the benchmark level of 13.6 percent in FY91 and hovered above 14 percent during the mid-1990s. The said share once again started to increase in the second half of the 1990s, recording its peak in FY06 (15.0 percent). It is important to note that in comparison to its neighbors, public expenditure-GDP ratio in Bangladesh remains quite low. For example, in Sri Lanka and Pakistan central government expenditures as a share of GDP (2005) were about 23.5 percent and 18.2 percent respectively, whereas the ratio was 12.3 percent in India. However, in terms of the quality of public expenditure allocation, Bangladesh performed much better compared to these countries.³¹ For example, both interest payments and defense spending as percent of GDP in Bangladesh are lower when compared with India, Pakistan and Sri Lanka, while social expenditures increased over the years in the country (Glinskaya et. al., 2005).

(a) Current Expenditures

Traditionally, current expenditures in Bangladesh are around 6-8 percent of GDP, one of the lowest even in the South Asian region. Current expenditures as a share of GDP experienced a sluggish rise throughout the 1990s. However, it is observed that the average growth of current expenditure was lower during the first half of the 1990s compared to the second half. For instance, current expenditures as a percent of GDP were, on average, 6.7 percent during the FY91-FY95 period; whereas the comparable figure for the next period (FY96-FY00) was 7.2 percent. The said ratio increased to 8.5 percent on average during the first five years of the new decade (FY01-FY05). The latest available data from budget FY07 for the period of July-June FY06 shows that actual current spending was 10.1 percent higher than the corresponding figure of the previous fiscal year. Actual spending up to June FY06 was 97.3 percent of the total FY06 target, which was 101.4 percent during the same period in FY05. A detailed sector-wise share of revenue

expenditure suggests that interest payments have the largest share (21.7 percent), followed by Education (18.6 percent), General Public Services (13.7 percent) and Defense (12.7 percent).

(b) Annual Development Program (ADP)

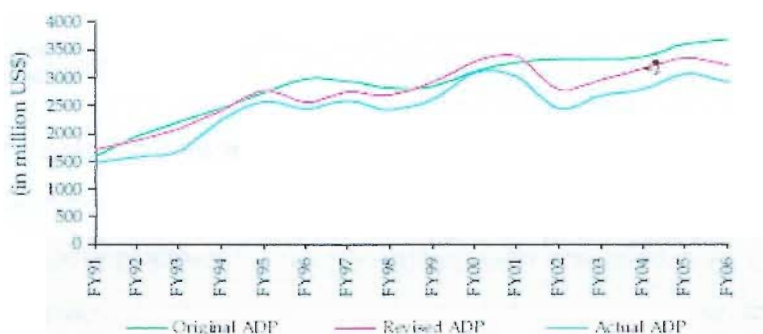
During the 1990s, the records of the Annual Development Program (ADP) do not show any consistency between original, revised and actual outlays. In the first half of the 1990s revised allocations of ADP plunged below the originally budgeted amount except for FY91 and FY95; this trend continued in the first three years of the second half of 1990s as depicted in Figure 2. A tradition of increasing the size of the ADP during its revision has been observed for the three consecutive years since FY99. However, original ADP has been above the revised ADP during the FY02-FY06.

Actual ADP fell short of the original as well as the revised targets during the last one and half decades (see, Figure 2.29) showing weak project implementation.

The actual ADP size has risen steadily during the 1990s with local peaks in year over- year growth recorded in FY94 (34.2 percent), followed by FY00 (18.2 percent). The annual performance (in US\$ terms) took a sharp negative turn in FY02, and reached to the end-millennium level by FY06. However, as a share of GDP, a downward trend was observed in the actual ADP-GDP ratio since the end of 1990s. On average, the figure stood at 5.4 percent for FY91-95 and 5.9 percent for FY96-FY00. During the first six years of the new decade (FY01-FY06) the said ratio continued to decrease and stood at 5.7 percent.

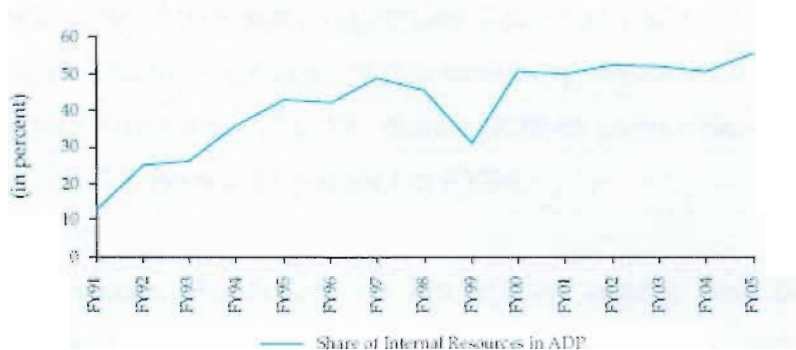
One of the key constructive trends in public expenditure management of Bangladesh throughout the 1990s has been the decrease in the dependence on foreign aid for financing the ADP. The realized share of the domestic contribution in ADP financing increased from about 13 percent in FY91 to more than 50 percent at the end of the decade - with the exception of the flood year FY99 as depicted in Figure 2.30. It needs to be pointed out that the

Figure 2.29 : Original, Revised and Actual ADP (in million US\$)



Source : Author's construction based on MoF (2002-2006).

Figure 2.30 : Share of Internal Resources in Actual ADP (FY91-FY05)



Source : Author's construction based on MoF (2002-2006).

incremental share of domestic financing of the ADP was underwritten only in part by domestic revenue, and by government borrowing from the banking and the non-bank public sources.

Recent data for the period of July-June FY06 indicates that 90.57 percent of the revised ADP allocation was spent, implying some underutilization of the development expenditure. Nevertheless, the actual expenditure during July-June FY06 is 4.0 percentage points higher than the amount spent during the comparable period of FY05 and it constitutes about 5.9 percent of GDP in FY06.

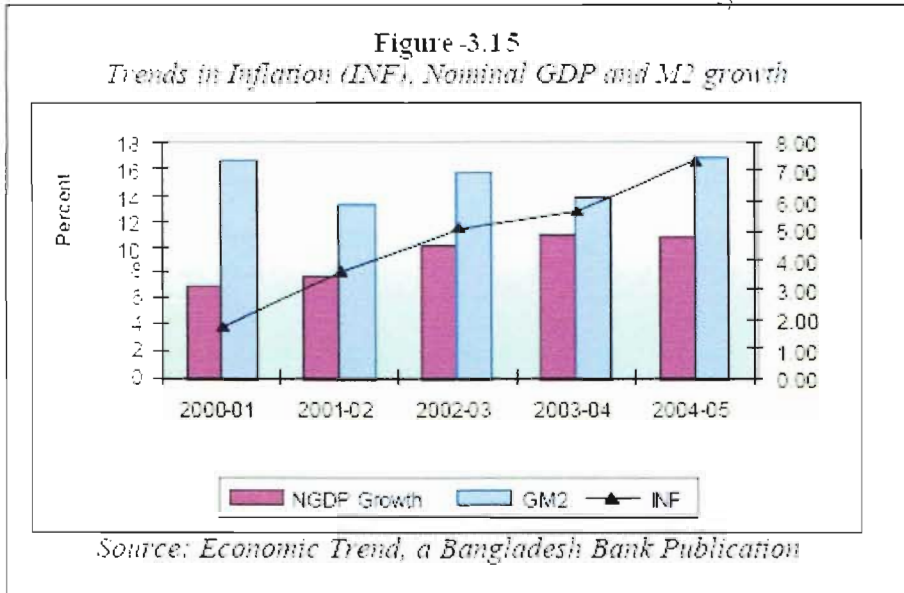
Despite the ADP underutilization in FY06, the size of ADP for FY07 has been set at BDT 260 billion which is 33.5 percent higher than the actual ADP of FY06.

MONEY SUPPLY AND CREDIT MARKET DEVELOPMENT

This section analyzes monetary and credit developments in Bangladesh during the period from FY94 to FY05. In this period Bangladesh Bank pursued cautiously accommodative monetary policy with the objective of raising the rate of economic growth by ensuring adequate credit flow for productive pursuits. The policy stance helped to drive the real GDP growth up to 6.3 percent in FY04 the highest ever record. This is also evident from Fig-3.17 that the growth rate of monetary aggregate (M2) was higher than the growth of nominal GDP. The very success of this monetary stance also contributed to rising inflationary pressures. The 12-month point-to-point inflation went up to 7.35 percent in FY05 from 5.64 percent in FY04.

However, the sources of inflation are not entirely arising from the demand side. The supply side factors, particularly rising food costs and a jump in international oil prices contributed partly to put an upward pressure on inflation during FY05. However, the policy stance changed significantly in September 2004 as it became clear that both inflation and exchange rate pressures were increasing, and consequently the Bangladesh Bank responded promptly by tightening monetary policy.

Bangladesh Bank revised the *cash reserve requirement* (CRR) for the scheduled banks from 4 percent to 4.5 percent of their demand and time liabilities effective March 1, 2005 which was increased further to 5 percent as of October 1, 2005. The yield on treasury bills (e.g., 28-day) was raised from 4.04 percent as of end June '04 to 4.71 percent as of end June '05. The yield on treasury bonds (5-year) also rose from 8.00 percent as of end June '04 to 8.75 percent as of end June '05. To mop up excess liquidity in the money market, repo and reverse repo rates were also raised gradually. The reverse repo rates increased from 2.50 percent as of end June '04 to 4.50 percent as of end June '05.

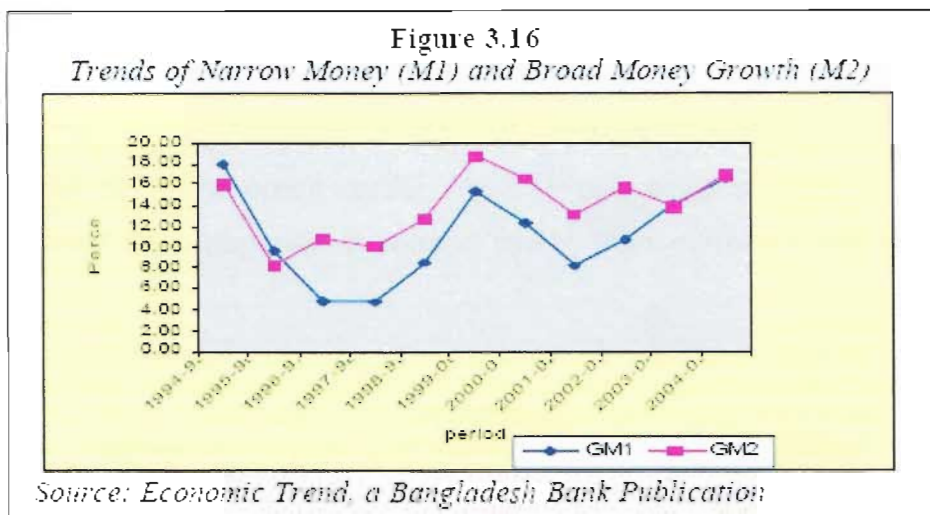


In the Medium-term Macroeconomic Framework (MTMF) the projection⁴⁶ for real GDP growth during the period of FY06, FY07 and FY08 are set at 6.0 percent, 6.0 percent and 6.5 percent, respectively, where the projection for 12-month average inflation are 7.5 percent, 6.0 percent and 5.0 percent, respectively. It will be challenging for monetary authority to pursue a policy regime to facilitate the growth momentum in one hand and to bring down inflation to the level projected in the MTMF.

Broad Money (M2)

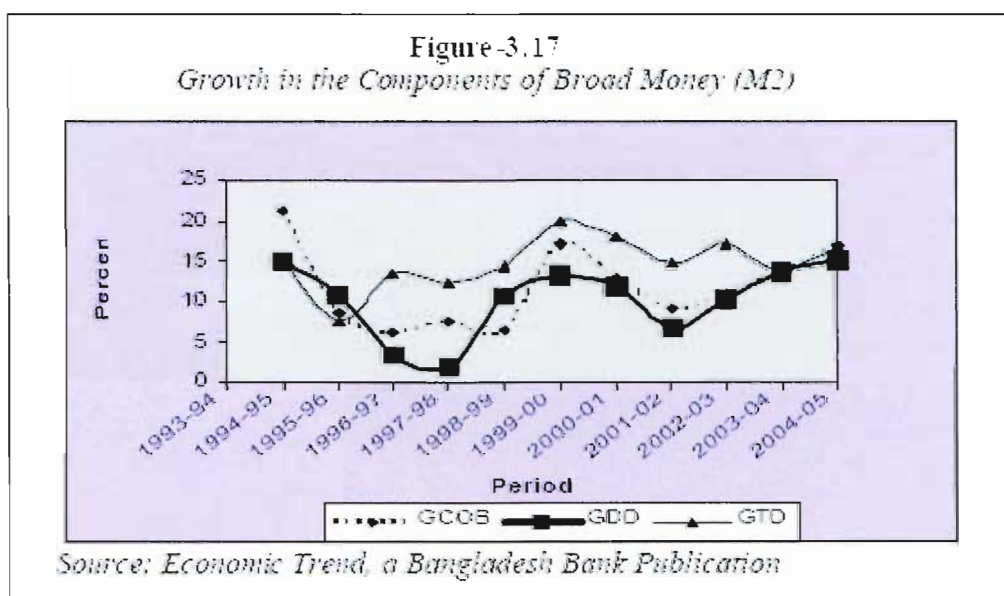
Figure-3.16 shows the trends of broad money (M2) and narrow money (M1) during the period from 1993-94 to 2004-05. Initially the growth rate of M2 was lower than M1, but the former started to increase since FY96 and maintained a higher growth than M1 until FY03. During FY05 the growth rate of M2 slowed down resulting from slower growth in time deposits and higher growth in currency demand (Fig-3.17). An analysis of the components of broad money (M2) show that growth rate of time deposits started to increase from FY96 and maintained higher growth than that of currency and demand deposits until 2003-04. During FY05 the growth rate of currency demand was higher than that of demand and time deposits reflecting higher demand for

holding currency in the face of higher inflationary expectations. The growth rate of currency outside banks contributed to growth in M1 from 14.05 percent in FY04 to 16.54 percent in FY05 and M2 from 13.84 percent in FY04 to 16.7 percent in FY05 respectively.



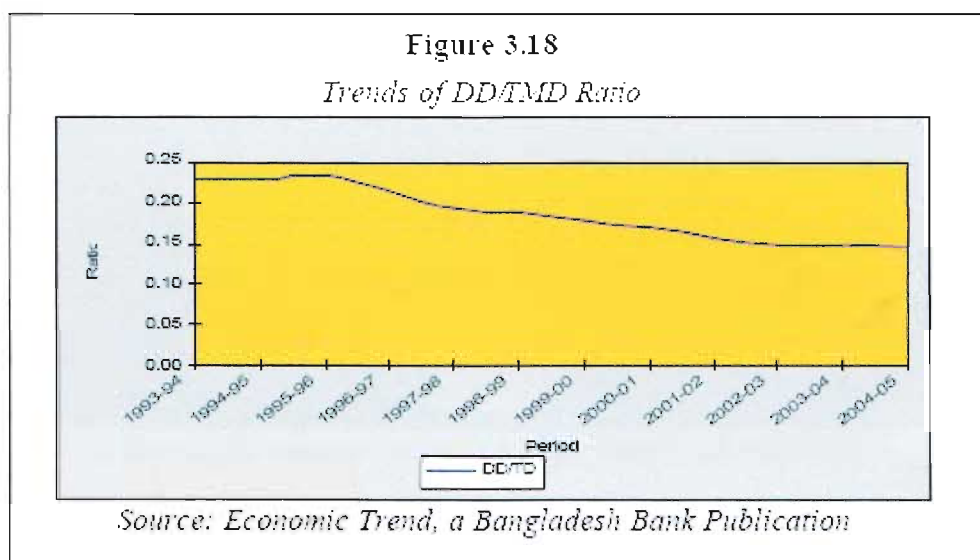
Demand to Time Deposits Ratio (DD/TMD)

An analysis of the trend in demand and time deposits shows (Fig.3.18) that the ratio (DD/TMD) started to decline from 0.23 in FY96, and gradually declined to 0.16 in FY05. The higher growth in time deposits (TMD) partly reflects the higher opportunity cost of holding money due to attractive returns on different term deposits during this period, though the deposit had declined toward the end of FY04. This decline was intended to decrease the cost of borrowing and thus to stimulate the economy.



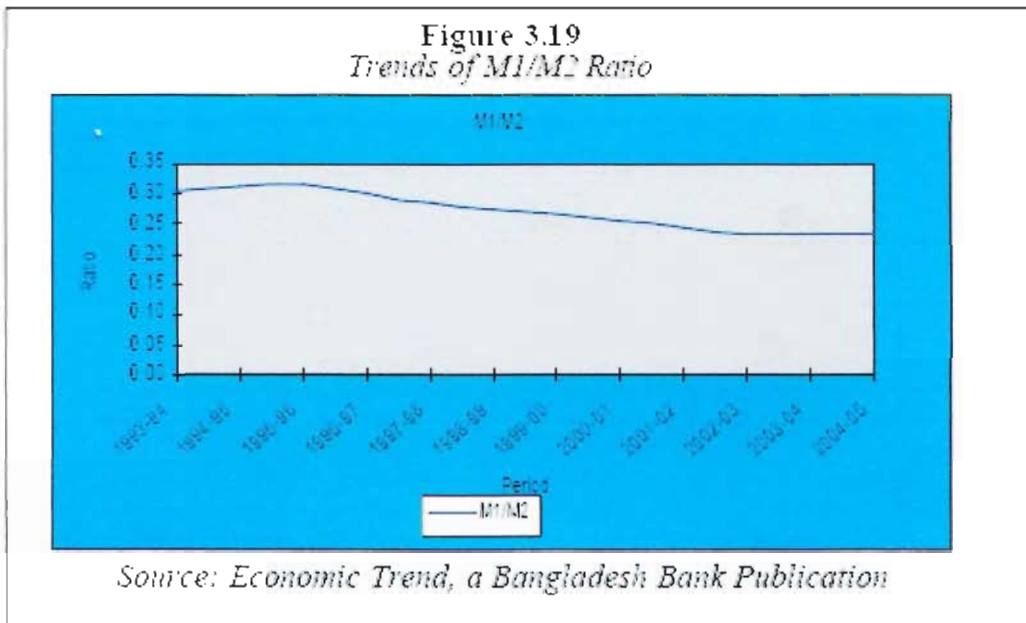
M1 to M2 Ratio

The liquidity preference of the economy, as measured by M1 to M2 ratio (Fig-3.19), which was on a slight upward trend during FY94 to FY97, but started to decline secularly since FY96, and stood at 0.23 in FY05 vis-à-vis 0.31 in FY93. The reason for decrease in M1/M2 ratio would be due to a decrease in the demand for holding currency or demand deposits (say due to innovations such as ATM, debit and credit cards). Fig-3.18 also suggests that during the identical period time deposits increased faster than currency and demand deposits.



Currency-Deposit Ratio (C/D)

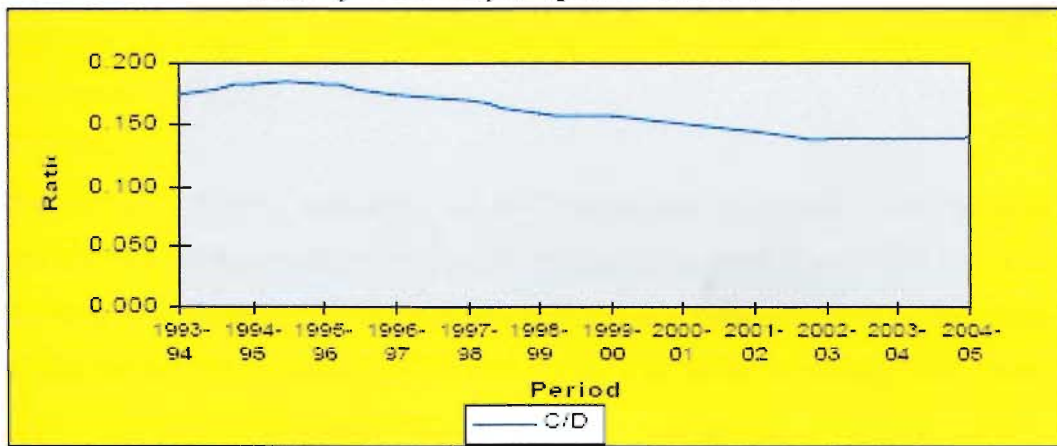
A striking development evident over the last few years is the gradual decrease in the currency to deposit ratio, which suggests an increased intermediation through the banking system. The decline in the (C/D) (Fig-3.20) ratio reflects the lower currency demand since FY95, largely due to increased financial innovations cited above.



M2 to GDP Ratio

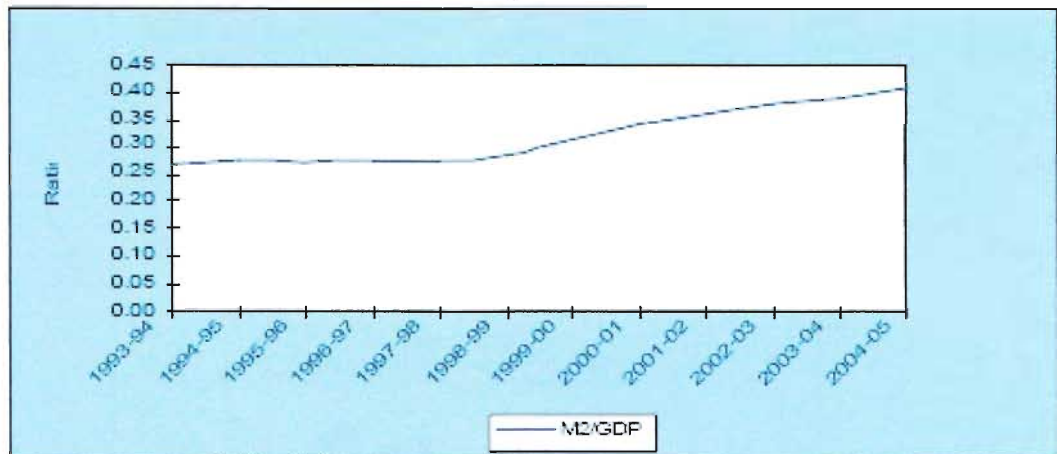
A welcome development recorded during the last few years is the secular rise in M2 to GDP ratio (Fig-3.21). The higher monetary expansion during this period was principally driven by the acceleration in net domestic assets (NDA) coupled with low inflation. This pattern also reflects higher monetization of the economy amid increasing financial sector intermediation of economic activities.

Figure 3.20
Trends of Currency/Deposits Ratio (C/D)



Source: *Economic Trend, a Bangladesh Bank Publication*

Figure 3.21
Trends of M2/GDP



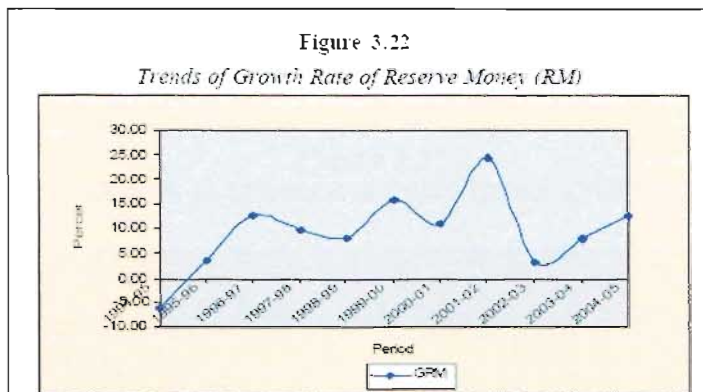
Source: *Economic Trend, a Bangladesh Bank Publication*

Reserve Money (RM)

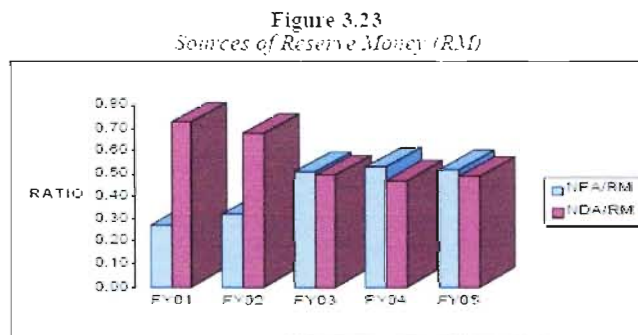
An analysis of the trend of reserve money (RM) growth show that RM started to increase from FY96 at an annual rate of less than 5 percent reaching close to 25 percent growth in FY02. However it dramatically fell to the 3-percent range in FY03 before attempting another run-up. The high figure of a few years ago was due mainly to growth in net foreign assets (NFA) and, to an extent, in net domestic assets as well (NDA). The FY03 drop in RM was led by an equally dramatic decrease in NDA (from Tk.159.43 billion in FY02 to Tk.120.01 billion in FY03) and increase in net foreign assets (from Tk.75.90 billion in FY02 to Tk. 123.12 billion in FY03). This behaviour may have been triggered in part by the impending floating of the national currency in the fourth quarter of FY03.

Bank Credit

The movements of total deposits (TD) and advances (ADVAN) of the banking system show a similar pattern (Fig.3.24) during the period from FY94 to FY05 except for a few deviations. The growth rate of total deposits was higher than advances during the period of FY00 and FY03, indicating significant monetary stimulus in those years of low inflation.

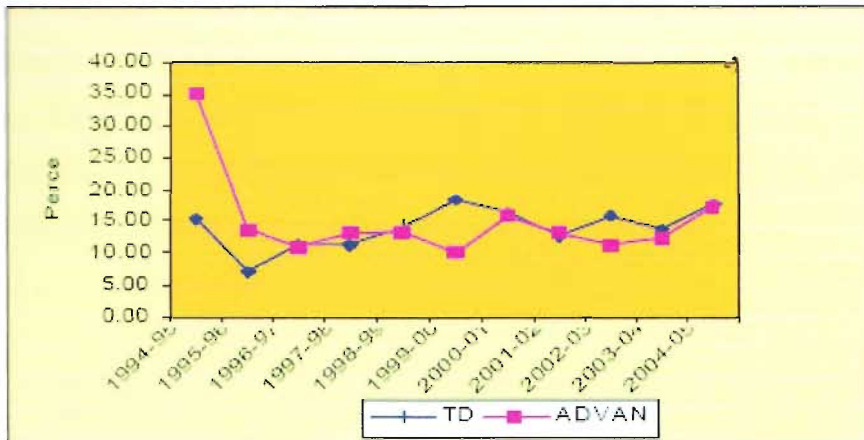


Source: *Economic Trend, a Bangladesh Bank Publication*



Source: *Economic Trend, a Bangladesh Bank Publication*

Figure 3.24
Movements of Total Bank Deposits and Advances

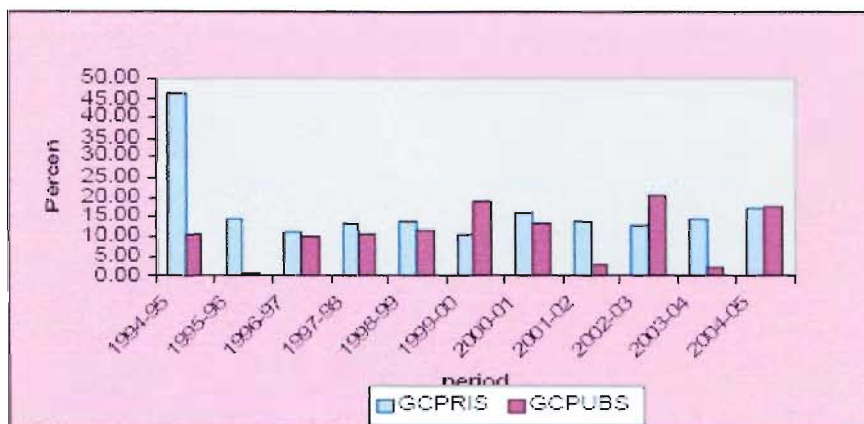


Source: Economic Trend, a Bangladesh Bank Publication

Credit to the Public and Private Sector

An analysis of the trends of the credit to the public and private sector by Deposit Money Banks (DMBs) during the period from FY95 to FY05 shows that credit to the private sector was higher (Fig-3.25) than that of credit to the public sector during FY01, FY03 and FY05 reflecting the accelerated pace of economic activities in selective years. This may be attributed to the decline in the real lending rate resulting from moderate downward trend in nominal lending rates together with upward trend in inflation.

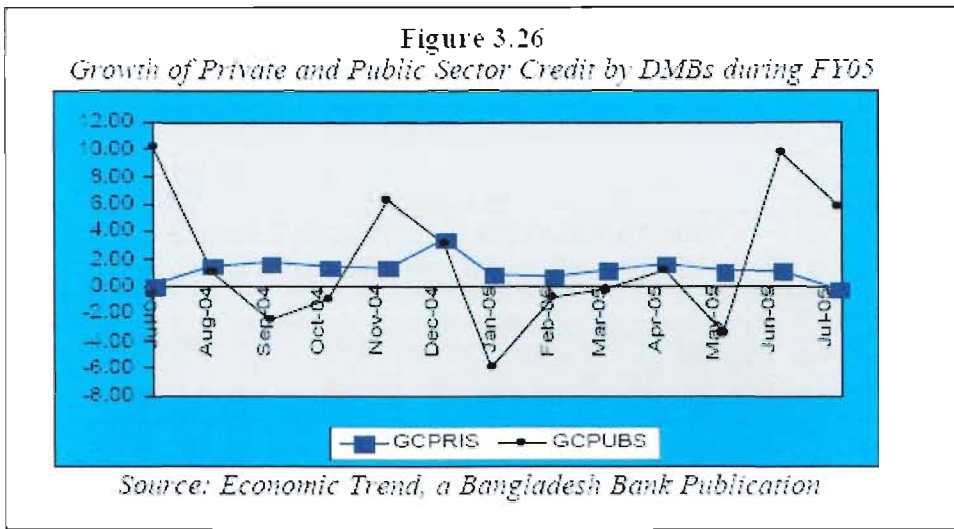
Figure 3.25
Trends of Growth in Private and Public Sector Credit by (DMBs)



Source: Economic Trend, a Bangladesh Bank Publication

Total Credit Growth to the Government by the Banking System

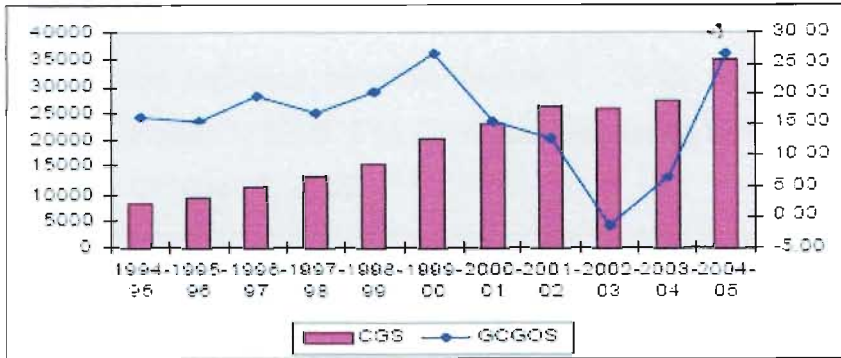
Total credit growth to the government sector during FY95 to FY02 was over 10 percent; it slipped down to the negative territory in FY03 before starting to recover. By FY05 it shot up to over 25 percent (Fig-3.27). Figure-3.28 illustrates the month to month fluctuations over FY05, which mostly reflect the seasonality in government spending.



Bank Deposits

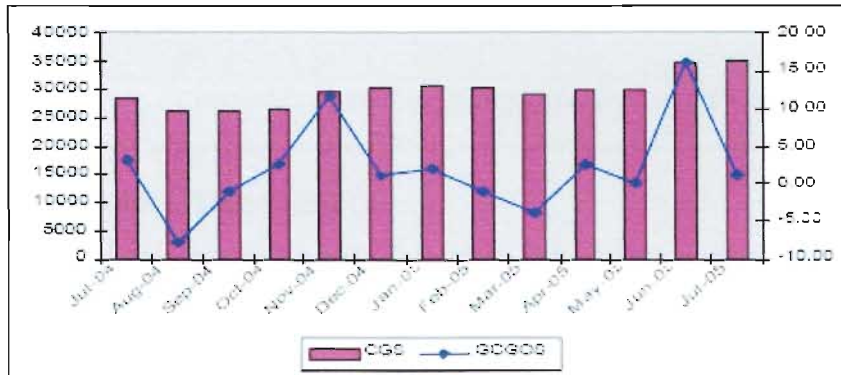
An analysis of bank deposits show that the relatively slower growth rate of deposits can be attributed to increased consumption and investment expenditure reflecting higher level of economic activity and lower real interest rate. On the other hand, downward revision of deposit rate may have some effect on the lower growth rate of time deposit.

Figure 3.27
Total Credit to the Government by Banking System



Source: Economic Trend, a Bangladesh Bank Publication

Figure 3.28
Growth Rate of Total Credit to Government Sector by the Banking System during FY05



Source: Economic Trend, a Bangladesh Bank Publication

Table 3.2 contains weighted average interest rates of scheduled banks on deposits and advances along with the spread during FY01 to FY05. It is evident from the table that the weighted average interest rates on deposits and advances were declining over the years with a view to stimulating investment and economic growth. The nominal spread between advances and deposit rates remained mostly within the range of 6.4 to 6.7 during the period from FY01 to FY03 before declining to 5.3 in FY05. The low real interest rate (even negative in some cases) on deposits is indicative of the absence of competitive pressures in the commercial banking system. The relatively high magnitude of the interest rate spread has been a topic of much discussion of late. Recently, a study by Roe and Peachey (2005) has examined this issue in detail and a brief review is given below in Box 3.2.

Cash Reserve Requirement (CRR)

The Cash Reserve Requirement (CRR) for the scheduled banks with the Bangladesh Bank has been revised upward to 4.5 percent of their total demand and time liabilities effective March 1, 2005, which had been 4.0 percent since October 1, 1999. The CRR was increased further to 5 percent in with effect from October 1, 2005.

Table 3.2
Weighted Average Lending and Deposits Rates (in percent)

Period	Nomina Lending Rate	Nominal Deposit Rate	Spread	Inflation (12 month AVG.)	Real Lending Rate	Real Deposi Rate
2000-01	13.75	7.03	6.72	1.94	11.81	5.09
2001-02	13.16	6.74	6.42	2.79	10.37	3.95
2002-03	12.78	6.29	6.49	4.38	8.4	1.91
2003-04	11.01	5.65	5.36	5.83	5.18	-0.18
2004-05	10.92	5.64	5.28	6.49	4.43	-0.85

Source: Economic Trend, a Bangladesh Bank Publication

Statutory Liquidity Ratio (SLR)

The Statutory Liquidity Ratio (SLR) for the scheduled banks, excepting banks operating under the Islamic Shariah and the specialized banks, was raised from 16 percent of their demand and time liabilities excluding inter bank items to 18.0 percent in October 2005. The SLR for the Islamic banks remained unchanged at 10.0 percent. The specialized banks continued to remain exempt from maintaining the SLR. Given the persistence of excess liquidity in the banking system, the issue, among other, of the appropriate level of SLR for the Islamic banking sector (vis-à-vis other DMBs) as well as for the entire sector warrants further consideration.

Bank Rate

The bank rate remained unchanged at 5.0 percent in FY05. This rate has been in effect since November 06, 2003.



THE FOREIGN EXCHANGE MARKET

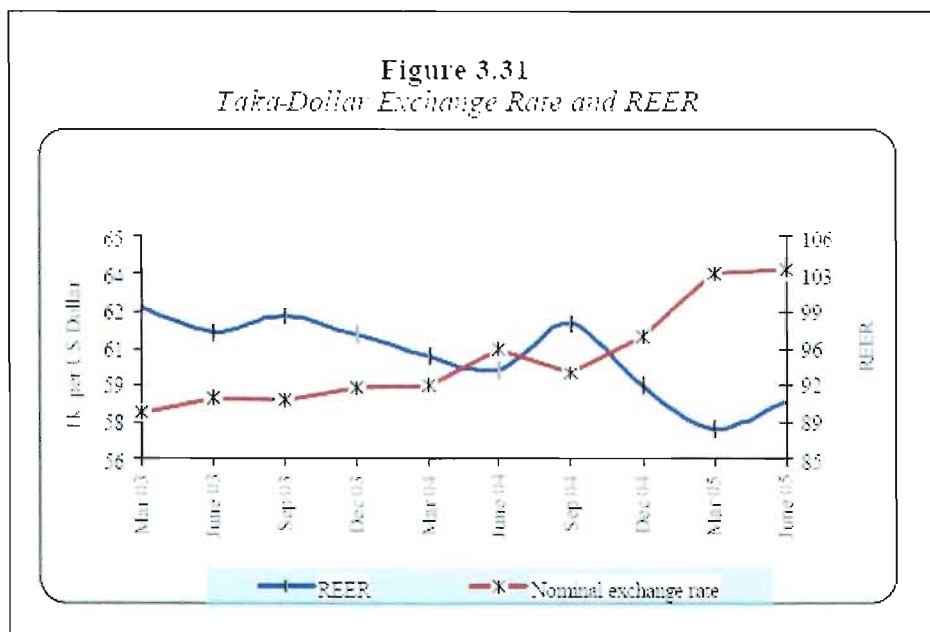
(a) Exchange Rate Regimes in Bangladesh

Within the nominal anchor approach, there are broadly two strategies for monetary policy in developing countries – exchange rate pegging and monetary targeting. Bangladesh followed a fixed exchange rate regime for most of the 1970s, and switched to a pegged exchange rate system in 1979. It was part of structural adjustment programs that aimed at achieving and sustaining macroeconomic stability for rapid economic growth. As the fixed or pegged exchange rate arrangement was not associated with disciplined fiscal and monetary policy, there was limited credibility in the peg. Until early 2003, Bangladesh followed an exchange rate policy of occasionally adjusting the rate with an eye on maintaining export competitiveness, mainly with reference to the trend of Real Effective Exchange Rate (REER) Index based on a trade weighted basket of currencies acting as a sort of benchmark. A market based floating exchange rate system has been introduced in Bangladesh from May 31, 2003. This has been expected to bring about adjustments of the exchange rate to changing market conditions. In view of embracing the market-based exchange rate system, Bangladesh entered into a floating exchange rate regime effective from May 31, 2003. Before the flotation of currency, BB used to administratively prescribe a preannounce rate band within which the purchase or sale of USD could take place between the authorized dealer banks and BB. Main objective of the flotation of currency was to let the market forces determine the par value of Taka. After the flotation, therefore, the BB no longer uses any preannounce rate for transactions with banks with the exception of occasional intervention by purchasing or selling foreign exchange to maintain orderly adjustment in the exchange rates. With a view to indirectly influencing the market exchange rate of Taka in the floating regime, in addition to the occasional intervention in the foreign exchange market, BB employs tightening or loosening in the money market through the auctions of Tbills, repos and reverse repos. Despite some concern, the transition to a floating rate regime turned out to be exceptionally smooth in Bangladesh compared to experiences elsewhere. As the main objective of the flotation of currency is to let the market forces to

determine the par value of Taka , respect some fluctuations and adjustments in the exchange rate is acceptable and usually influenced by the market fundamentals. With the flotation of the exchange rate, the monetary authorities have been more active in using market based instruments to manage liquidity and maintain short-term interest rates at levels appropriate for exchange rate stability. The monetary policy framework as described above, and incorporated in *the Monetary Policy Statement of the Bangladesh Bank*, further explains the precise role and modalities of the conduct of monetary policy in the country.

(b) The Inter-bank Foreign Exchange Market

In recent months, the foreign exchange market in Bangladesh witnessed some pressure on the Taka-Dollar exchange rate resulting from a relatively faster growth in the import bills than that of combined export earnings and workers' remittance flows. The weighted average Taka- Dollar exchange rate increased to Tk.63.75 at end June 2005 from Tk. 63.31 at end March 2005. This rate stood at Tk. 60.45 per USD at the end of June 2004 thus reflecting about 5 percent depreciation of Taka against US Dollar exchange market during the FY05.



During the fourth quarter of FY05 the real effective exchange rate (REER) also showed a depreciating trend; it declined to 90.34 at the end of June 2005

from 91.95 at the end of December 2004. As all authorized dealer banks were instructed not to undertake any non-real cross currency forward and swap transaction and because of the restriction imposed on building up of forward sales, inter-bank foreign exchange transaction volume in FY05 stood at USD 19.9 billion, which is 64.7 percent lower than the USD 56.4 billion of FY04. The Figure-3.31 exhibits very recent movements in Taka-Dollar exchange rate and REER index.

Since the flotation of the Taka the Bangladesh Bank has been active in maintaining orderliness of the changes in the market exchange rate by purchases at times of surplus and net sales at times of scarcity of liquidity in the inter-bank foreign exchange market. But even the necessary fluctuations need not be destabilizing. Because of relatively faster growth in import payments than export receipts, the net demand for foreign exchange was strong during the second half of FY05 generating pressure on the Taka-Dollar exchange rates. With a view to mitigating the mismatch between the supply and demand for foreign exchange, the Bangladesh Bank intervened by selling a sizeable amount of foreign currency in the foreign exchange market. The BB sold about USD 459.5 million as against the purchase of only USD 70.1 million in FY05. Earlier there were substantial net purchases of foreign currency in FY03 and FY04.

TOOLS OF BANGLADESH BANK

Control of Money Supply

BB, like all other central banks uses its power to alter the money supply growth for the purpose of overall monetary management of the country. Bangladesh attempts to alter money supply growth generally through the following traditional tools:

- **Bank rate**
- **Reserve requirement and**
- **Open market operation**

These general instruments at the disposal of the Bangladesh Bank remained more or less unchanged throughout the period from 1973 – 74 to 1989-90. However, various selective instruments like directed credit programmes and credit to priority sectors like agriculture, export, food were also used in the monetary management of the country.

Bank Rate

Bank rate is defined as the lending rate of the central bank to commercial banks. By raising or lowering the bank rate, Bangladesh Bank changes the cost of money for banks and therewith the incentive to borrow. At high bank rate, borrowing from the central bank is expensive and vice-versa. After the liberation of Bangladesh increased emphasis was placed on priority sector lending and concessional lending and as such the bank rate lost much of its significance. The bank rate was changed only one time during 1973-74 to 1979-80 while it was changed five times during 1980-81 to 1989-90 and thirteen times during 1990-91 to 1996-97. It may be noted that bank rate is also the borrowing rate of the government from the central bank, for this reason bank rate remained more or less static before the introduction of the Financial Sector Reform Programme in January 1990. It may be noted here that the predominance of directed lending programme and use of huge

Thus a change in reserve requirement causes:

- A change in excess reserves
- A change in the money multiplier.

From the foregoing analysis, it emerges that the lending capacity of the banking system changes with the change in their reserve requirements. It may be noted that after the liberation of Bangladesh, cash reserve ratio and statutory liquidity ratio of scheduled banks remained unchanged at 5% and 25% respectively of their total liabilities till FY 1986-87 despite significant inflationary pressure in the economy during the 70's. Cash reserve requirements and statutory liquidity requirements of banks were enhanced from 5% and 20% to 10% and 25% with affect from October 29, 1987 in order to reduce excess liquidity of banks and at the same time thwart the possible threat to price stability in awake of inflationary expectation in the economy. These ratios were again reduced to 8% and 23% respectively with affect from the 25th April 1991 in order to increase the loan able funds of the banking system. These rate were again reduced to 5% and 20% respectively during FY 1991-92% which remained unchanged II May, 1998) It should be noted here that Bangladesh Bank introduced 91 day Bangladesh Bank Bill with affect from the 23rd December, 1990 as a part of indirect monetary management.



OPEN MARKET OPERATION

Reserve requirements and Bank Rate are important tools of monetary policy for changes in money supply. But Open Market Operations are the principal mechanism for directly altering the reserves of the Banking system. Since reserves are the lifeblood of the banking system, Open Market Operations have immediate impact on bank reserves and money supply.

We know that people hold idle funds. They decide whether they will place their funds in transaction accounts or cash or to purchase securities. In the process of buying/ selling of securities by the Central Bank, the reserve position and ultimately money supply of the banking system tends to change. When the Central Bank buys bonds from the public, it increases the flow of deposits to the banking system. Bond sales by the Central Bank reduce the flow. In other words, Open Market Operations entail the purchase and sale of government securities for the purpose of altering the flow of reserves into and out of the banking system.

Open market Operation as a principal instrument of monetary management did not gain momentum in Bangladesh due to non-existence of Secondary market for government securities. The switch over from direct instruments of monetary management to indirect monetary management only started with the introduction of 91- day Bangladesh Bank Bill since December 1990. Since then the Bill is being issued regularly through fortnightly auctions at market related yields. Besides, 30-day Bangladesh Bank Bills are also being issued through November however the auctions of Bangladesh Bank bill has been discontinued from March 1997 in view of liquidity shortage in the banking system.

The huge expansion of banking network and increased flow of credit to the priority sectors during the 1970's and early 80's led to misallocation of resources and pile up of huge bad debts in the banking system. As per recommendation of National commission on Money, Banking and Credit and

the World Bank, the government initiated the Financial Sector Reform programme in 1990. The main objectives of the reforms programme included :

- Remove distortions in the interest rate structure
- Promote better monetary management moving towards indirect and flexible instruments of monetary control
- Establish appropriate and uniform accounting policies including classification of loan portfolio, provisioning against loan losses and capitalization
- Strengthen the legal framework for debt recovery and revision of regulation affecting bank and
- Improve the capital markets of the country.

The ultimate aim of FSRP was to move gradually towards a market oriented competitive economy through a larger role of the private sector.

The major areas of progress under the FSRP with respect to monetary management are outlined below:

➤ **Interest Rate Liberalization**

Since introduction of the FSRP in 1990, substantial progress has been achieved in the liberalization of interest rates and making them more market oriented. Banks were initially allowed to fix their own rates within the prescribed band once in a calendar month. Banks were also allowed to classify borrowers into low, average and high risk groups and charge three rates of interest subject to a maximum difference of 2 percentage points between the low and high risk groups. Subsequently, interest rate bands for all lending categories except 3 priority sectors viz agriculture (10-14%) exports (8-10%) and small scale and cottage industries (9-12%) were abolished with effect from 1st April, 1992, Banks were allowed to charge two different rates of interest on term lending to medium and large scale industries with effect from July 26, 1992. The number of sectors enjoying interest rate

subsidies and the rates of subsidies has also been reduced substantially. With effect from 31st august 1992 subsidy is admissible at the rate of 3% only in case of term lending to the small scale and cottage industries sector.

Interest rate bands on deposits were abolished from April 1992. However, to ensure a positive return to the savers especially the small ones floor rates have been prescribed for savings and fixed deposits. It may be noted that these floor rates were revised a number of times during the last six years in order to reduce the cost of funds for the banks while protecting the interest of the depositors. The floor rates of 6.50 percent for savings deposits and 6.75 percent for fixed deposits, which came into effect from October 31, 1996, have also been abolished from early 1997 (19-2-97).

➤ **Bank Rate**

The bank Rate (Discount Rate) at which the central Bank Lends money to the commercial banks and which is used as the reference rate for adjustment of deposit and lending rates of the banks was adjusted on a number of occasions during 1990-96 In order to accelerate the pace of economic activities by channeling increased flow of credit to the productive sectors at reasonable rates of interest, the Bank rate was gradually lowered from 9.75 percent in January 1990 to 5.5 percent on March 3,1994 Thereafter, the rate has been revised upward gradually to 6.5 percent with effect from February 1,1996 and to 7.0 percent with effect from 31st October, 1996. The Bank rate has been revised upward subsequently and it now stands at 8 percent w.e.f 24-11-97.

➤ **Rediscounting Policy**

In order to eliminate discrimination in respect of access to central bank resources, the liberal refinance facilities of Bangladesh Bank at various concessional rates for different sectors except for the agriculture credit

of BKB and RAKUB were discontinued with effect from 1st January, 1990. A rediscount system was introduced in its place from that date. With effect from 1st July, 1991 refinancing of agricultural credit by BKB and RAKUB are made at the Bank Rate while refinancing of BRDB's agricultural credit by the nationalized commercial banks is made at the current interest rate. In place of refinance facility a single rediscounting window has been opened for all lending to scheduled banks by the Central Bank.

➤ **Capital Adequacy Requirement : Recapitalization of Banks**

In order to meet the short fall in bad debt provisions that appeared in the 1989 annual accounts of the nationalized banks and also to enable these banks to raise their capital up to 5% of their total deposits, the Government had initially provided the nationalized commercial banks with special long term bonds worth Tk. 1500 crores. To meet the short fall in required capital and provisioning, the Government again issued Special Treasury Bonds worth Tk. 1500 crores in favor of the NCBs in June, 1993. of these Tk. 1000 crores worth of bonds was paid for in cash in November, 1993 and for the remaining Tk. 500 crores long-term bonds with 15 years maturity and bearing interest at 5% per annum were issued, In order to help the NCBs meet their short fall in bad debt provision improve their capital adequacy as also to make up the losses incurred by BKB, RAKUB and other nationalized commercial banks because of loan forgiveness the Govt. has so far issued total of Tk. 4550.40 crores worth of bonds and paid Tk. 1185.00 crores in cash. It may be noted that all other banks have been instructed to make arrangements for adequate provisions against the possible loan losses and raise capital to the required level. Subsequently capital requirements for the banks were raised to 6% of their total deposit liabilities. At present, instead of basing capital adequacy on total liabilities banks have been asked, to preserve 8% as capital on the basis of risk weighted assets.

➤ **Strengthening Bank Supervision: Improving Efficiency**

A large number of supervision personnel have been imparted training on bank supervision to upgrade their skill in supervision and inspection of banks in line with the new system and procedure of loan classification and provisioning and other financial norms introduced under the FSRP. A number of steps has been taken to improve the management and operational efficiency of the commercial banks, Accordingly, a series of measures have been taken which include the introduction of the Lending Risk Analysis (LRA) Loan Classification, Large Loan Reporting System (LLRS), New Loan Ledgers (NLL) Performance Planning System (PPS) and Management Information System (MIS) in commercial banks and Large Loan cell, Credit Information Bureau (BIB) Early Warning System (EBS), CAMEL Rating and problem Bank Unit established in Bangladesh Bank, Besides, Memorandum of Understanding was signed by banks to expedite speedy recovery of stuck up loans. A number of legal reforms have been made to make the relevant laws more effective, accordingly a number of special courts have been set up to try cases of loan default and bankruptcy. Continuous efforts are on to modernize and automate the banking operations. For this purpose training of bank officials both of the central bank and the commercial banks has been accorded special priority. It is expected that the banking arena will witness a wind of favorable change all over after the successful completion of the CBRP in the days ahead.

Most central banks in developing countries attempt to control money supply through various monetary policy measures. In Bangladesh, attempts were made to control money supply through control of reserve money growth. But some elements of monetary policy are not within the control of Bangladesh Bank. Government policy in respect of fiscal deficit has important effect on monetary base, which is virtually out of control of the central bank. On the other hand, accretion to net foreign assets remained outside the control of the central bank. In case of Bangladesh, if we look at money supply growth during

1985-86 to 1989 – 90 and during 1990-1991 to 1996-97 the contention that increase in net credit to government leads to growth in money supply does not seem to be tenable. Similarly, the contention that contraction/expansion in net foreign assets influence money supply growth also does not hold good in case of Bangladesh. Growth in money supply probably occurred due to expansion in net domestic assets and/ or depletion in excess reserves in the banking system.

RECOMMENDATION

Followings are the recommendation of this paper:

- ◆ As banking sector soundness and macroeconomic stability go hand in hand, more efforts are to be made to run the banking system more sound and solvent way.
- ◆ Efforts are to be undertaken to remove distortions in the interest rate structure
- ◆ Steps may be taken to establish appropriate and uniform accounting policies including classification of loan portfolio, provisioning against loan losses and capitalization
- ◆ More concentrated and coordinated efforts from all sectors are required to make the system smooth and efficient.
- ◆ Improving the transparency of the price mechanism. Under price stability people can recognise changes in relative prices (i.e. prices between different goods), without being confused by changes in the overall price level. This allows them to make well-informed consumption and investment decisions and to allocate resources more efficiently;
- ◆ Reducing inflation risk premia in interest rates (i.e. compensation creditors ask for the risks associated with holding nominal assets). This reduces real interest rates and increases incentives to invest;
- ◆ Avoiding unproductive activities to hedge against the negative impact of inflation or deflation;
- ◆ Reducing distortions of inflation or deflation, which can exacerbate the distortionary impact on economic behaviour of tax and social security systems.
- ◆ Preventing an arbitrary redistribution of wealth and income as a result of unexpected inflation or deflation.

CONCLUSION

Economists differed on the issue of monetary management. However there is a broad consensus regarding the objectives of monetary management. Macroeconomic objective of price stability has been broadly recognized as the primary objective of monetary policy. In the recent decade, efforts are being made to improve the efficiency and soundness of the banking system through reform programs. Because efforts to improve financial sector efficiency and soundness are needed to support improved macroeconomic and monetary management. Bangladesh is also not an exception to this awareness of this recent trend. Financial Sector Reform Program was initiated in 1990 to achieve bank soundness and efficiency. The operating procedure of monetary management is also witnessing changes with the start of the reform program. It may be noted that Bangladesh economy depicted more or less stable price situation in the 1990's although persistent rate of growth of inflation and money supply were seen in the previous two decades. National output did not grow as it was expected. However, banking sector soundness and macroeconomic stability go hand in hand. Efforts are underway to make the banking system more sound and solvent.



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