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Challenges of price stability, growth and employment in Bangladesh: Role of the Bangladesh Bank

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Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization*,[1] and which has now been widely adopted by the international community.

The comprehensive and integrated perspective to achieve this goal are embedded in the Employment Policy Convention, 1964 (No. 122), in the Global Employment Agenda (2003) and, in response to the 2008 global economic crisis, in the Global Jobs Pact (2009) and in the Conclusions of the recurrent discussion on Employment (2010).

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Azita Berar Awad
Director
Employment Policy Department

[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

[2] See http://www.ilo.org/employment.

Foreword

This study is inspired by the current debate on whether central banks, especially in the developing world, should pursue a single mandate or dual/multiple mandates. It examines the Bangladesh Bank's (BB) aspiration to adopt a multiple mandates approach. These include, besides the objective of price stability, the promotion of "output, employment and real income". In recent years, the BB has widened its developmental role to play its part in the national strategy of "inclusive growth", and is seeking to model itself as a developmental central bank. According to an ILO content-analysis study of objectives and missions of central banks, Bangladesh is cited among the very few countries where the central bank has an explicit development objective.

This study has shown that Bangladesh has enjoyed a period of relative macroeconomic stability, with inflation around 7 per cent. With respect to price stability, the BB is trying to bring the inflation rate down further through the credit/money channels. The study contends that BB has an "imprecise control" over price stability owing to weak transmission mechanisms. Also, its existing instruments have a limited capacity to address volatile food inflation that weighs heavily in general inflation.

The study contends that the BB has solid reasons to engage in multiple mandates, especially in financial structure development and financial inclusion initiatives. These, apart from serving the national strategy of social inclusion, could potentially lead to strengthening and deepening of the financial sector and, hence, support both price stability and employment creation. While tangible progress is observed, concerning financial structure and financial inclusion, the study discerns a number of limitations and constraints. It then recommends some broad policy initiatives that might circumvent these constraints and enable the BB to strengthen its role as a developmental central bank.

An important feature of this study is that it has relied heavily on stakeholder consultations and benefited from the support received from the Governor's Office of BB. This has enabled the author of the study to provide insights into the policy implementation process of the BB that would otherwise not be possible.

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Abbreviations

BB	Bangladesh Bank
BIBM	Bangladesh Institute of Bank Management
BIDS	Bangladesh Institute of Development Studies
BRAC	Bangladesh Rural Advancement Committee
CARs	Capital Adequacy Ratios
CSR	Corporate Social Responsibility
CPD	Centre for Policy Dialogue
CPI	Consumer Price Index
DFIs	Development Financial Institutions
ECB	European Central Bank
FI	Financial Inclusion
FCBs	Foreign Commercial Banks
ICOR	Incremental Capital Output Ratio
IFIC	International Finance Investment and Commerce Bank Limited
I/GDP	Investment-GDP ratio
ILO	International Labour Organization
IMF	International Monetary Fund
IT	Inflation targeting
MDs	Managing Directors
MDGs	Millennium Development Goals
MFIs	Microfinance Institutions
MFS	Mobile Financial Services
MPD	Monetary Policy Department (Bangladesh Bank)
MPS	Monetary Policy Stance
MRA	Microfinance Regulatory Authority
NAIRU	Non-accelerating Inflation Rate of Unemployment
NBFIs	Non-Bank Financial Institutions

NCCWE	National Coordination Council for Workers Education
NPL	Non-Performing Loan
ODA	Overseas Development Assistance
PCBs	Private Commercial Banks
PKSF	Palli Karma Shahayak Foundation
REER	Real Effective Exchange Rate
RM	Reserve Money
RMG	Ready-made Garments
ROA	Return on assets
ROE	Return on equity (ROE)
SAARC	South Asian Association for Regional Cooperation
SBs	Specialized Banks
SMEs	Small and medium-sized enterprises
SPB	State Bank of Pakistan
SOCBs	State Owned Commercial Banks
WB	World Bank
WDI	World Development Indicators
WEO	World Economic Outlook

1. Introduction

1.1 Towards a monetary policy framework for developing countries

1.1.1 Central banks and macroeconomic objectives

Central banks are undoubtedly critical stakeholders in maintaining macroeconomic stability in an economy, and hence their role in developing a monetary policy stance (MPS) is closely linked to the *objectives* of macroeconomic policies. These objectives themselves have been the subject of intense debate and controversy, and the *practice* of macroeconomic planning has varied over time and across countries. During the unprecedented high-growth era after the Second World War, in Europe and the United States, macroeconomic policy framework was defined by the objectives of both price stability, *and* the goal of full employment.[1] The role of central banks was closely aligned to these objectives, and they were seen as active agents of growth and employment, in addition to their pursuit of price stability functions.[2] However, during the 1970s, especially after the two oil-price shocks of 1973 and 1979 that led to major macroeconomic disorder, there was a regime change in macroeconomic policy-making, where liberal policies inclined towards market forces gained momentum with a primary focus on "getting prices right". Central banks in many countries, whether developed, emerging or developing, started aligning their mandate to this new regime, and employment generation as an objective appeared to get "dropped off the direct agenda of most central banks".[3] For many analysts this would seem curious since most developing countries consider employment and poverty reduction challenges as foremost in their national priorities.

In more recent times, an increasing tendency has evolved among central banks to move towards a more defined and allegedly more accountable framework to address price stability, viz. "inflation targeting". Unlike the former situation, where inflation is addressed through intermediate targets, in the latter, central banks target the "final objective, i.e. inflation".[4] Inflation targeting (IT), which initially came to be introduced largely in the advanced economies of New Zealand, Canada and the United Kingdom, was soon followed in the emerging and developing countries. The International Monetary Fund (IMF), in a recent survey-based study of 88 developing countries, shows that more than half were inclined to adopt an inflation-targeting framework of monetary policy. However, as Hammond (2012) in *State of the art of inflation targeting* points out, there are a number of limitations and constraints, particularly in the setting of targets, and approaches to attaining these.[5] There now exists several country-based and cross-country studies of the performance of IT regimes, many of which are critical of them (Frankel, 2012; Epstein, 2007; also various country studies reported in the latter).[6] A particular problem observed in IT regimes is the stipulation of a strict adherence to a very low inflation. There are frequent "misses" of the targets, as noted by Epstein (2007). But, more significantly, tight monetary controls, together with strict fiscal discipline, have led to a slowdown in growth and employment. So far, in IT, there appears to be a curious coexistence of the desire among developing countries to adopt its broader logic, and the burgeoning evidence of its limitations. While Bernanke (2003) tries to allay fears by arguing that IT should be seen as

[1] See among others, Bruton (1997), Krugman (1999), Pollin (2011).
[2] See Epstein (2007); (2008).
[3] cf. Epstein (2007).
[4] See Mohanty (2010).
[5] In general, IT frameworks would *at least* require that price stability is seen as the explicit goal of monetary policy (i.e. no other anchors); that there is a low quantitative target (point or an inflation range) that is publicly announced; that there is an inflation forecast, and an effective accountability mechanism. cf. Hammond (2012).
[6] Also see Mishra et al. (2010) on the monetary transmission weaknesses of the developing countries.

"a policy framework, not a rule" and that "all inflation targeting is of the flexible variety",[7] there are various studies to suggest that most developing countries do not have an adequately developed framework for its implementation.[8]

1.1.2 Growth-inflation-employment nexus: Key issues in the MPS

Given the evolving emphasis on macroeconomic objectives, and the unsettled global debates surrounding these, it would be natural for central banks in developing countries to reflect on why they should be confined to a single (or overriding) mandate of price stability (IT or otherwise). This is particularly confusing when there are hardly more than a handful of countries facing rampaging inflation. There are, among others, two issues that would tend to shed light on this. First, it is the *inflation-unemployment trade-off*. The rise of neo-liberalism, which shifted macroeconomic policies towards inflation control and getting prices right, was underpinned by the Non-Accelerating Inflation Rate of Unemployment (NAIRU) discourses in the near-full employment economies that had to weigh their individual country's relative costs for choosing between higher inflation or higher unemployment. Such a debate is, however, somewhat tangential in most developing countries, which are a long way off from a full-employment situation, and where a tangible slack in the labour market, as well as in investment, is observed.

Second, there is the debate on *inflation-growth trade-off*, which though related to the above, also has its own dimensions. Strict proponents of price stability in developing countries tend to emphasize its importance because of the dangers of high inflation hurting growth. However, several studies contend that the threshold values at which an inverse relationship is registered vary across countries and over time. For example, during the global boom period of 2002–2007, it was observed that growth and inflation did not necessarily follow an inverse relationship (see Table 1 below), and that the relationship was often tenuous.

Table 1. Median growth and inflation rates (%), 2000–2007

Growth category	Growth median	Inflation median
High growth (40)	7.7	5.8
Medium growth (74)	4.6	5.7
Low growth (31)	1.8	3.0
Full sample (145)	4.7	5.4

Note: Number of countries in sample shown in brackets.
Source: Islam and Anwar (2013).

Keeping inflation low is, and must be, a significant consideration in MPS. However, contentions arise when particular inflation ceilings are proposed and how *quickly* these should be attained; for many countries, multilateral donors indicate low single-digit inflation, while protagonists of IT regimes are even more stringent, often below three per cent.[9] Several studies tend to suggest that growth is usually adversely affected when inflation is much higher than those suggested above; estimates provided by Pollin and Zhu (2006) and Islam and Anwar (2013), suggest an inflation threshold of 15 to 17 per cent beyond which growth would be adversely affected.[10] Both studies also find a non-linear relationship between growth and inflation, suggesting that the GDP growth rate could equally be less than optimal when the rate of inflation is *below* a certain level. Thus, in the current development curves of most developing countries, moderate inflation does not

[7] Bernanke (2003), p.5.
[8] Mishra et al., op.cit.
[9] *cf.* Epstein (2007); Islam and Anwar (2013) op.cit.
[10] Also, see Khan and Senhadji (2001); Muqtada (2010).

appear to be incompatible with growing GDP (as well as a stable exchange rate). A strict sudden contractionary monetary policy, as observed in many countries during the 1980s and 1990s, can lead to significant output crisis.[11] However, it is imperative that a continuous monitoring and analysis of inflation-growth threshold values are conducted at the country-level in order to set realistic targets and the policy instruments defined accordingly.

1.1.3 Implementing the MPS: A key constraint

There are various historical, structural and institutional factors that need to be continuously reviewed at individual country levels, before setting strict inflation targets. While, for central banks, setting inflation targets is a challenge, attaining them is equally daunting. There exists a vast empirical literature that contends central banks, largely in developing countries, have "imprecise control" over inflation. Mishra et al. (2010), Mishra and Montiel (2014), Mohanty (2010), Epstein (2013), Rummel (2012) and many others provide significant insight and evidence on why this is so. In particular, they draw attention to the distinctive differences in the monetary and financial structures of the developed and developing countries, and hence the observed weak monetary transmission mechanisms in the latter. This is also the reason why the short-term policy (bank) rate, which is widely in use in mature economies, cannot, under prevalent constraints, be considered as the dominant channel; the current approaches, which rely mainly on credit/money targeting in developing countries, are, as will be noted subsequently, somewhat eclectic. Thus, there is an urgent need for central banks to review and assess the weaknesses and imprecisions in the transmission mechanisms, undertake steps to strengthen their monetary and regulatory systems and develop and deepen their financial structures. The latter would constitute an *additional* mandate in the MPS central banks.[12]

1.2 Objective and plan of the study

The recent debates on whether an economy, and the central bank as guardian, should pursue *overwhelmingly* the objective of price stability, and whether it should adopt an IT regime, have mostly been driven by conditions faced by the advanced countries. These discussions do not adequately reflect the characteristics and conditions of developing countries. Not much analysis has been done to understand how these may affect the mandates and design of monetary policy frameworks. The present study attempts to shed light on these controversies regarding the role of central banks in developing countries, i.e. whether they should adopt a single mandate confined to price stability, or multiple mandates to pursue equally the goals of growth and employment and whether conflicts or trade-offs exist among these goals (inflation and growth/employment).[13] Given the discussions in the previous section, it appears that central banks in developing countries have a *prima facie* case to be wary of a single mandate approach towards price stability. In fact, pursuing other mandates, such as growth, financial sector development and employment, as many central banks are currently doing, can in turn, through appropriate articulation and coordination, contribute substantially to price and macroeconomic stability.[14] The study focuses on these issues through the particular case of the role of the BB.

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[11] See Easterley (2001); Muqtada (2014)
[12] See Subbarao (2013)
[13] On some of these issues, especially on the varied mandates of central banks across countries, see, for example, Gray (2006), Hammond (2012), Mishra and Montiel (2012), State Bank of Pakistan (SBP) (2014).
[14] *cf.* Muqtada (2010).

Similar to most developing countries, Bangladesh also faces crucial challenges of price stability, growth and employment. The present study reviews the role and mandates of the BB in meeting these challenges. In South Asia, although the central banks generally pursue multiple mandates, there is a growing discussion and contention that these are likely to dilute their focus, and that it is imperative to concentrate on the primary objective of price stability (SBP, 2014). Similarly, there are studies and discussions at the country level on the potential and merits of introducing IT.[15] In a backdrop of growing orthodoxy in monetary policy and intense debates on IT, the study attempts to assess the rationale of the BB's pursuit of multiple mandates; to examine whether there are any trade-offs between them, and how effectively it, given its MPS and the instruments at its disposal, is able to pursue the mandates.

Section 2 of the study briefly examines the nature and extent of the challenges of stability, growth and employment. These challenges are bound to intensify as Bangladesh attempts to accelerate its GDP growth and undergo structural transformation in a bid to attain the status of a middle-income country. Section 3 provides some insight into the price stability question in the context of Bangladesh and underlines a few issues and concerns. Section 4 discusses the MPS of the BB, the effectiveness of the various monetary instruments in respect of price stability and factors that could lead their "imprecise control" on inflation. Section 5 seeks to examine BB's policies and programmes towards (the additional mandate of) developing the financial infrastructure and discipline, which are seen as prerequisite for strengthening transmission mechanisms. Some of the anomalies in the financial structure are pointed out. Section 6 provides a critical assessment of BB's growing emphasis on financial inclusion initiatives as a strategy to widen the financial network to hitherto unbanked/underserved groups and sectors, and thus to contribute to the national strategy of inclusive growth. Section 7 provides a scoping exercise on how the current policies and programmes are contributing to the objectives of stability, growth and employment, albeit within the framework of its MPS.

2. Bangladesh: Macroeconomic stability, growth and employment

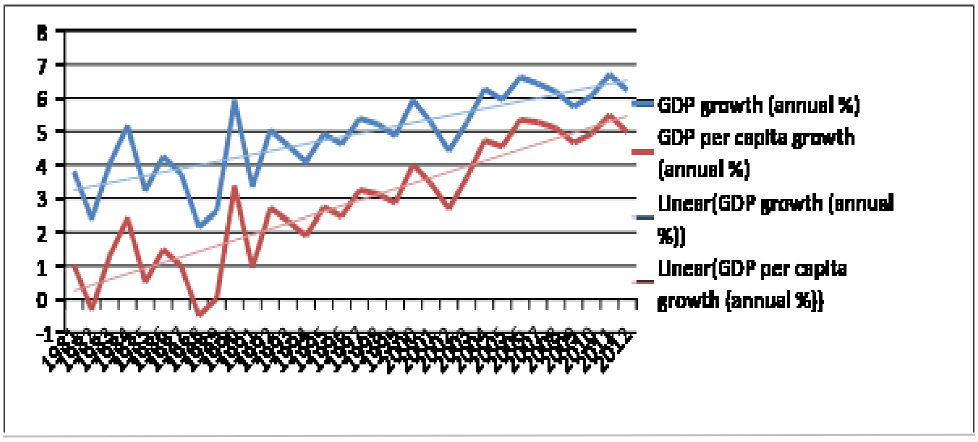
2.1 Growth and stability

In the immediate years following independence, in 1971, Bangladesh was struggling to recover from a war-torn economy and to feed its population.[16] Since then it has made significant progress towards growth and poverty alleviation. Given resource constraints during the initial two decades, GDP growth was modest, but it started accelerating during the 1990s (4.9 per cent) and has oscillated around the six per cent mark since 2003 (see Figure 1). This average growth of nearly six per cent over the past decade, despite the global financial and economic crisis, has been a commendable feature of the economy. Researchers point to one other significant feature of this growth, viz. the per capita income growth of Bangladesh.

[15] See for example, Rajan (2014), who makes a strong case for IT in the case of India; his position is backed up by the Urjit Patel Commission report which recommends a 4 per cent +/- 2 per cent CPI as the nominal anchor. There is a strong debate on the Commission's recommendations. Also, see Choudhury (2004), who explores the potential and current constraints to IT adoption in Bangladesh.

[16] During those early years of economic development Bangladesh was heavily dependent on food aid; a former US Secretary of State allegedly dubbed Bangladesh as a "basket case". Faaland and Parkinson (2009) stated that Bangladesh at the time of independence had all the ingredients and challenges that made it a "test case" for development.

Figure 1. GDP and per capita growth: Long-term trends



Source: World Bank, WDI 2014.

Population growth, within a dynamic of declining fertility and mortality rates, has declined quite perceptibly; the demographic factor, often neglected in growth analysis, has played a significant role. As shown in the Figure above, per capita growth has been faster than overall GDP growth, moving from 1.5 per cent during the 1980s to nearly five per cent in recent years.[17] Together with respectable per capita growth, the introduction and rapid proliferation of various public expenditure and NGO programmes (especially microcredit) towards poverty alleviation, safety nets and special employment and income programmes, have now nearly halved the incidence of poverty from its benchmark of nearly 57 per cent in the early 1990s.

During the 1980s, Bangladesh faced an acute crisis of resource imbalances. In general, huge burdens on public expenditure relative to the very small revenue base, led to substantial fiscal deficits. The large number of loss-making State enterprises in the then mainly nationalized economy added to the resource burden, and the country's development expenditure was met through donor resources. Monetization of government deficits and adverse movements in terms of trade, especially in the aftermath of the second oil-price shock, contributed to a sharp deterioration in macroeconomic imbalances. These led to significant fiscal and current account deficits and an increase in the inflation rate during the mid-1980s.[18] Bangladesh undertook major macroeconomic reforms during the 1980s, and more vigorously in the 1990s, essentially within the framework of its stabilization and structural adjustment programmes that were shaped by the loan facility agreements with the Bretton Woods institutions. Stabilization reforms were focused on restraining fiscal and current account deficits and on lowering inflation rates. These were accompanied by various liberalization (trade and financial) measures and structural adjustment programmes (e.g. privatization and sectoral loans). While many analysts raised issues with the pace and sequencing of these programmes, as well as the initial (social) costs and impact on the economy, the reforms had helped the macroeconomic framework gain a stronger footing.[19]

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[17] *cf.* Mujeri (2014).
[18] For an account of the state of the Bangladesh economy during this early period see, among others, Khan (1995); Bhattacharya and Titumir (2001).
[19] Mahmud (2004); also, Osmani (2008); Ahmed and Mahmud (2009).

Concurrently with the stabilization and liberalization drive, various developments helped Bangladesh to build up its resource balances, both internal and external. Export earnings shot up on the back of escalation in ready-made garments (RMG) exports. Major growth in food agriculture helped to bring down the food import bill. Similarly, remittances from migrant workers grew significantly. Thus, trade deficits declined and foreign exchange reserves grew substantially (Table 2).

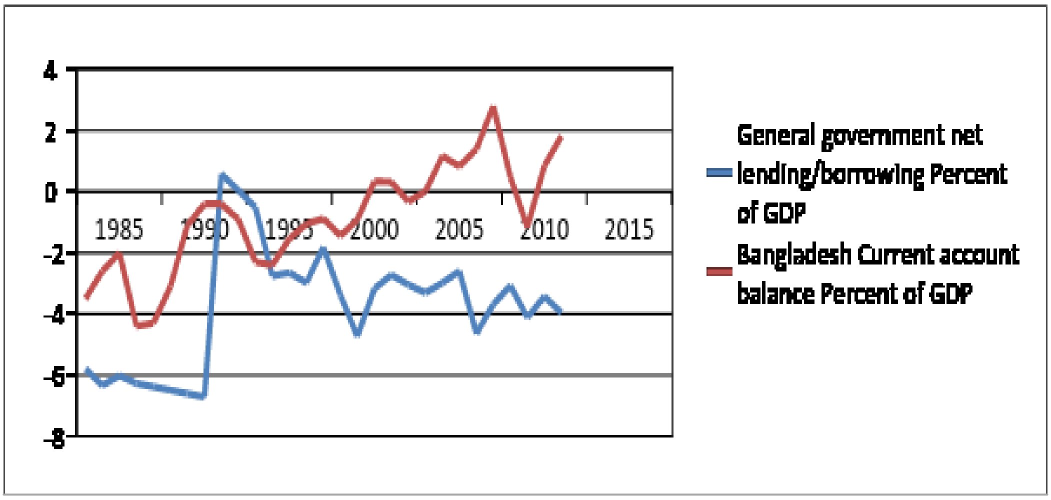
Table 2. Remittances; Overseas Development Assistance (ODA); Foreign exchange reserves

Fiscal Year	Remittances as percentage of GDP	ODAs as percentage of GDP	Foreign exchange reserves as percentage of GDP
2001	4.01	2.91	2.78
2002	5.26	3.03	3.33
2003	5.90	3.05	4.76
2004	5.97	1.83	4.79
2005	6.37	2.46	5.01
2006	7.75	2.53	5.62
2007	8.73	2.37	7.42
2008	9.95	2.46	7.73
2009	10.84	1.86	8.36
2010	10.95	2.16	10.71
2011	10.41	1.59	9.75
2012	11.06	1.75	8.93
2013	10.83	2.09	11.47

Source: Bangladesh Bank.

Bangladesh, by the usual indicators of stabilization has, since the turn of this century, witnessed a comfortable period of macroeconomic stability. Figure 2 shows that fiscal deficits were below 4 per cent during this time, while the current account was in surplus.

Figure 2. Budget deficit and current account deficit (%)



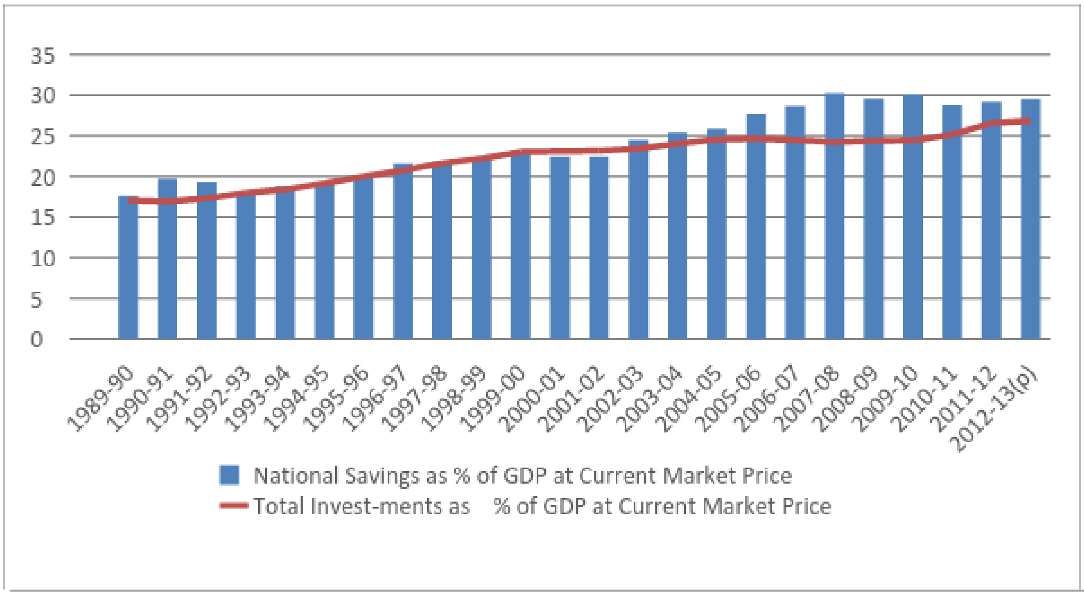
Source: IMF WEO 2014.

2.2 The challenges

Despite its record in growth and macroeconomic stability, Bangladesh faces a number of challenges, particularly in progressing towards its vision of attaining a middle-income status by 2021, and in giving effect to its commitment to "inclusive growth". In the context of the present study, the following four challenges appear as critical.

First, the GDP, which has been growing at nearly six per cent, has so far failed to gather further momentum. This is intrinsically linked to the growth of the investment-GDP ratio (I/GDP) that has stagnated around 25 per cent. In a milieu of macroeconomic stability, a reasonably high savings ratio and high excess liquidity in the banks and financial institutions, the lack of growth in private sector investment is a cause of major concern. Bangladesh is projecting a growth of nearly eight per cent by 2015, and ten per cent by 2021. According to the Planning Commission, this would require I/GDP to increase to 32.5 and 38 per cent (or more, assuming the existing Incremental Capital Output Ratio (ICOR)), for the respective growth rates/periods.

Figure 3. Savings and investment as per cent of GDP



Source: Bangladesh Bank.

Nonetheless, this is a tall order, but not unachievable. The government is trying to step up its public investment programmes, both to enhance I/GDP and also to crowd in private investment through intensifying development of physical (roads, ports, communications) and social (skills, education, health) infrastructures. In particular, the Ministry of Finance, points to the significance of enhancing public investment at a time when private investment is sluggish. They contend that private investment was not only held back by inadequacies of the monetary and financial sector, but also various other factors that can be addressed through increased public investments.[20]

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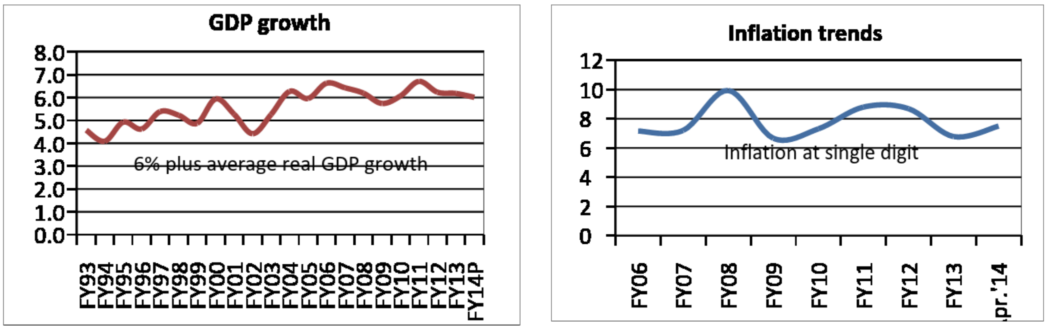
[20] This is based on the author's interview with senior officials of the Planning Commission and the Ministry of Finance. The BB, however, maintains that a major factor in the relatively slow growth of I-GDP and private sector credit is the long spell of sluggish growth in the global economy, which has restrained growth in exports and FDIs. According to the BB and the latest MPS, there is a recent upward tendency in growth of imports and industrial loans, which if sustained, could lead the economy to pick up higher growth.

Numerous factors are put forward to explain the recent slowdown in the pace of private investment, such as infrastructure bottlenecks, energy crisis, skilled manpower and high bank lending rates. However, there are the broader issues of corruption and political stability. In a World Bank survey, 2013, the major constraint as reported by 37 per cent of business enterprises surveyed, was political instability.

Second, maintaining a balance between price stability in the projected GDP growth scenarios above would be a critical challenge. It has been noted that various reforms (especially financial reforms; fiscal restraints) and different developments, whether policy-induced or owing to fortuitous circumstances, have so far helped maintain such a balance. Figure 4 below shows that Bangladesh attained a growth rate of around six per cent in an inflation range of 6–8 per cent. With the Planning Commission's GDP forecast of 8–10 per cent, a review of how a faster growth of aggregate demand, and the wider implications for the economy's fiscal, current accounts and exchange rate will be accommodated, is required.

Figure 4. GDP-inflation stability



Source: Bangladesh Bank Statistics.

Third, poverty reduction and productive employment generation for the growing labour force will continue to present crucial challenges. Bangladesh's sustained growth, together with a large number of public and NGO programmes have led to a significant fall in the incidence of poverty, and is poised to meet the Millennium Development Goals' (MDGs) target of halving poverty by 2015 (see Table 3). There have also been significant improvements in various other MDGs and social indicators.[21]

Table 3. Poverty headcount ratio at national poverty line

Year	Ratio (%)
1992	56.6
1996	50.1
2000	48.9
2005	40.0
2010	31.5
2013	26.4

Source: World Bank, WDI 2014 online database.

Nonetheless, the absolute number of people in poverty is still in the range of 45–50 million. On the US$2/day poverty line, the number would be much higher. Analysts are

The figures on and the issue of political instability are reported in the Bangla edition of, *Poverty and inequality in Bangladesh: Path to recovery (2014–2015),* Ministry of Finance, Bangladesh; p. 47–48.

[21] Mujeri (2014) *op cit.*

also expressing concern over growing inequality that could potentially inhibit the pace of growth and poverty reduction.[22]

Productive employment generation will be an imperative policy challenge in order to absorb the growing labour force and reduce poverty in a sustainable way. According to recent Labour Force Surveys, the labour force is growing at 3.51 per cent annually, while employment is growing at around 3.36 per cent.[23] Although the unemployment rate is officially stated as below 5 per cent, the rate of underemployment is high. Thus, the employment challenge would be to absorb not only the net additions to the workforce, but also the stock of unemployed and underemployed. Based on currently observed labour force growth, employment elasticity (0.55), and the extent of surplus labour (approximated as underemployment of 20 per cent), Islam (2014) estimates that it would require an economic growth rate of almost eight per cent for a sustained period of nearly 15 years to meet the employment challenge. Further, there are studies to suggest that the bulk of the labour force is vulnerable. These include particularly those in self-employment, own-account workers, unpaid family helpers and casual day workers.[24] Reduction of poverty and equality, and enhancing the living standards of the bulk of the population through productive employment, remain a major development challenge. In order to ameliorate the conditions of the bulk of these vulnerable groups and millions of others, who constitute the socially excluded, Bangladesh has embarked on an inclusive growth strategy.

Fourth, Bangladesh is far from achieving a structural transformation, as, for instance, measured by the changes in the sectoral shares of employment. As Table 4 shows, the share of employed workforce in agriculture remained constant from 1995–2010, although the sector's share in GDP fell sharply.

Table 4. Sector composition of employment

Sector	1995–96	1999–2000	2005–06	2010
Agriculture	48.85	50.77	48.10	47.50
Manufacturing	10.06	9.49	10.97	12.38
Construction	2.87	2.82	3.16	4.81
Services	38.79	36.15	37.55	35.30

Source: Islam, R. (2014).

Similarly, another yardstick for a movement towards structural change is the gradual increase in the employment share of manufacturing that has also remained very low. Among some of the other indicators of structural change is the growth of formal sector employment, of which the wages-and-salaried workers constitute an important proportion. Again, the progress is unsatisfactory (Table 5).

[22] Ibid.
[23] See Islam (2014); CPD (2011) for a detailed account of the employment and various labour market challenges in Bangladesh.
[24] *cf.* Islam *et al.* (2011).

Table 5. Wages and salaried workers

Year	% of total employed
1996	12.4
2000	12.6
2003	13.7
2005	13.9

Source: World Bank, WDI 2014.

Thus, in order to achieve sustained growth towards a middle-income country, Bangladesh would have to undergo substantial *structural transformation* commensurate with the foundations of growth in a higher income economy. Such a transformation is observed not only in terms of *sectoral changes in GDP*, but also in the shifts in the *sectoral shares in total employment*. In particular, this is associated with tangible increases in the modern sector's share in total employment. The latter simply characterizes rising labour productivity in the economy, with the labour force shifting away from low-productivity agriculture to high productivity manufacturing and services sectors.[25] In order to boost productivity and structural transformation, measures would need to be put in place to upgrade skills and education, and infuse higher technology and innovation. Thus, productive employment generation would need to be associated with growth of jobs in higher productivity sectors, together with other conditions to facilitate labour movements between sectors, as well as between regions.

In the following sections, the role of BB and the relevance of its mandate in respect of the above national priorities and challenges of stability, growth, employment and social inclusion, will be examined.

3. Price stability in Bangladesh economy: Initial considerations

As noted above, in current discourses on macroeconomic stabilization, there is a pervasive tendency to consider price stability as the ultimate target for the macroeconomic regime in general, and for central banks in particular. Price stability is almost exclusively focused on control of inflation rates (and, by extension, to the exchange rate). This is a goal that must be undisputedly desired by planners and central bankers of all countries. The devil is, however, in the details. The concern and the debates arise when trying to establish the inflation target in an economy as a single-statistic, and when attempting to fathom why and how this rate is optimal. Indeed the conventional wisdom is that inflation rates must be low, since high prices affect businesses and the poor adversely. In fact, as observed in a previous section, proponents of inflation-targeting would ideally wish to see inflation below three per cent, or lower.[26] As empirical evidence shows, it would be imprudent to rely on an "ideal" rate across all countries; such an advocacy is likely to face similar criticisms as levelled against the now discredited one-size-fits-all stabilization campaign of past decades.

The price stability challenge for central bankers, especially in a developing country like Bangladesh, is rather complex. It involves articulation of what constitutes a realistic target in the short-run; how low should it be, and whether it is defined by inflation-growth trade-offs; whether inflation should be taken as the final end objective (as in IT);[27] and which measure of inflation should form the target (core, headline, CPI). Also, it is equally significant not only to analyse the underlying causes of inflation, but also the shifting

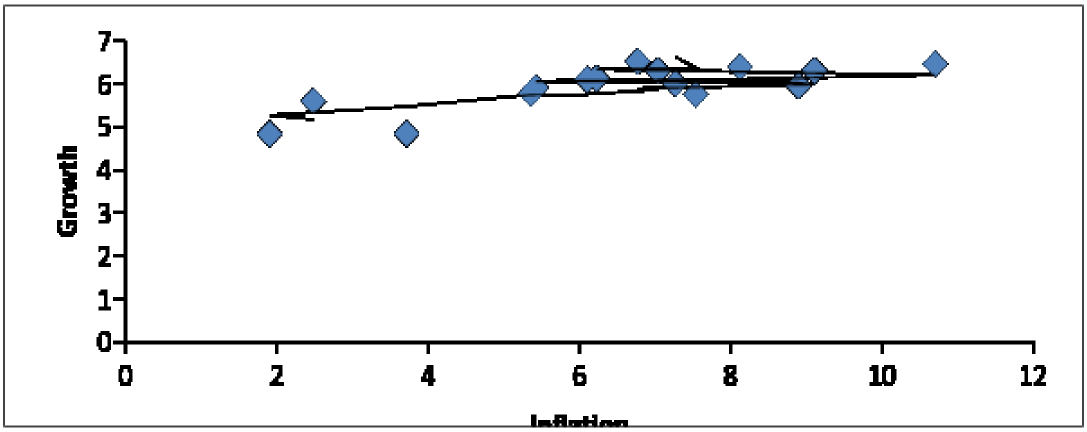
[25] This signifies the Lewisian turning point.
[26] See, Hammond (2012) op cit.
[27] See ibid.; Mohanty (2010) op. cit.

nature of such causes. This would better rationalize the targets, and the instruments and approaches adopted to reach short-term goals.

In the above context, the broad inflation trends in Bangladesh, and their relationship to growth, i.e. whether and to what extent they may have affected it, are examined. Figure 4 in the previous section provides trends in inflation and GDP growth since the 1990s.

There are a few important dimensions regarding output-price trends. First, during the past three decades or more, Bangladesh has not faced the type of runaway inflation experienced by many developing countries, especially Latin America. In fact, since the 1990s inflation barely crossed the double-digit figure, except in 2011. Second, despite some oscillations in the inflation rates, GDP registered a relatively sustained growth path. Nevertheless, studies tend to show a negative (though weak) relationship between the two when long-term trends are considered.[28] However, taking a more recent period, such as between 2000 and 2013, a mildly positive relationship is observed (see Figure 5). Whether such a positive relationship can be sustained over the medium term is open to debate and subject to many factors. This relationship between the *rate of growth* of prices and GDP must not be interpreted as necessarily the optimal paths in the future. It simply satisfies the contention that a mild inflation has, *at the current stage of Bangladesh's development*, served the economy well. It does not, however, shed light on how much lower the inflation rate should be and, most importantly, how to attain that level without affecting output levels.

Figure 5. Growth-inflation relationship 2000–2013



Source: IMF, WEO 2014.

There is not much empirical work on the inflation-growth trade-offs in Bangladesh, i.e. trying to establish the threshold level of inflation beyond which growth would be adversely affected. Farashuddin (2008) forwards an intuitive threshold of 7–8 per cent for Bangladesh. Ahmed and Mortaza (2005), using time series data for the period 1981–2005, point to a "6 per cent threshold level (i.e. structural break point) of inflation above which inflation adversely affects economic growth".[29] Mallik and Chowdhury (2001) also come up with a similar conclusion, suggesting that Bangladesh was turning the corner from positive to negative in the growth-inflation relationship. However, Younus (2012), using a longer time series data (1976–2012), and on the basis of alternative estimations, suggests that the inflation-growth relationship appears to be non-linear, and the trade-off seems to

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[28] See, for example, Ahmed and Mortaza (2005).
[29] Ahmed and Mortaza (2005), p.15.

occur in the 7–8 per cent range.[30] Thus, the study justifies the target set by the BB for the financial year 2012/13 at 7.5 per cent. Further, more rigorous and continuous analytical work would be necessary to confirm the robustness of such estimates, and to conclude whether, given the trends in various related macroeconomic indicators, an inflation level of six or eight per cent could be judged as moderate. The more conservative planners would contend that any tendency towards inflationary pressure might lead to inflationary uncertainties. Whether the monetary policy authorities have an adequate cushion to risk-manage sudden shocks, domestic or external, to price stability, has to be examined. In a situation of rising inflation, a contractionary policy engaging higher interest rates is likely to increase capital inflows and exchange rate volatility. There are, of course, many other factors in Bangladesh, economic and non-economic, that can be a threat to price stability (see section below), and which can potentially lead to inflation uncertainties.[31]

In the above context, it may be noted that, while inflation-growth trade-off studies tend to establish the upper bound of the inflation target in the economy (since in many cases inflation rates are often above those targets), there are very few attempts to examine how low the inflation rate needs to stabilize at. As observed earlier, in the advanced economies, persistent attempts over a prolonged period to bring down inflation have created a deflationary situation that, according to many analysts, can create long-term adverse effects in the economy.[32]

While estimating an inflation target is a complicated and tricky exercise, there are many other considerations that relate to understanding the causes of inflation. In a country like Bangladesh, inflation can be as much a problem of aggregate demand as of supply constraints. This indeed creates a huge dilemma i.e. to what extent the existing monetary tools and practices can effectively control inflation. In Bangladesh inflation is monitored as a weighted index of food and non-food inflation. There are studies that suggest a large contribution to inflation comes from food inflation.[33] Food price inflation can occur owing to several factors, including: supply disruptions owing to bad weather; natural disasters; price distortions created by market intermediaries; other supply shocks; and a rise in food import prices. With regard to the latter, for instance, recent studies tend to suggest there is a strong correlation between inflation in Bangladesh and India,[34] and that recently a significant part of Bangladesh's imported inflation comes from trading with India.

There is a need, especially in a developing country like Bangladesh, for a clearer understanding of the price stability goal, the sizing of the challenge in terms of the target (e.g. inflation rate), the (often shifting) causes of inflation, and for articulating as transparently as possible the MPS and the approaches to address the targets. In the light of the broad issues and concerns above, the following section reviews the MPS of the BB in the pursuit of its mandate on maintaining price stability.

[30] A non-linear relationship between inflation and growth is also reported in various other countries. Using cross-country data, Islam and Anwar (2013) come to similar conclusions (see Section 1.1).
[31] See Bernanke (2003), op. cit. on the significance of controlling inflation, as well as inflation uncertainties.
[32] See Yellin (2014). Currently the United States Federal Reserve Bank and the European Central Bank (ECB) are more concerned at bringing inflation up to 2 per cent and not down to 2 per cent!
[33] Farashuddin (2008) suggests that nearly two-thirds of the general inflation come from food price inflation. Also see CPD (2014).
[34] See BB, MPS, Jan–July 2014, Chart 1.

Box I
Fostering growth-inflation stability

The overall trend relationship between inflation and growth in Bangladesh over the past several years appears to be relatively stable, but analysts and practitioners maintain that there is no scope for complacency, i.e. that the inflation rates would gradually need to come down further. There was a broad consensus on the above among banking sector practitioners, government officials and researchers who were interviewed by the present study.[35] The various groups, however, based on extensive research and experience, have expressed some concerns over the above relationship in the medium-term.

- Researchers generally agree that moderate inflation is acceptable under the current macroeconomic conditions, and that rapid, contractionary policies may hurt growth. There is apprehension, however, regarding the efficiency of the existing monetary and financial system, and their ability to sustain inflation and exchange rate stability, especially should the economy open up further, and take to a higher growth path, as projected by the government.
- The banking sector in general concurs with the current thrust of BB's MPS, especially that it has put relatively more weight on reducing inflation than increasing credit growth. The interviewees contend that such a move would not necessarily lead to contractionary effects since private investment and credit growth are anyway currently stagnant – even though the macroeconomic fundamentals are reasonably sound. They also pointed out that while inflation needs to decline further, in the current situation it is not necessarily the major constraint to investment.
- Officials of the Ministry of Finance (and Planning Commission) and others, while acknowledging the *cyclical* impact of existing monetary and financial policies on non-food inflation, are sceptical on how far the BB can control *general* inflation, two-thirds of which appears to come from food inflation. Major public investments and other measures would be needed to address *structural* factors and food price volatility. Senior BB officials accept this, and maintain that many of the recent initiatives of the BB are intended to support/complement such measures proposed by various ministries.

4. Price stability: Bangladesh Bank's Monetary Policy Stance

4.1 Channels of transmission

Price stability is a key "ultimate" target of BB's MPS. However, as has been observed, Bangladesh, like many other developing countries, pursues multiple mandates, with growth being another crucial goal. The State Bank of Pakistan (SBP) (2014), in its comparative study on South Asian Association for Regional Cooperation (SAARC) central banks, also observes that many of them pursue more than one ultimate target.[36] The study also provides a comparative profile of the means and processes by which a central bank conducts its MPS to reach the ultimate target, as well as intermediate and operational targets, based on which various monetary instruments are used to influence these.[37]

With respect to addressing price stability, BB, again like many of its SAARC counterparts, takes money aggregates (M2) as the intermediate target, that would serve as a reliable link between the ultimate and the operational target, which is reserve money (RM). That is to say, BB conducts its MPS predominantly through the credit/deposit channel. The Bank rate (the policy rate) has been held constant for a number of years now (since 2003/04).[38] However, the BB uses the repo rate as a proxy policy rate (the interest rate

[35] Interviewees included senior BB officials, MDs of private banks, heads of think tanks, senior government officials of the Ministry of Finance (see Annex).
[36] SBP, 2014, p.6.
[37] *Ibid.*
[38] See BB online statistics.

corridor), to intermediate standing lending facilities, and thereby the liquidity position of commercial banks. It may be pertinent to emphasize here that the reasons behind the restricted applicability and impact of the existing interest rate channel are also those that restrict the BB to resort to a (short-term) policy rate channel. Some of these factors are examined below.

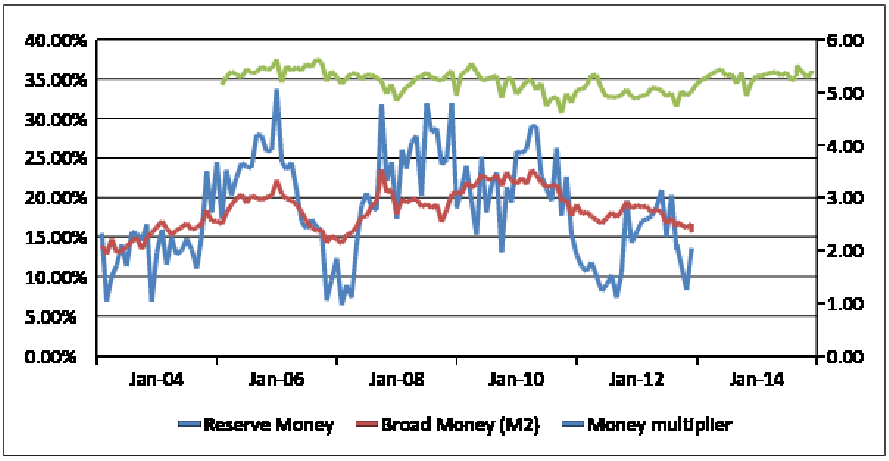
There are a variety of transmission mechanisms (channels) and every central bank tends to choose one or multiple channels from the following: credit channel; policy rate channel; deposit (money) channel; exchange rate channel; asset price channel; and expectations channel. Other channels are equally important, but given the status of monetary and financial institutions, and the strength of transmission mechanisms, the BB finds it expedient to restrict its conduct of monetary policy largely through the credit channel. It is extremely important to assess the significance of the various channels and the associated monetary and financial architecture that would define the strength and weaknesses of the transmission mechanisms and, hence, their influence on the ultimate targets, both financial and real.

Even in the case of a chosen channel, such as the credit channel in Bangladesh, there is a need to assess many factors in the MPS, not only the stability of money demand and supply functions, but also various other macroeconomic variables, such as output gap, fiscal dominance issues, trade balances, capital flows and movements in the exchange rate.

4.2 Policy instruments and inflation control

The BB's MPS modus operandi and the stability it has attempted to establish between its operational and intermediate targets, and thereby the ultimate target, i.e. price stability, is now examined. Figure 6 shows the BB has been able to maintain a fairly controlled relationship between the reserve money (RM) and M2, with a slightly oscillating money multiplier. Of significance is the BB's decision on setting M2 targets (intermediate), which is a careful calibration of inflation rate tracking and potential output growth, weighted by a money demand multiplier.[39]

Figure 6. Trends in growth of reserve money (RM, broad money (M2) and money multiplier

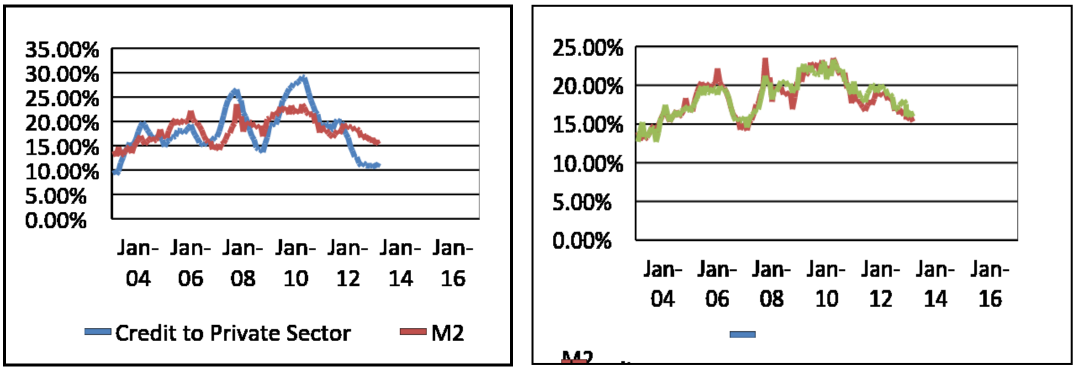


Source: Bangladesh Bank.

[39] This is often a summing up of the projected inflation, GDP growth plus a multiplier factor (e.g. income elasticity of money demand). See Mohanty (2010) for an illustrative example.

The Bank rate has remained unchanged. Given the limited impact of policy rates on price stability[40] (see: reflections on the weak monetary transmission mechanisms in Bangladesh), BB effectively resorts to credit and money channels as the dominant ones to maintain price stability (i.e. inflation control). Younus (2005) has conducted tests on the relationship between M2 and credit and deposit growth to establish the strength of monetary transmission via bank assets and liabilities.[41] Over a more recent period, the following two graphs (Figure 7) have been constructed. They show, despite some volatility, a close relationship between M2 growth and private sector credit growth. This empirically observed relationship over time has provided a degree of confidence and accountability for the BB to continue to pursue the credit/money channels. *While the above two channels show a degree of stability in the relationship between M2 and credit/deposit growth, their correlations can still be consistent with frequent misses of inflation targets, as noted below.*

Figure 7. M2 and private sector credit growth (left); M2 and deposit growth (right)



Source: Monetary Policy Department (Bangladesh Bank) (MPD) statistics.

The BB's MPS is articulated in the six-monthly Monetary Policy Statements issued at the beginning of each six-month period. It is instructive to compare the two most recent (Jan–July 2014 and July–Dec 2014), characterized more by their similarities than by their differences. Both have exactly the same conclusion *ad verbatim*.[42] Thus, over the two Statements, the BB has continued to maintain similar objectives and, equally, the broad approaches to attaining these. This partly conforms to a "communication strategy" (Bernanke, 2003) to allay fears of inflation uncertainties that, in turn, helps instill a degree of confidence among businesses, lenders and depositors,[43] especially with regard to reining in inflation. Nevertheless, the policy framework and the instruments traditionally applied face various constraints that may continue to register discrepancies between *targets* and *actual* achievements. The main points of difference between the two Statements are the downward revisions of budget targets: inflation target (from 7 to 6.5 per cent); GDP (6.5 from 7.3 per cent), and the associated programme measures to reduce growth of private sector credit and M2. Some have welcomed this revised contractionary stance, arguing that the BB has given preference to stability over growth. This is, however, debatable. Analysts

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[40] See Mishra et al. (2010) for their conclusions on the limitations of the use of policy rates owing to weak transmission mechanisms in developing countries.

[41] Younus (2005) on the patterns and effectiveness of transmission mechanisms of these two channels in the context of Bangladesh.

[42] "*BB will continue to focus on achieving its inflation targets while providing sufficient space in its monetary program for lending to activities which support broad-based investment and inclusive growth objectives. BB will use both monetary and financial sector policy instruments to achieve these goals.*" See Bangladesh Bank (2014; 2014a).

[43] See appreciation of the downward revision of inflation target in the latest MPS by an FCB, Standard Chartered Bank, "*Although the central bank has openly stated that reaching this target could prove difficult, a 6.5 per cent target sends the right message on inflation, directionally, the UK-based bank said.*" See MPS strikes right notes: *StanChart*, in *The Daily Star*, 4 August 2014.

would suggest that private sector credit growth had been slowing down anyway over the past several quarters,[44] especially during 2013–2014, and the BB was simply re-calibrating M2 growth consistent with a potentially declining GDP. Political turmoil and countrywide shutdowns have been put forward as proximate factors behind this slowdown. However, it must be pointed out that the I/GDP had been stagnant, even before these political uncertainties.

Table 6. provides an indication of the BB's inflation and M2 targets over the recent past and their actual achievements. It shows that there have been frequent target "misses", targets being consistently higher than achievements, barring the odd year.

Table 6. Inflation, GDP and M2: targets and actuals

Fiscal Year	M2 Growth		GDP		Inflation		
	Actual	Target	Actual	Target	Actual		Target
Source		MPS (Year on year % change)	Annual Report-Appendix 2- Table II (at FY96 constant market price)	Budget Speech	BB Research Department*	Annual Report-Appendix 2-Table II (base: FY96=100)	Budget Speech
2008	17.63	16.00	6.20	7.00	9.94	8.80	6.50
2009	19.17	17.50	5.70	6.20	6.66	6.50	9.00
2010	22.44	15.50	6.10	5.50	7.31	6.50	6.50
2011	21.34	15.20	6.70	6.70	8.80	7.50	6.50
2012	17.39	17.00	6.30	7.00	10.62	8.00	7.50
2013	16.71	17.70		7.20	7.70		7.50

* Source: Bangladesh Bank Time Series Data, from www.bangladesh-bank.org

** Consumer Price Index and Rate of Inflation for National (Base: 1995-96 = 100), Internal and Islamic Economics Division, Research Department, BB.

In fact, the BB Research Department's estimations show an even higher gap between targeted inflation and the observed inflation rate. These frequent misses, which tend to undermine BB's mission to control "inflation uncertainties", may provide a basis for considering a realistic *inflation range* as a target,[45] rather than point targets. More importantly, these gaps highlight some of the basic issues raised in the previous section. That is, how appropriately are the targets set, and whether the existing monetary policy instruments (targeting the money aggregates vis-à-vis potential GDP growth), are adequate to reduce the gaps and/or price volatility? The IMF in its *Article IV Consultation 2013* notes that non-food inflation has been contained (in fact reduced) in recent years, but not general inflation which is tangibly influenced by food/fuel prices. In such a scenario, it may not be unrealistic to expect target misses. Hence, the BB would have to review not only how to fortify its MPS, but also how to contribute to measures that would support ensuring price stability and reducing price volatility. Ironically, in a country like Bangladesh, it is necessary to consider moving beyond an immediate inflation control mandate to ensure price stability.

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[44] For example CPD (2014).
[45] For example Botswana stipulates a 3–6 per cent inflation range.

Box II
The interest rate, inflation: Some anomalies

Many analysts and practitioners are curious about the precise relationship between inflation and BB's policy rate (rather, the lending rate) and the measures it undertakes to control this relationship. For instance, the banks have accumulated excess liquidity, and yet the lending rates are quite high.

- The business community, according to the Bangladesh Employers' Federation, find lending rates much too high to attract investment, and a factor why private credit growth has come down to about 11 per cent, from about 20–22 per cent in the not too distant past. Others observe that while there is an anomaly of high lending rates remaining unaffected by existing excess liquidity, it is equally curious that high credit growth in the recent past took place when lending rates were even higher. The relationship between lending rates, credit growth and investment needs closer scrutiny.
- The MPS pledges a further reduction in inflation. Under normal circumstances, inflation is curbed through contractionary monetary policies, i.e. raising the policy rate, which is likely to increase the lending rate. But the BB has kept the bank rate constant; instead it targets M2, mops up excess liquidity, yet the lending rates have remained largely unaffected. Observers query whether there are structural factors, e.g. non-competitive behaviour that could explain this.
- Financial liberalization and banking sector reforms have freed the sector from directed credit and interest ceilings. However, interest rates still vary depending on how each institution rationalizes its costs, risk management and provisioning. Nevertheless, the variations in interest rates on advances within bank groups and between financial segments are often very large. Observers have expressed scepticism on whether the range is always justified, and on the manner in which competitiveness is being sought in the financial sector.
- Similarly, according to the National Coordination Council for Workers Education (NCCWE), there has been a huge proliferation of Microfinance Institutions (MFIs) (Microfinance Regulatory Authority (MRA) licensed or otherwise) and credit in the rural areas. Yet, the interest rates remain high and vary greatly. This requires closer review and rationalization to avoid abuse of the microfinancial system.

Furthermore, there are various other *potential threats* to price stability that can trigger inflation uncertainties. There are several such possibilities. *Foremost* among these is fiscal dominance. As Mansur (2014) contends, Bangladesh at its current and projected pace of growth would require much higher public expenditure to meet various infrastructure and social needs. Should revenue growth fail to match up, an increased borrowing, especially from the banking sector, is likely to cause monetary-fiscal imbalances and price instability. A *second* potential threat is exchange rate volatility. During the recent past, the Real Effective Exchange Rate (REER) has been stable. Although in principle, Bangladesh has introduced a market-based, free-floating exchange rate regime, BB does intervene occasionally to buy/sell foreign currency to smooth volatility and ensure international competitiveness of exports. Again, in a growing economy, much will depend, *cet. par.*, on the export capacity to meet the import surge, and the future of remittance flows. *Third,* risks to BB's MPS can equally come from non-price factors affecting inflation (supply shocks) or non-economic factors (e.g. political instability).

5. Financial stability: A development mandate for BB

5.1 Seeking a rationale

While inflation remains a critical consideration, BB like many other central banks in developing countries, has avoided the inflation fetish that often leads to contractions in output and aggregate demand. Rather, it has continued to pursue multiple objectives as mandated, and as warranted by national goals and priorities. Moreover, as noted, the *policy rate* as the instrument to control inflation on the one hand would hardly be effective, owing to weak transmission mechanisms and the dominance of food inflation in total inflation, on the other.

Furthermore, price stability in the economy does not necessarily equate to financial stability. If the financial system is weak and unable to withstand shocks (as observed during the global financial crisis), it is necessary that central banks undertake to strengthen financial structures and integrate various segments of the financial sector.[46] In fact a strong integrated financial system would help support and sustain price stability. Attaining financial stability thus becomes an additional mandate for the central bank, and the strengthening of financial infrastructure and deepening of the financial system constitute a development issue. It is equally necessary that the financial system develops in a manner that can anticipate and withstand shocks coming from exchange rate movements, capital flows and major asset-price changes.

There are, therefore, at least the following reasons/factors that would underscore the rationale for BB to pursue multiple/dual mandates: (i) *historical argument*, i.e. as observed earlier, central banks of many of advanced economies, in their early phase of growth, undertook purposeful measures to support growth and job creation,[47] and, in fact, had the "full employment" goal as an explicit objective;[48] (ii) *financial infrastructure argument*, the development of which is a prerequisite for strengthening transmission mechanisms and sustaining price stability and also essential to ensure a better play of market forces, where short-term policy rates are the dominant signal in affecting aggregate demand via influences on savings and investment; (iii) *policy coherence argument*, i.e. the need for central banks to align their goals and operations to support national goals and priorities.

Thus, the BB has taken a cautious, and as shall be seen subsequently, somewhat unconventional approach to pursue various objectives warranted by the current and evolving considerations on stabilization, growth, jobs and inclusion. Incidentally, it may be recalled that these have been stated objectives of the BB since the 1972 Order. The previous section dealt at length with BB's various approaches to pursuing the price stability mandate, and the strengths and limitations of its MPS to control inflation. In this and the following sections, issues of financial sector development, including the new "financial inclusion" initiative, which the BB contends would not only deepen the system and ensure stability, but also act as a major contribution to the national goal of inclusive growth, will be examined. Therefore, the BB is obliged to act as, what it calls, a "developmental central bank". The implicit mandate to pursue financial stability and financial infrastructure-building effectively cuts across its proclaimed mandates.

5.2 Structure and functioning of financial markets

At the outset it needs to be emphasized that the financial system in Bangladesh is rather fragmented. The BB characterizes the markets as:

- Formal
- Semi-formal
- Informal.

The above characterizations are based on the nature and degree of regulations that guide the financial entities. The formal institutions are those that are fully regulated, and include all commercial banks, non-bank financial institutions (NBFIs), insurance companies, merchant banks and MFIs. The semi-formal institutions are regulated, but do not fall under the BB's jurisdiction. These are largely the specialized financial institutions,

[46] See Subbarao (2013).
[47] See Epstein (2007), *op cit*.
[48] Pollin (2011) maintains "A high employment economy is the best tool for fighting poverty"; see also Khan (2001); Muqtada (2010).

such as the House Building Finance Corporation (HBFC), Grameen Bank, Palli Karma Shahayak Foundation (PKSF) and NGOs. The informal financial entities operate completely outside the regulatory framework.

The core of the formal financial sector comprises about 52 scheduled and four non-scheduled banks, 31 NBFIs, 67 life- and non-life insurance companies, and about 599 MFIs (as licenced under the MRA).[49] There is a degree of skewness in the proportion of loans and advances within and between the different segments of the financial system. For example, within the MFIs, the ten largest ones account for 81 per cent of MFI lending.[50] As a percentage of GDP it is approximately 2.5 per cent, compared to the total formal sector's outstanding credit of 41 per cent. [51]

The formal financial sector in Bangladesh has undergone a series of reforms since the very early 1990s.[52] These included recommendations that Bangladesh gradually moves towards a more market-based financial system, and the BB introduces various types of financial discipline to weed out anomalies and limitations, which the financial sector in general, and the banking sector in particular, were facing.[53] The former involved such measures as withdrawing past practices of directed credit and interest ceilings, while the latter included *inter alia* procedures for loan classification, provisioning, greater autonomy of banks and a greater role for the BB in the supervision and oversight of commercial institutions. Various other reforms and recommendations were continuously put forward. These translated into some of the subsequent amendments to the Charter of the BB, for example: greater instrumental autonomy; independent design of the MPS; and greater control over the private commercial banks (PCBs).[54] Within the context of these reforms, the BB introduced several measures to increase vigour in the regulatory, accounting and transparency frameworks for the bank and non-bank financial institutions. The latter related to a number of diverse issues such as: rationalization/merger of loss-making nationalized commercial bank branches; default loans policy; loan restructuring; guidelines for single borrower exposure limits and stress tests; and, the introduction of the CAMELS rating system,[55] in particular the enforcement of capital-adequacy ratios. These measures, especially after 2001, certainly brought about significant improvements in the financial system. For instance, the Non-performing Loan (NPL) ratio came down from 31.5 per cent in 2001 to about 6 per cent in December 2011. It has, however, gone up again to more than 12 per cent in September 2013.[56] Similarly, the return on assets (ROA) and return on equity (ROE) showed vastly improved performances, especially by the PCBs.[57]

The financial sector in the last two decades, despite many failings, has contributed significantly to the needs of a growing economy, and those of consumers and businesses. There has been a marked progress in the mobilization of savings and growth of credit to the private sector. Although, over the last few quarters, stagnation in the growth of the latter can be observed, private sector credit (as a percentage of GDP) has grown substantially, from about 26 per cent in 2001 to 44 per cent in 2013. There is, therefore, the need to appreciate the implications of long-run developments, as opposed to short-term constraints in the financial sector. Similarly, M2/GDP has also grown commendably, and currently

[49] See, Bangladesh Bank website; Rahman (2014).
[50] *cf.* www.mixmarket.org/mfi/county/Bangladesh
[51] Rahman (2014) *op. cit.*
[52] Various issues were reviewed and reforms designed largely under the Financial Sector Review Project, 1992.
[53] See the recommendations of the National Commission on Money, Banking and Credit. Also see recommendations and evaluation of the Banking Reform Committee (BRC).
[54] See Islam, M.A. (2012), Choudhury (2012).
[55] Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risks.
[56] CPD (2014).
[57] Choudhury (2012) *op cit.*

stands at 56 per cent, which is higher than many countries with similar levels of per capita GDP, and is close to the situation in India. There is also discernible progress in M3/GDP, indicating progress in financial mobilization and deepening.[58] The following table captures some key indicators of financial deepening in Bangladesh (Table 7).

Table 7. Financial sector deepening

Fiscal Year	M2/GDP*	Total Credit / GDP*	Private Sector Credit / GDP*
2001	0.34	0.33	0.26
2002	0.36	0.34	0.27
2003	0.38	0.37	0.28
2004	0.39	0.37	0.29
2005	0.41	0.40	0.30
2006	0.43	0.43	0.32
2007	0.45	0.43	0.33
2008	0.46	0.45	0.35
2009	0.48	0.46	0.36
2010	0.52	0.49	0.39
2011	0.55	0.54	0.43
2012	0.56	0.55	0.44
2013	0.59	0.55	0.44

* GDP at current market price from “Monthly Economic Trends”', May 2014.
M2 is the 12 month average of Broad Money (M2).
Total Credit is the 12 month average of Domestic Credit.
Private Sector Credit is the twelve month average of Private Sector Credit.

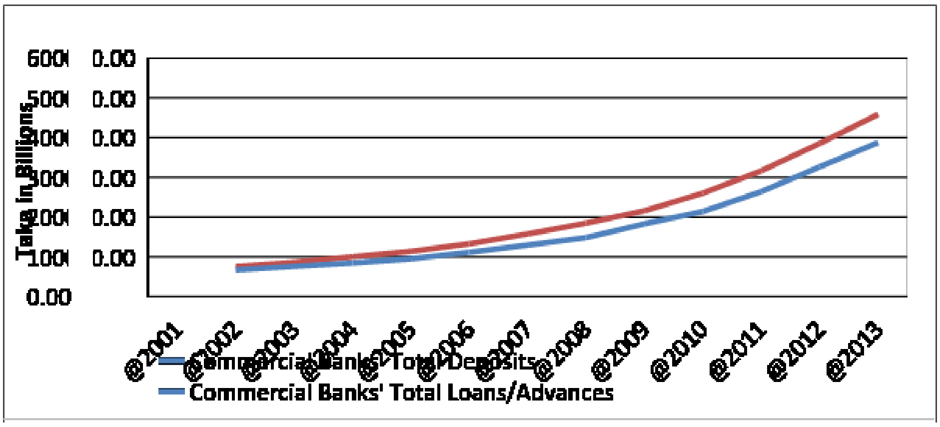
At the heart of developing a strong financial system and infrastructure lies the consideration of sustaining price stability, and enhancing growth through a better investment climate and incentive structure. There are multiple ways in which the above variables are linked. For its role as a developmental central bank, it is critical for the BB to review how its two-pronged approach — price stability and financial sector initiatives – can lend itself to boosting investment and growth, i.e. in addition to generating jobs and income for the poor. While observers tend to cite various constraints concerning the rather slow growth in I/GDP, especially at a time when the government is keen on spurring growth to attain a middle-income country status, an immediate concern is to ensure smooth, trustworthy, sustainable financial policies and transactions.[59]

In this context it would be instructive to review some of the crucial factors, especially those that are structural in nature, inhibiting the smooth functioning of the system.[60] There exist evaluations on various dimensions of the financial markets in Bangladesh, and the regulatory framework.[61] These studies, while appreciative of the progress in the financial sector reforms, do point to several areas that need careful review and further strengthening: (i) high NPLs; (ii) high interest rate spreads; (iii) excess liquidity; and (iv) large proportion of classified loans (especially in the state-owned banks), are some of the symptoms of

[58] See Islam, M.A. (2012) for implications.
[59] The BB has already announced a 5-Year Strategic Development Plan 2015–2019, currently under preparation, which is expected to provide a comprehensive view of BB’s future strategies towards monetary and financial discipline and developments, sustainable finance, as well as on its contributions toward inclusive growth.
[60] Choudhury (2012); Islam, M.A. (2012).
[61] *Ibid.*

financial sector malaise.[62] Lack of competition and undue influence coming from vested quarters has added further to the distortions in the sector. A current preoccupation of the BB is in respect of excess liquidity, with the rate of advances falling consistently below that of deposits (Figure 8). Although the BB has used its instruments (e.g. cash reserve ratio) to mop up some liquidity based on stipulations of the deposit-to-credit ratio, there still exists substantial excess liquidity in the banks. The real concern is that the excess liquidity has had little downward impact on lending rates. The banks, especia PCBs and foreign commercial banks (FCBs), continue to maintain high interest rate spreads, and to earn positive ROAs and ROEs.[63]

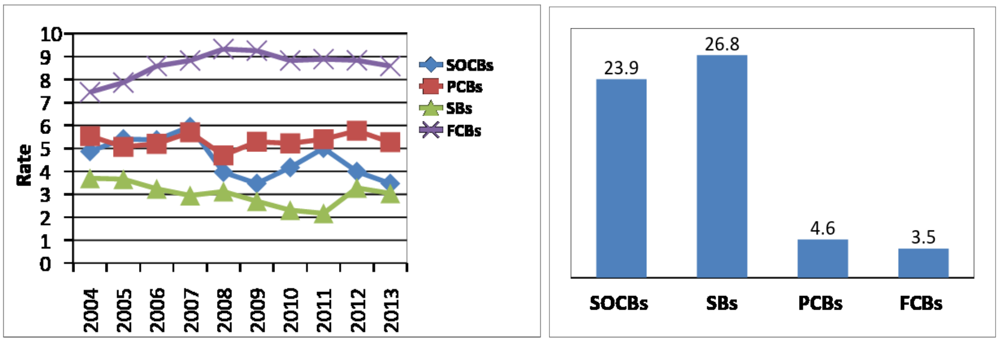
Figure 8. Trends in commercial banks' loans and advances



Source: Bangladesh Bank.

An alternative way to take stock of the anomalies in the system would be to conduct *a comparative review of the composition and functioning of the various groups of banks and non-bank financial institutions,* notwithstanding that some of these are mandated to serve specific sectors. The State-owned commercial banks (SOCBs), PCBs, including Islamic Banks, specialized banks (SBs) and FCBs constitute the core of the formal financial system in Bangladesh. The performance of these institutions provides interesting and contrasting examples of financial discipline, lending priorities, credit allocation and risk management. This becomes evident when some performance indicators in a comparative framework are examined. For example, Figure 9 illustrates the NPLs and interest rate spread of these four sets of banks.

Figure 9. Comparative interest rate spread (left); Non-performing loans 2012 (right)



Source: Scheduled Bank Statistics (various issues), Bangladesh Bank.

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[62] See CPD (2014); Farashuddin (2008); Unnayan Onnesha (2014) etc. for perspectives on these.
[63] *Cf.* Choudhury (2012);

It can be seen that the FCBs maintain the highest interest rate spread and hence higher margins from intermediation, while the SBs have the lowest spread. However, it must be noted that the latter, by their very mandate, have different profiles with regard to their credit allocation and specialized client exposure (e.g. Krishi Bank lending to agricultural sector). While there can certainly exist variations in objectives and approaches among these groups of banks, it would be worthwhile to review and examine their performances to learn positive lessons, and for cross-fertilization, and thereby reduce structural anomalies. This would also provide lessons on accountability and transparency and a smoother transition to market principles and healthy competition. These would also shed further light on the governance of the financial sector.

Box III
Financial system and governance issues

The strategy behind developing a sound financial system is to ensure a smooth interaction between mobilization of resources (deposits etc.) and credit flows (advances) to productive use in a competitive market framework. While the BB has undertaken several measures (see text), the present study gathered the following concerns expressed by several senior Bank officials, and by participants at a Roundtable at the BIBM:[64]

- *Confidence in the banking sector.* While the BB has taken several important steps towards financial sector development and financial regulations, interviewees expressed that given major scams and influences (political as well as from the bank Board members) on bank lending, there is a confidence crisis in the sector. Measures have been urged to ensure transparency, investor confidence (e.g. merit-based loan structuring in default cases) and consumer protection (e.g. deposit insurance), as well as other safety net measures.
- *Proliferation of PCBs.* Concerns have been expressed at the rationale of the recent addition of nine PCBs in the banking sector. Researchers in particular point to the lack of transparency in this move, and doubt whether this will improve competition in the sector. A large part of banking transactions is still “directed” by vested interests; in particular, those that are influenced through the Board of Directors.
- *Credit concentration.* Currently there exists a skew in the distribution of credit to the private sector. With excess liquidity in most banks, there is too much credit chasing too few clients. Credit appears concentrated in a few sectors, e.g. RMG and textiles, and to a small group of “chosen” clients in the corporate sector. Measures need to be undertaken to diversify credit allocation and broaden the lending base.
- *Climate of apprehension.* Some PCB officials have expressed apprehension on the degree and nature of BB’s measures to exercise financial discipline. While they fully concur on the need to curb financial irregularities, they point out that conflating “regulation” and “control” may lead to unnecessary bureaucratic impediments. So far as the PCBs are concerned, the contractual appointments of CEOs/MDs with no certainty of contract extension leave them with little scope to design and implement long-term strategies of a bank.

The above would require a rethink of how far the current approaches of the MPS, of calibrating demand-supply of liquidity with potential output growth, can cope with a growing economy that is increasingly opening up. Greater play of market forces is likely to place increasing onus on the policy rate that would warrant much greater financial deepening (e.g. strengthening credit/debit markets; strengthening interbank transactions and

[64]Senior bankers included MDs of three private commercial banks. The Roundtable at the BIBM, held specifically to discuss the present study, was attended by its Director General and senior staff of the Institute.

interbank rates) and integration; and a more efficient regulatory framework to ensure discipline and greater competitiveness.[65]

6. Financial inclusion (FI)

6.1 The FI setting in Bangladesh

Financial inclusion, in some form or other, has long been an integral part of the development and poverty alleviation strategy of developing countries, especially those with a persistently high incidence of poverty. Although the definition, design and content of FI vary across countries, at the heart of it lies the extension of credit and/or financial services to the poor and vulnerable sections of the population at affordable cost. Microcredit and microfinance programmes, pioneered by such initiatives as the Grameen Bank in Bangladesh, are the well-known variants of FI that support poorer people through access to resources/opportunities and financial choices, strengthening their efforts for a better livelihood and enhancing individual capabilities.[66] There are various forms of extension, implementation and delivery of credit and related services, and the scale of different programmes ranges from the very limited to some that are nationwide. The objectives too, of FI, are being expanded from a purely poverty-reducing instrument to its wider application to various hitherto underserved and unbanked sectors, regions and population groups. Given its growing significance, the G20 underscores the following: *"The G20 commitment to financial inclusion recognises the benefits of universal access to financial services and acknowledges that more than two billion adults do not have access to formal or semi-formal financial services and that millions of micro-, small- and medium-sized enterprises (MSMEs) face a serious lack of access to finance."*[67]

After the Independence of Bangladesh in 1971, when it was struggling to restore growth in the economy, and when more than two-thirds of its people were below the poverty line, microcredit extension at the grassroots level, through various NGOs and government agencies, started to support rural livelihoods. This movement gathered speed and space through the, now internationally reputed institutions, such as Grameen Bank, the Bangladesh Rural Advancement Committee (BRAC) and Proshika. The setting up of the PKSF in 1990 as an apex funding agency, and which operated through its partner organizations gave a further boost to the growth of microcredit and microfinance. There have been many evaluations concerning the impact of the innumerable programmes, and results are rather mixed depending on their nature and the indicators examined.

Microcredit's benefits, when designed, implemented and monitored properly, are almost universally applauded. However, with the huge proliferation of credit, severe criticisms have arisen of loan default, double-dipping and a tenuous link between credit and its income and social effects.[68] A critical concern of contemporary relevance is the re-examination of the very objectives set by various MFIs, many of which according to Ahmad (2012), seem to be leaning more towards profit-making and away from the stipulated social objectives. There seems to be a growing disconnect, albeit not among all

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[65] *Cf.* Rahman (2014), *op cit*. for a further account of the various limitations of the financial market, and major measures required to address these.
[66] In this sense, financial inclusion could be seen as constituting part of, what Amartya Sen called "instrumental freedoms". See Sen (1999).
[67] See the G20's recently set up Financial Inclusion Experts Group's G20 Financial Inclusion Action Plan. Also note various national plans have started integrating financial inclusion and national committees have been set up for devising more systematic approaches, e.g. the Committee on Financial Inclusion in India, in 2008 under the Chairmanship of C. Rangarajan.
[68] See, for example, Ahmad (2012) for a detailed assessment of micro-credit performance in Bangladesh.

MFIs, between the interests of the intended beneficiaries and the lending institutions.[69] In 2006 the MRA, under the chairmanship of the BB, had been established to oversee the functioning of the MFIs and to ensure that there is a better "social inclusion" of the poor and the vulnerable. It has to be seen how the functioning of the MRA provides a better discipline in credit delivery objectives and attainments.

6.2 The FI initiatives of the BB

In the above situation, the BB has introduced a major campaign and initiative on FI. These initiatives go beyond the hitherto stated objectives of microcredit and broaden the role of the BB as a developmental central bank. There are several explicit and implicit objectives behind this drive. *First*, FI is seen as part of and a significant contributor to the national objective of inclusive growth, by extending credit and financial services to the underserved and unbanked population and regions of the country. *Second*, FIs are seen as a major avenue to develop financial structures and to deepen the financial sector by strengthening and extending institutions to non-traditional sectors. *Third,* FI activities are being designed and directed to enhance output and reduce volatility, especially in agricultural production, which would tend to ease supply constraints. Thus, these are measures purported to curb food inflation and sustain price stability. In the above scenario the FI initiatives of BB intend to go beyond the simple social profitability context of MFIs and are defined as only those that are under supervision of official authorities.[70] The intended objectives are to ensure greater access to finance to the underserved population who would invest in productive activities and diversification, and entrench structures of financial services that would allow greater mobilization of savings.

Among the many FI initiatives during the recent past, the following are noteworthy:

- *Agriculture sector credit policy.* Although agricultural credit extension has long been a practice of the government, administered largely through two specialized banks,[71] the sector was facing declining budgetary allocations. In order to increase lending in the agricultural sector, the BB has undertaken a policy to encourage all commercial banks (state-owned, privately-owned, domestic or foreign), by drawing on their Corporate Social Responsibility (CSR)-induced financing. The commercial banks are being supported by the BB's refinancing schemes (via interest rate subsidies) and are encouraged to follow a planned approach as coordinated by them i.e. "directed-lending". Each year the BB publicly announces its agricultural credit policy and, in consultation with commercial banks, sets disbursement targets for the next financial year. There are broad indicators to suggest that agriculture credit lending has been increasing substantially.[72]

- *A credit programme for sharecroppers.* Sharecroppers as a vulnerable group have historically been outside the financial system because of lack of collateral. In 2010, the BB introduced a special refinance facility (of about US$72 million) exclusively for landless sharecroppers. This is being conducted in collaboration with BRAC, which has to date, provided loans to nearly half a million sharecroppers.

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[69] *Ibid.*
[70] For example "... banks and financial institutions supervised by BB, MFIs supervised by MRA, credit cooperatives supervised by the Registrar of Cooperative Societies, insurance companies supervised by Insurance Development and Regulatory Authority (IDRA), capital market institutions like investment banks, merchant banks, stock exchanges supervised by the Bangladesh Securities and Exchange Commision (BSEC) ...". See Rahman (2012).
[71] Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank).
[72] Bangladesh Bank, Developmental Central Banking in Bangladesh (n.d.).

- *10 Taka account for farmers.* The BB has taken a novel initiative to facilitate the opening of bank accounts for poor farmers, wage labourers and other vulnerable groups, with an amount as small as 10 taka (US12 cents). These new accounts, which have reached nearly 13 million of the underbanked population, are being used as a savings and payments medium, as well as to receive various input subsidies and social safety net payments from the government.[73]

- *Access to finance for small and medium-sized enterprises (SMEs).* As in most developing countries, the growth of SMEs in Bangladesh is predominantly hampered by lack of access to finance. The BB has undertaken a comprehensive policy on credit lines for SMEs, primarily through setting up an indicative target for SME loan disbursement by various commercial banks and non-bank financial institutions. Again, as in the case of agricultural credit, the BB, in collaboration with the government and international donors, is reinforcing the programme through various refinancing schemes. These are designed to support and attract commercial banks and financial institutions towards lending to SMEs. The BB is also following an "area approach" and "cluster development policy" and emphasizes priority lending to small businesses and women entrepreneurs. Table 8 shows the progress in lending to SMEs by the various groups of banks and financial institutions.

Table 8. SME loans as percentage of total loans

Quarter	SOCBs	PCBs	FCBs	SBs	NBFIs	Total
Oct.-Dec. FY12	18.2	25.3	8.9	26.4	12.4	22.3
Oct.-Dec. FY13	18.4	27.1	9.5	29.7	11.4	23.9
% change of SME loans	**-5.7**	**18.5**	**5.9**	**28.4**	**15.2**	**14.9**

Source: Bangladesh Bank.

- *Mobile banking.* With an ever expanding mobile telephony and increasing demand for mobile financial services, the BB has recently issued guidelines for MFS in 2012. Mobile banking licences have been granted to several banks, e.g. BRAC Bank's subsidiary, bKash, which are rapidly expanding their services throughout the country.

- *Other initiatives.* The BB has been a keen promoter of *environment friendly projects* and has introduced special refinanced lines to encourage commercial banks and financial institutions to extend loans to such areas as renewable energy and energy-efficient technologies. It has also introduced incentives towards "planned" promotion of lending for crop diversification and cultivation of crops that could potentially reduce dependence on their imports.

There are multiple programmes and activities within each of the FI initiatives mentioned above, and the BB is intrinsically engaged in their implementation and oversight through creation and strengthening of dedicated management, supervision and regulatory frameworks. The FIs have fairly ambitious objectives, which are being pursued through diverse programmes, although there is still very little objective impact assessment of them. The basic indicators of progress are in terms of their expansion, the numbers of beneficiaries reached and the CSR ethos generated among the commercial banks and financial institutions that relate to their commitment to planned targets and actual disbursements.

[73] Bangladesh Bank, *op. cit.*

Box IV
FI initiatives: Some reflections from within

The FI programmes initiated by the BB are being conducted within a supervisory and oversight framework of the Bank through its various units/departments. Although BB is purportedly a catalyst and initiator, i.e. since most of these are implemented through commercial banks and MFIs, these units/departments maintain a strong role in extension and monitoring. The officials in charge of these offer the following reflections on FI:[74]

- *Enhanced "capabilities".* Those operating at the grassroots level report strong enthusiasm among the beneficiaries, especially in recounting how access to low-cost credit has opened up their options and *choices*, and access to employment and income *entitlements*. Observers report that credit availability, together with new scope for starting low-deposit accounts and electronic payments, has created ground for better connectivity of the hitherto unbanked population, with formal credit channels.
- *Scale and pace.* The programmes since their inception have been increasing, and there appears to be a greater demand for credit than supply. Most of these are based on the refinancing schemes of the BB. Ways must be found to scale up, and speed up the process. The pace of some programmes, such as SMEs, are often held back by various constraints, such as collaterals (or guarantees) and lack of information dissemination.
- *Real impact.* While grassroots operators report and monitor the progress of these FI initiatives, there is a need for an objective method for real impact analysis, and a longitudinal information base. The sustainability of the programmes would be best assessed through such analysis.
- *Capacity building.* If the FI initiatives were to expand on a larger scale, there is a need for capacity-building and coordination at every stage of their implementation (at the BB, among the banks and financial institutions, the MFIs and other agents). Such coordination should encompass not only credit extension, but also financial education and awareness.
- *Mainstreaming.* There has been a suggestion to better integrate and mainstream the FI initiatives in the regular MPS of the Bank.

Apart from the fact that it is too early to assess the true impact, it would be a complex task to assess the accomplishments. Such an impact assessment can be gleaned from the Table 9 below.

Table 9. FI: Selected indicators

	End–2009	End–2013
Bank branches per 1000 sq.km	48.1	58.9
Bank branches per 100,000 pop^n	5.1	5.7
No of ATM per 1000 sq.km	8.0	35.55
No of deposit account per 1000 pop^n	267.3	412.8
No of loan account per 1000 pop^n	60.2	62.9
Bank sector assets (%GDP)	59.0 (June)	80.0 (Dec)
No of accounts: Conventional (mill.)	37.6 (end 2008)	49.9 (end 2013)
No of accounts: Innovative (mill.)	-	13.5
of which farmers 10-taka Account (mill.)	-	9.7
Farmers getting agricultural credit (mill.)	2.1	3.3
SME (mill. Enterprises, Jan 2010– Mar 2014)	-	1.9
Women enterprises (mill. Enterprises, Jan 2010–Mar 2014)	-	0.9

Source: Bangladesh Bank (adapted from various BB sources).

The above table shows quite substantial progress during the period 2009–2013, but only in terms of the indicators stated. From the above *it would be difficult to relate them to*

[74] Participants in the meeting included heads and senior officials from: SMEs; Monetary Policy Dept; CSR; Green Finance; Agriculture credit; Debt Management Dept.

the various objectives of the FIs as mentioned previously. The BB has introduced an FI index that provides an approximation of FI in the economy. In 2008, according to this index, 78 per cent of the population was deemed to be financially included.[75] This is still a rather crude indicator (e.g. overlaps in estimation), and needs to be further refined to capture the depth of FI.

There are several issues that need to be probed and resolved in order to understand the true dynamism of the FI initiatives. *Foremost,* there is the need to establish an appropriate link between the FI objectives and the programmes that are purported to achieve these. This would require setting up focused impact assessment cells, both in the BB as well as in the cooperating banks and financial institutions that would develop appropriate databases, methodologies and analytical frameworks. This would be necessary to assess the true employment and income effects on the groups and beneficiaries for whom the FIs are designed. It would also allow better approximation of the various *multiplier* effects that these programmes are having in increasing output, curbing volatility and sustaining price stability. *Secondly*, although the loans to SMEs in general are increasing, the smaller of the enterprises are yet to benefit from these in a substantial way. For instance, less than 15 per cent of the SME loans actually accrue to the smaller members.[76] Further SME loans are still of shorter term maturities; medium and long-term lending is yet to take off in any tangible manner. *Thirdly*, while access to finance is a critical instrument in uplifting livelihoods, "credit only" approaches in the FIs are likely to face similar limitations as observed with the microcredit assessments mentioned earlier. *Fourth*, the various FI initiatives induced through CSRs, and supported by refinancing schemes, are indeed noteworthy, especially in respect of the coordinated thrust towards a planned channelling of credit to underserved sectors and groups. However, the scale is still too low since commercial banks' disbursements to such sectors/groups are largely determined by the level of refinance availability. Studies suggest that there is not yet much correlation between CSR practices in the banking sector and the revenues, net income and deposit growth of these banks.[77] It must also be noted that the refinancing initiatives are an aberration of a recommendation from the National Commission on Money, Banking and Credit regarding the replacement of refinancing facilities with a single discount window. *Fifth,* the extent to which FI is currently helping to sustain price stability and financial stability, through widening and deepening financial structures, is a complex phenomenon and not easily discernible, since this would require controlling many other variables that influence stability.

The BB is vigorously pursuing its FI initiatives, not only in its attempt to contribute to the national goal of inclusive growth, but also to strengthen and reinforce the development of the financial networks by extending these to the underserved regions and unbanked population. The BB maintains that these would encourage and strengthen the foundations of the banking and the financial system as a whole, within a common framework of prudential regulations. Unlike the microcredit campaign of the MFIs, the FI initiatives of the BB are likely to impart impulses to growth of productivity and structural changes, through its multi-pronged credit advances to productive sectors and economic diversification. This, according to the BB, is the true mission of a developmental central bank, and one which so far has not prejudiced its critical role on maintaining price and macroeconomic stability.[78]

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[75] This is measured as the number of bank deposit accounts plus number of MFI members, plus number of members in cooperatives – all divided by the adult population. See Rahman (2014a).
[76] BB; Also Banerjee , in his paper in the BIBM (2013) points out "the small and cottage and services industries did not receive required attention from SCBs, PCBs, SBs, and FCBs in spite of BB's repeated direction to enhance lending to this sector", p.17.
[77] See, for example, Shahidullah (2013).
[78] See, Rahman (2014) *op. cit.*

7. Integrating a dual mandate in BB's monetary and financial policy framework

7.1 An interpretation

As global experiences show, and as observed in Bangladesh, it appears that central banks in developing countries (dominant institution responsible for inflation control), have at best an "imprecise control" over price stability.[79] Among the factors that tend to support such a contention, there are at least two that need to be emphasized: (i) imprecisions in understanding the causes of instability (inflation), some of which may be structural in nature; and (ii) identification of transmission channels and setting of targets and instruments, the appropriateness of which is affected by the underdeveloped nature, and efficiency of financial and money markets. Mishra et al. (2014) contend that "monetary policy may be a highly unreliable instrument with which to pursue macroeconomic stabilization in countries that are characterised by a poor institutional environment and an uncompetitive banking sector".[80] It is in this context that establishing the rationale of the BB's MPS of pursuing the multiple mandates, as stipulated in the Bank Order 1972, could be sought. In fact, the BB has, as a continuation of various financial sector reforms, moved to adopt (though not explicitly stated) "financial stability". This is a crucial supporting mandate for maintaining price stability by attempting to strengthen financial markets, regulation and financial discipline. Based on the encouraging responses to its major initiatives on FI, BB has decided to model itself as a "*developmental central bank"*. Reservations are expressed on whether the BB has the capacity to conduct, supervise and monitor the existing gamut of activities. And, whether there may be conflicts and compromises involved (e.g. standardization of the regulatory framework) that may dilute financial discipline and efficiency. As discussed, in the absence of objective evaluations, it would be premature to draw conclusions on such issues as, how far FI could strengthen financial stability, or how the real economy is being affected (e.g. mobilization of savings and employment generation). Nevertheless, two conclusions tentatively emerge: (i) BB's initiatives are intended to be in line and policy coherent with the national goals and priorities; and (ii) BB's contributions, as a stakeholder, would be defined by and conducted through the monetary and financial instruments at its disposal.

As a *developmental central bank*, BB has currently set itself goals and objectives that can be interpreted as conforming to the dual mandate of: *price stability* (purporting to contribute directly to the goal of macroeconomic stabilization); and *inclusive growth* (subsuming several sub-objectives, such as inducements to growth, employment and income generation on the demand-side and to increased productivity, diversification and reduced volatility of output on the supply side). The BB's contribution to inclusive growth is largely predicated on its array of programmes on FI, the merits and limitations of which have been examined in a previous section. In order to assess precisely the impact of all these individual and cluster of programmes, and how they would support the dual mandate, it is extremely important that a methodological and evaluation mechanism is established. Equally important is to "unpack" inclusive growth, a catch-all term that requires a functional approach so that BB's policies and actions are seen to contribute to defined/specified goals.

The BB clearly declares a "two-pronged approach" dedicated to supporting the government strategy of inclusive growth: (i) a CSR-induced FI programme under BB guidance that would serve the underserved sectors/groups enhancing employment income

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79 See Hammond (2012) *op. cit.*; Mishra et al. (2010) *op. cit*, Rummel (2012) *op. cit.*
80 *cf.* Mishra et al. (2014), *op. cit.*

and output; and (ii) BB's credit policies, with a distinct "directional bias" to ensure their use in productive sectors, which would also stimulate employment and income.[81] In other words, BB's actions carry a strong commitment to enhancing productive employment and income generation, via output growth, diversification and targeted FI interventions. Such a policy stance is consistent with the dual macroeconomic mandate of price stability and employment. This was pursued by most of the advanced countries during the post Second World War period towards attaining full employment.[82] It may be pertinent to recall that, in order to achieve sustained rates of poverty reduction and absorb slack in the labour market, the economy would need to create productive employment. This would not only generate market-induced access to sustained incomes and earnings, but also release the government's fiscal pressure on transfers and subsidies. The positive link between productive, remunerative employment and poverty reduction is not only analytically established, but also supported by a large base of empirical evidence.[83] Moreover, historically, countries which have successfully eradicated poverty are also those that have attained full-employment or near full-employment.[84] Furthermore, to realize the government's commitment to attaining a middle-income status, the generation of productive, remunerative employment is crucial in effecting structural transformation (especially in terms of shifts in sectoral employment) associated with a middle-income economy. The current policy stance of the BB promises to *support* such a commitment.

7.2 An MPS towards inclusive growth

It should be noted yet again that the BB is pursuing a "multiple mandates" approach. This is in accordance with the Bank Order 1972, as amended by the subsequent Act of 2003, and appears to effectively conform to a dual mandate of *price stability* and *inclusive growth*.

The BB's policy stance on its major mandate on price stability, and its effectiveness, has been examined in detail in previous sections. They have also pointed to some of the limitations and means to address these. This section explores the BB's pursuit of the second mandate, i.e. inclusive growth, and how it proposes to contribute, as it declares, to the national objectives of employment-income growth through its MPS and its instruments.

The employment-income growth objectives in developing countries, which have a surplus of labour, are pursued through a proactive policy stance that promotes sustained labour demand. As often advocated, and as observed across countries, such a stance tends to include the following:

- growth-induced employment (via employment elasticities);
- sectoral growth incentives that are more employment-friendly;
- special intervention and targeted measures to enhance employment and incomes.

It needs to be re-emphasized that the above national goals require major coordination among all stakeholders; the BB is one of these, with a proactive stance. Various initiatives of the BB are purported to support, directly or indirectly, the above. Some of the caveats, and means to address the objectives more effectively, are examined below.

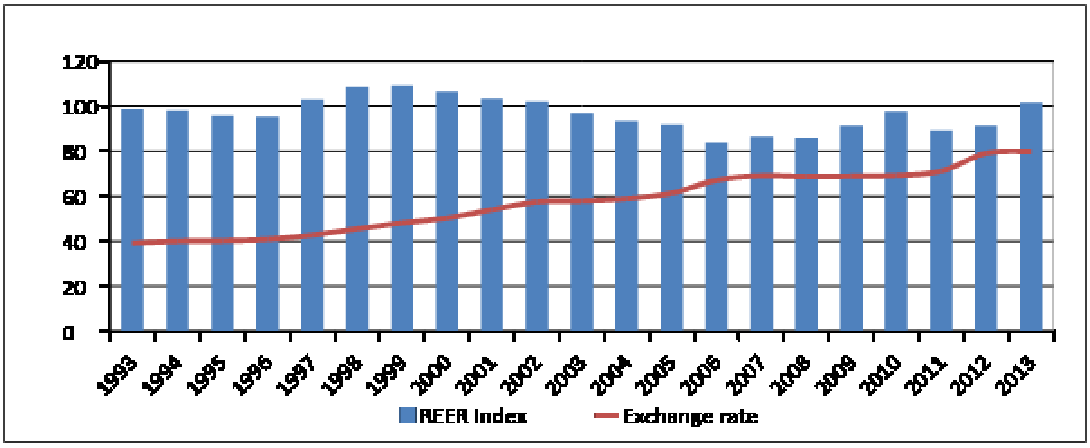
[81] See BB (n.d.), p.7.
[82] cf. Epstein (2007), Pollin (2011).
[83] See Khan (2001); also *Ibid.*
[84] The advanced economies as well as the East Asian emerging economies are cases in point.

7.2.1 Growth-induced employment

As observed earlier, Bangladesh has grown at a respectable rate during the past two decades. It has generated reasonable employment, though not adequate to absorb the current stock of un/underemployed plus new additions (nearly 2 million) to the labour force each year. A higher growth rate (than the current 6 per cent), and a higher employment growth rate (than the current 3.3 per cent) will be required to cope with the labour force growth, as well as to absorb the existing stock of un/underemployed (see Section 2.2).

i. A major mechanism by which BB can contribute to such a growth is through continuing to sustain a moderate inflation along with exchange rate stability. The MPS, together with various favourable factors, has been able to contain inflation, arguably within the moderate zone. The REER, despite some decline during 2006–2009, has attained a stable state in the more recent period (see Figure 10).

Figure 10. Exchange rate and REER Index



Source: Rahman, H. (2014).

Remittances, and relatively robust export earnings, have created favourable conditions. Although Bangladesh has officially maintained a floating exchange rate, the BB intervenes in the foreign exchange market to keep the REER stable and competitive, which has substantially supported the growth of exports, especially RMG.[85] A competitive REER would, as observed in many countries, support trade expansion, employment and economic diversification.[86] Recent uncertainties with regard to remittances and RMG exports warrant that vigil needs to be exercised to cushion against possible shocks to the REER, domestic or external.

ii. It would be critical for the BB to review how it can, through its instruments, influence savings and investment, and hence aggregate demand. Savings appear to be tenuously related to policy/deposit rates and more responsive to income growth.[87] The critical constraint seems to lie with the I/GDP growth rate, which has been rather stagnant, especially private sector investment.[88] There are various factors behind this and BB can

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[85] Given the various interventions of the BB, the IMF classifies the Bangladesh exchange rate arrangement as a managed float. See IMF (2013a).
[86] See Epstein (2007).
[87] See Farashuddin (2008) *op. cit.*
[88] See CPD (2014) and various evaluations it has conducted on the macroeconomic performance of the Bangladesh economy.

address only a few of these, especially through monetary and credit incentives for investments.

iii. Another concern is how to bring down the lending rate. Despite a savings-investment surplus persisting in the economy for some time, and excess liquidity in the banks and non-bank financial institutions, growth of private sector credit has been stagnant during the past few quarters. Attempts to influence lending rates through targeting money aggregates (and a reduction in the repo rates) have had some impact on a reduction in the deposit rates, but little effect on the lending rates. This, together with the fact that the interest rate spread is high, is often attributed to loan defaults (and scams), but also to alleged "collusive, oligopolistic fixing of lending rates".[89] Some of these factors are linked to political and vested interests that negate the initiatives to bring financial institutions towards best-practice standards.[90] The clear call is for the BB is to step up its regulatory functions and closer supervision. For instance, as Table 10 shows, despite the BB's attempts to reinforce compliance with the Basel-II framework,[91] there is a huge variation in the Capital Adequacy Ratios (CARs) among the various groups of banks. The State-owned banks and Development Financial Institutions (DFIs) are doing particularly poorly.

Table 10. Capital to risk weighted assets ratio (per cent)

Types of Bank	2008	2009	2010	2011	2012	End of June 2013
State-Owned Commercial Banks	6.9	9.0	8.9	11.7	8.1	1.2
Development Financial Institutions	-5.3	0.4	-7.3	-4.5	-7.8	-9.0
Private Commercial Banks	11.4	12.1	10.1	11.5	11.4	11.4
Foreign Commercial Banks	24.0	28.1	15.6	21.0	20.6	20.3
Total	**10.1**	**11.6**	**9.3**	**11.4**	**10.5**	**9.1**

Source: Bangladesh Bank.

While the above depends on an individual bank's risk-management strategy and credit allocation efficiency, lessons from a closer review of such discrepancies would help draw up measures towards better standardization of rules and their compliances. In view of the high lending rates in the domestic sector, the BB has recently approved access for local enterprises to foreign borrowing on a limited scale. Apparently, this is to enhance private sector credit growth, as well as to put downward pressure on domestic rates. The latest MPS sets a target of 2.5 per cent for foreign borrowing. Caution needs to be exercised with regard to liabilities in foreign currencies (e.g. the US dollar). The economy may run the risk of a mismatch between liabilities in foreign currency and assets in local currency.[92] In the event of a sudden depreciation, this mismatch could sharply accentuate, and in some cases, lead to a currency crisis. Hence, the effects of this recent move by the BB would need to be seen and monitored in a protracted way, in relation to how the borrowing firms perform, how exchange rate fluctuations could

[89] *cf.* Islam (2012) *op. cit.* p.41.
[90] See, for example, Rashid (2012).
[91] Choudhury (2012) notes that since the introduction of the Basel II framework in 2009, there has been greater accountability and risk resilience capacity in the sector, but there is still need for closer enforcement to curb loan defaults and government interferences that impairs the risk management culture.
[92] Currently, the BB, however, fully restricts foreign-owned funds from accessing the local, short-term markets.

affect repayments and a draw on foreign reserves and whether such a step has any real impact on the lending rates.

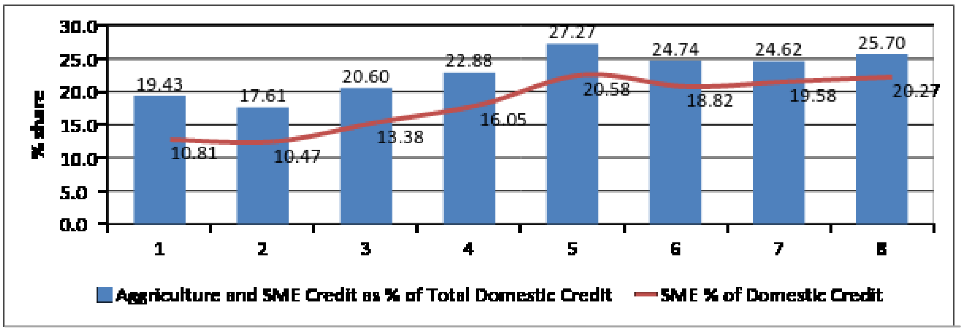
iv. Financial sector deepening will need to continue both to invigorate the financial structure as well as to facilitate growth, employment and incomes. The theme has been treated in some details in this study (see Section 5). Suffice to say, that the banking and financial institutions have served a growing economy well, and growth in such indicators as M2/GDP, M3/GDP and private-sector-credit/GDP broadly indicate a marked progress in the deepening of the financial sector. There is, however, a need for the integration of various segments of the financial system to strengthen the transmission channels and to bring about greater competition. As noted in Rahman, A. (2014), various facets of financial sector development and strengthening would include, *inter alia*: (a) increase in medium and long-term financing (such as for large/medium industrial investments and housing finances). This is closely linked to the paucity of long-term deposits and savings; (b) establishing a well-functioning "mechanism for debt-restructuring and resolution", the current absence of which is leading towards business distress, loan defaults, and higher costs of borrowing; (c) reducing the influence of political allegiances that seriously handicap BB's financial disciplining; (d) proactive enhancement of risk-management culture in financial intermediaries. A maturing financial sector would also allow a more significant role of the short-term policy rate as a channel of transmission toward stability, through its influence on real economy variables.

7.2.2 Credit to sectors and diversification

" ... BB's credit policies maintain some degree of *deliberate directional bias*, encouraging and supporting credit flows for productive purposes while discouraging credit expansion for unproductive wasteful and speculative purposes." (italics added)[93]

As part of its developmental role, the BB uses its instruments, guidance, supervisory mechanisms and moral suasion to channel credit to targeted sectors and groups that are largely unbanked or underserved. Earlier sections have provided insights into some of these initiatives. To summarize: there is a large range of activities across various sectors, sections of the population and regions of the country. Priority is given to the agricultural sector (including small farmers; sharecroppers; crop diversification initiatives), the industrial sector (mostly for SMEs; female entrepreneurship; cluster development; area/regional development), and the "green" sector. Thus, these are initiatives intended not only to extend credit and financial services to those underserved and build their productive/asset bases, but also to boost growth and diversification of sectoral output.

Figure 11. Directional credit towards agriculture and SMEs



Source: Bangladesh Bank statistics, as quoted in Rahman, A. (2014).

93 Bangladesh Bank (nd.) *op. cit.,* p.7.

The above initiatives are generally based on the BB's persuasion of all commercial banks and non-bank financial institutions to extend credit, as part of their CSR obligations, to sectors/groups according to agreed/planned targets set out in annual programmes. There is, thus, "a deliberate directional bias", as well as an indicative floor (e.g. 2.5 per cent of bank credit to be advanced to agriculture) and ceiling on interest rates. Figure 11 provides a broad picture of the extent of such directional credit.

As mentioned, it is too early to gauge, especially in the absence of objective assessments (using appropriate methodology), the nature and extent of their impact. Of course, credit extension is only one of the many factors that would affect sectoral growth and structural change, but it is an important one. However, the scale of the programmes seems to be rather small in relation to the objective, and there is a real need to intensify them. Apart from the credit expansion programmes, the BB also provides close support to various other development initiatives, such as entrepreneurship development, export development and incentives to exports (e.g. the US$1.5 billion Export Development Fund),[94] production of import-substitutable crops and support to development of low-carbon technologies.

On a broader perspective, structural change and sectoral diversification (output and employment structures) would require long drawn- out measures and budgetary allocations. While BB's initiatives are likely to provide important inputs, the broader goal would require close coordination of various ministries and agencies.[95] A different challenge to the BB can, however, come from elsewhere. Should a major drive at restructuring and infrastructure investments take place, to attain the 2021 vision of a middle-income economy, and require the government to exceed its current borrowing limits, the BB would need to review its MPS to ensure how far a fiscal space could be accommodated without driving up inflationary pressures.[96] This would require the BB to develop a carefully formulated strategic plan.

7.2.3 FI interventions for employment and income generation

As stated earlier, FI is a major initiative of the BB in support of the national strategy towards inclusive growth (detailed assessment and critique are provided in Section 6.) These are purported to generate employment and incomes to people and groups with little or no access to supervised credit and formal channels. By the same token, they would help to broaden the net of the formal financial system and bring underserved groups and regions into the financial sector. Again, the real impact of these programmes, direct and indirect, vis-à-vis the respective objectives, needs to be analysed in the future.

These are important initiatives, and are likely to generate an ethos of expanding credit extension, not only through CSR-induced programmes, but through normal banking channels as well. Some banks are already experimenting in mobile financial services (MFS). The BRAC Bank has recently launched (2011) its subsidiary, bKash, which is using the mobile banking platform to extend MFS to the unbanked population.[97] At this stage, commercial banks continue to be slow in reaching the less advantaged sectors and groups through their existing lending plans. For example, as Table 11 shows, the share of advances of all the banks to the agricultural sector constitute less than 5 per cent, and the bulk of these appears to go to more formal sector enterprises.

[94] *Cf.* MPS July-Dec 2014.
[95] This has been strongly underscored at the discussions with Ministry of Finance officials.
[96] Currently there is the Cash and Debt Management Committee that monitors monetary-fiscal coordination to contain fiscal dominance.
[97] The Bill and Melinda Gates Foundation is an investor partner of bKash. See Bangladesh Bank (2012).

Table 11. Advances of Each Group of Banks to Different Economic sectors in 2012 (%)

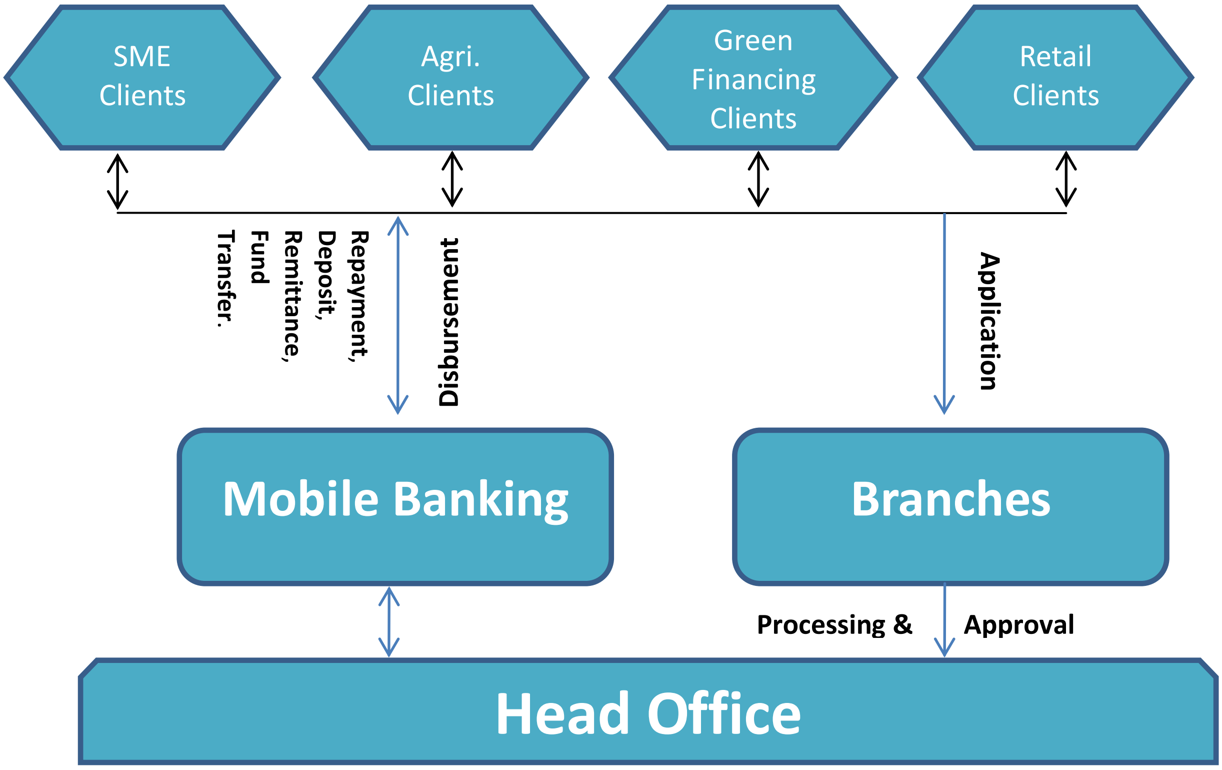
Economic sector	SOCBs	PCBs	SBs	FCBs	All Banks
1. Agriculture, Fishing & Forestry	6.31	0.95	41.61	2.08	4.85
2. Industry (Except W/C)	27.08	19.49	17.07	9.99	20.42
3. Working Capital (W/C)	9.67	14.23	9.55	22.02	13.37
4. Construction	9.53	10.01	4.42	1.58	9.09
5. Transport and Communications	0.75	2.42	2.37	6.09	2.26
6. Trade	37.26	41.68	19.64	28.91	38.60
7. Others*	9.40	11.22	5.33	29.33	11.40
Total	**100**	**100**	**100**	**100**	**100**

* Others include water, works and sanitary services, storage, and miscellaneous.

Source: Scheduled Statistics, Bangladesh Bank.

Nevertheless, it is important to note that private commercial banks are actively considering expansion of their lending to regions and groups that have hitherto been unbanked. Of course, various other considerations are at work. Private sector credit growth being low, there is excess liquidity. With too many banks competing for too few sectors/clients in urban areas, the "rural connect" is emerging as a significant avenue to diversify their lending portfolios. The critical issues for normal banking would relate to how to minimize operating and credit risks, and reduce delivery costs. In this regard, the IFIC, one of the PCBs, is in the process of evolving a strategy that would advance the "rural connect" as well as extend normal banking approaches, albeit adapted to local circumstances (see Figure 12 below).[98]

Figure 12. An FI approach to standard banking



Source: IFIC.

[98] I am grateful to the Managing Director, IFIC, for sharing his important insights and materials. It must be pointed out that the strategy is being further explored, and not yet in operation.

Further approaches, strategies and credit lines need to evolve to widen and integrate financial segments, urban and rural, formal and informal. Currently, there is a majority of bank branches (58 per cent) in rural areas, but which account for only 8 per cent of total advances.[99] The above initiatives would help to reduce such imbalances, provide increased choices on lending portfolios and credit allocation, and extend support to inclusive growth. In this regard, BB's initiatives could act as catalytic models. Further, the introduction and consolidation of automation in the banking system, mobile banking, e-banking, modernization of payment systems, regulations, guidelines and supervision are all likely to bring about greater transparency and accountability, with a reduction in costs of delivery of financial services. It would be interesting to see how the BB interfaces with, and extends support to the banks and non-bank financial institutions, to provide new intermediation initiatives between bank profitability and FI. This could potentially lead to significant developments in the banking and financial sector.

The various illustrations of the BB's multi-pronged activities, despite some limitations and constraints, are purported to demonstrate its progress to evolve into a developmental central bank, together with the potential to support the objectives of price stability, growth and employment.

8. Conclusions and recommendations

In the context of the current debate on whether central banks, especially in the developing world, should pursue a single or dual/multiple mandate, the present study has examined the BB's stance to follow the latter. These include, besides the orthodox objective of price stability, the promotion of "output, employment and real income". In recent years, the BB has widened its developmental role to play its part in the national strategy of "inclusive growth", and is trying to model itself as a developmental central bank. And, according to an ILO content-analysis study of objectives and missions of central banks, Bangladesh is cited among the very few countries where the central bank has an explicit development objective.[100]

This study has shown that Bangladesh has enjoyed a period of relative macroeconomic stability,[101] with inflation around 7 per cent. With respect to price stability, the BB is trying to bring the inflation rate down further through the credit/money channels. The study contends that BB has an "imprecise control" over price stability owing to weak transmission mechanisms. Also, its existing instruments have a limited capacity to address volatile food inflation that weighs heavily in general inflation.

In this regard, the study has reviewed the MPS of the BB and the instruments it uses to sustain price stability. As in many developing countries, the BB targets money aggregates, and, under assumptions of stable money demand, calibrates M2 growth with potential output growth. Although non-food inflation has been somewhat responsive,[102] there have been target "misses" with respect to general inflation. Moreover, current MPS has had a limited impact on the lending rates and/or real economic variables, viz. boosting investment.

The study contends that the BB has adequate reasons to engage in multiple mandates, especially in financial structure development and FI initiatives. These, apart from serving

[99] *cf.* Choudhury (2012), *op. cit.*
[100] cf. Chatani et al. (2014).
[101] IMF (2013), *op. cit.*
[102] *Ibid.*

the national strategy of social inclusion, could potentially lead to strengthening and deepening of the financial sector and, hence, support price stability. While tangible progress is observed, concerning both financial structure and FI, the study discerns a number of limitations and constraints.

Given the BB's mandates and the findings of the study, it would be necessary for it to design a middle- to long-term strategy to strengthen its existing policy stance, and to initiate policies that would allow greater play and effectiveness of its instruments. Some of the areas that the BB may need to focus on, already mentioned in the text, include *inter alia* the following.

First, a major way that the BB could give effect to its mandates of price stability, growth and employment, is through maintaining a moderate rate of inflation and a stable exchange rate. Whereas prices have been relatively moderate and stable recently, the BB is attempting to reduce them further. The critical policy consideration is to avoid being fetish about a strict adherence to low inflation targets warranting sharp contractionary monetary measures. Nevertheless, as noted previously, the existing MPS (especially the use of the credit channel), is likely to be challenged if the economy were to follow the predicted growth path to Vision 2021. Greater opening up of the economy and future financial liberalization would require the BB to enforce greater integration of financial market segments and market resilience to avoid disruptions in price and exchange rate stability. The strategy would require more attention to strengthening and accommodation of the increasing importance of the policy rate and exchange rate channels.

Second, given the weaknesses in the transmission mechanisms, the BB has been articulating its policies and programmes to strengthen and integrate financial markets, and the regulatory/supervisory framework for greater competition and effectiveness of policy rates. Lending rates need to come down appreciably. Major anomalies still remain, as evident from the comparative performance and risk-management indicators of the four groups of banks. The BB could undertake a closer scrutiny and review of this for a better enforcement of its regulations. Further measures need to be designed to achieve improved outcomes in the current implementation of the Basel II framework, and to curb any non-competitive behaviour in the sector.

Third, the study observed that, while financial deepening is progressing commensurate with the economy's needs, integration of segments of the financial market require additional measures. These would include, apart from standardization and enforcement of regulations, strategies and instruments towards mobilization of longer-term savings and investment. Further, a well-functioning financial sector would require not only increasing the size of the sector, but also developing secondary markets for securities that would control interbank rates (and transactions).[103]

Fourth, the study has noted some of the novel FI programmes purported to extend credit and financial services to the underserved population/groups (poor farmers, sharecroppers, SMEs, women, green technology), drawing upon the CSR-induced lending programmes of commercial banks. These are "directed" credit lending, subsidized and supported by the BB's refinancing schemes. Though well-intended, there needs to be a review to assess the real employment/effects of the FI initiatives, and their sustainability. Such a review would also enable the BB and its partner organizations to seek alternative measures to scale up programmes (other than through BB's refinancing support) and to

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[103] The interbank rate is "*assumed to influence aggregate demand through the transmission mechanism and thus to affect the central bank's ultimate objective(s) typically, price stability and/or full employment*", Mishra *et al.* (2010) p. 5-6.

enhance the capacity needed to meet the objectives tangibly. The BB would also need to design an overall *strategy and guidelines on its FI programmes*: currently, as some analysts note, credit extension is, to some degree, ad hoc. Furthermore, closer coordination with relevant line ministries and agencies would be needed for potential *mainstreaming* of these initiatives.

Fifth, the study argues that these initiatives, and the much-needed "rural connect" in the financial system, could be boosted through penetration of normal commercial banking, using innovative strategies, products and credit portfolios that would reduce risks and costs. Here, the significance is the catalytic nature of the FI programmes. These could be scaled up if the commercial institutions enhanced their CSR-induced credit programmes, and/or extended normal banking operations for the above initiatives. This would imply the penetration of the financial system beyond the directed programmes. Some of the commercial banks are already engaged in exploring such strategies. The BB could continue to encourage and buttress such a process through its FIs and various efforts in their implementation and extension. Further strengthening and support to mobile banking, automations in payment systems, agent banking, and designing of confidence-building regulations and guidelines could act as an important catalyst towards standardizing commercial banking across the country, rural or urban.

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Mr Fahimul Islam, Dy Secretary, Ministry of Industries

Mr K.O. Rahman, Jt Secretary, Ministry of Agriculture

Mr K.Mostan Hossain, Jt Secretary, Ministry of Labour

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Mr Nurul Amin, Managing Director and CEO, Meghna Bank Ltd

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[104] These persons were consulted during the course of a two-week mission to Dhaka undertaken by the author in July 2014. He is grateful to Dr Habibur Rahman (Bangladesh Bank) and Mr Shahabuddin Khan and Ms Banoshree Biswas (ILO) for facilitating the programme of meetings.

[105] The author also had a roundtable meeting with General Managers and heads/senior staff of SME &SPD; Monetary Policy Dept; Green Banking & CSR, Agriculture; Debt Management Dept. etc.

[106] The author is grateful to the DG and Director of BIBM for organizing an informal roundtable meeting in which 17 members of the staff, including two former Governors of Bangladesh Bank, participated.

Mr Shah A. Sarwar, Managing Director and CEO, IFIC Bank

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Workers' Group

Mr Zafrul Hasan, Chairperson, National Coordination Council for Workers Education (NCCWE)

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