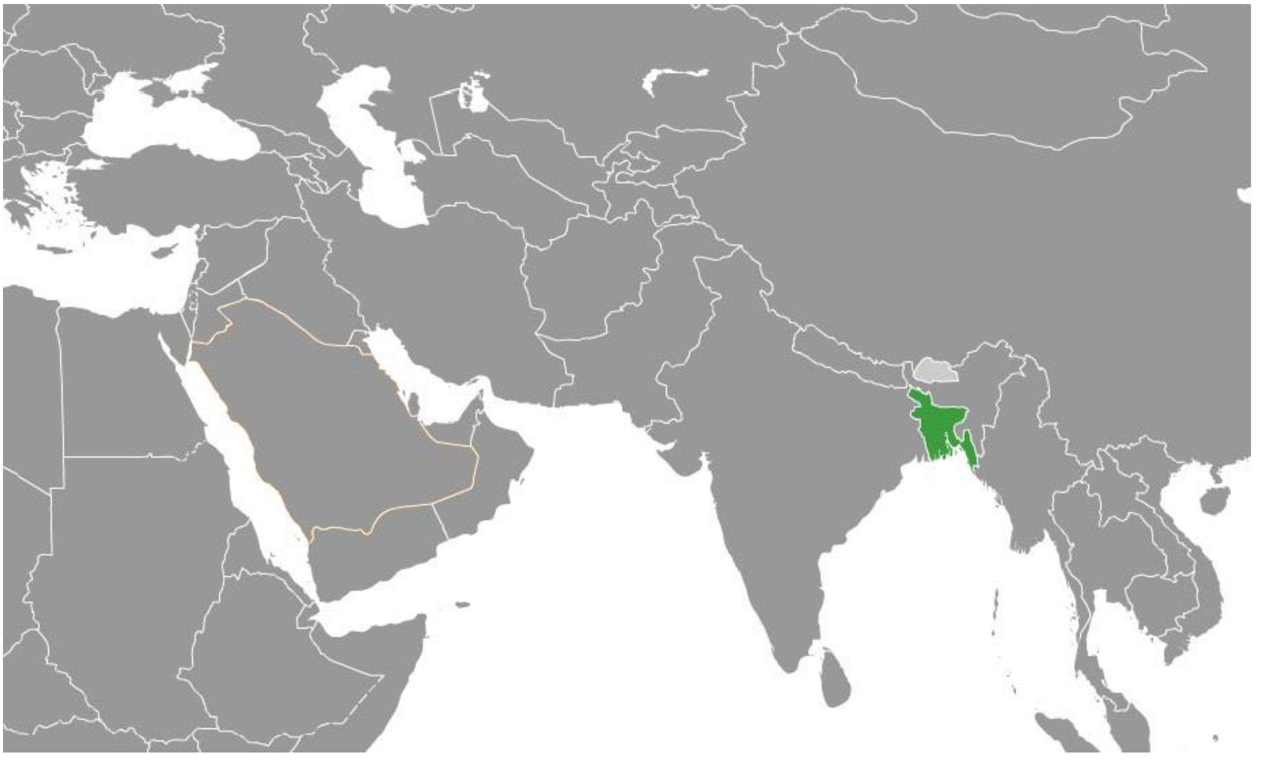

Monetary Policy Update

H1 FY19

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Policy Stance	June 2019
Inflation Projection	**5.40%-5.80%**
Repo Rate	**6.0%**
Reverse Repo Rate	**4.75%**
Broad Money (M2) Growth	**12.0%**
Reserve Money (RM) Growth	**7.0%**
Domestic Credit Growth	**15.90%**
Public Sector Credit Growth	**8.50%**
Private Sector Credit Growth	**16.80%**
CRR	**5.50%**
SLR	**18.50%**

Source: Bangladesh Bank

Policy Highlights

- BB projects GDP growth of 7.50%-7.70% in FY19, against the government's target of 7.80%. Provisional GDP for FY18 stands at 7.65% against target of 7.40%.
- Inflation projections have been slightly reduced to 5.40%-5.80% from previous level of 5.70%-6.0% due to expectations that one-time weather related supply shocks will dissipate.
- Repo rates were reduced from 6.75% to 6.0% with effect from April 15, 2018 due to a liquidity crisis in the financial sector. The MPS keeps repo and reverse repo rates unchanged at 6.0% and 4.75% respectively.
- The CRR was cut by 1 percentage point in April 15, 2018 from 6.50% to 5.50%. The CRR and SLR are kept unchanged at 5.50% and 18.50% respectively.
- Projections for Broad Money (M2) and Reserve Money (RM) growth have been reduced from 13.30% to 12.0% and from 12.0% to 7.0% respectively. The large current account deficit is expected to reduce growth in Net Foreign Assets (NFA), which will exert a negative effect on domestic money supply.
- Domestic credit growth projection has increased slightly from 15.80% to 15.90%. Public sector credit growth projection has been slightly raised from 8.30% to 8.50% while private sector credit growth is left unchanged at 16.80%

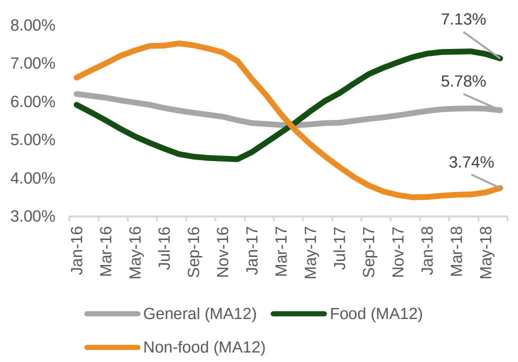
Key Observations

The H1FY19 Monetary Policy Statement (MPS) covers the period when general elections are expected to take place at the end of 2018. Election times in Bangladesh usually come with an expectation of increased inflation, heightened political risks and increased money laundering. Bangladesh is already facing a massive current account deficit, which reached USD 9.4 billion in the July-May period of FY18, equal to 3.3% of GDP. Allegations exist that part of the deficit is caused by over-invoicing imports to launder money abroad. As a result of the deficit, NFA growth has reached -4.3% in June 2018, placing pressure on domestic liquidity conditions. The current account deficit has already led to the BDT depreciating by 4% against the USD in 2018, and there is a high possibility of further depreciation as the current account deficit continues to widen. Addressing the risk of inflation and the spiralling current account deficit will be the main challenges for the central bank going forward.

Global economic growth has also shifted into high gear, which is expected to boost the price of oil and other commodities, which might lead to increased non-food inflation. At the same time, rising risk-free rates in the US amid higher trade-related tensions and an appreciating USD might lead to a reversal of capital flows from emerging markets. This will create even further pressure on the BDT as foreign investors withdraw their portfolio investments.

This MPS takes a conservative approach to address the risks facing the Bangladesh economy going forward. The broad money and reserve money growth targets have been revised downward, which will help restrain inflation, while credit growth rates remain unchanged. The BB will continue to resort to intensive and intrusive supervision to ensure that credit flows to priority sectors, which will help address concerns of money laundering through over-invoicing imports. The previously implemented cut in the CRR and repo rate are expected to help achieve domestic credit growth targets. Increased exchange rate flexibility is expected to lead to a depreciation of the BDT, which will help boost exports and remittances and restrain imports, stemming the current account deficit.

Chart: Inflation

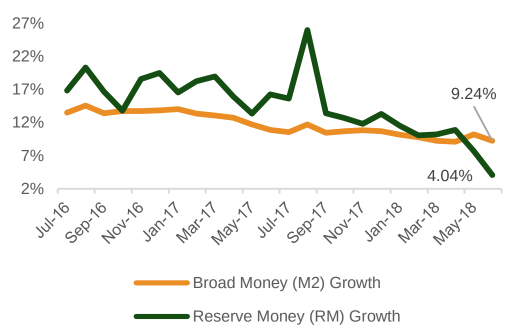


Source: Bangladesh Bank

Inflation Outlook

Inflation saw a sharp rise from January 2017 due to supply shock created by floods in the northern regions of the country. The government moved to import rice from the international market, and subsequent harvests have resulted in food inflation gradually coming down again. 12 month average food inflation reached 7.13% in June 2018, down from 7.31% in March 2018. Non-food inflation, on the other hand, witnessed a declining trend since the last quarter of 2016, falling from 7.53% in August 2016 to a low of 3.50% in December 2017 before rising to 3.74% in June 2018. 12 month average inflation rose from 5.38% in April 2017 to a high of 5.83% in April 2018, before abating to 5.78% in June 2018, which was higher than the 5.50% target for FY18. Greater oil and commodity prices on the international markets are expected to lead to greater non-food inflation going forward.

Chart: Growth of Reserve and Broad Money

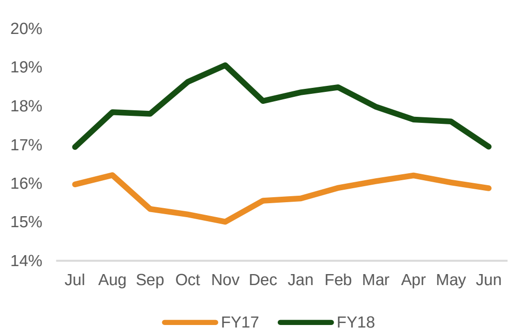


Source: Bangladesh Bank

Broad Money (M2) and Reserve Money (RM) Outlook

Broad money and reserve money growth stood at 9.20% and 4.0% in June 2018 against MPS target of 13.30% and 12.0% respectively. The main reason was negative 4.2% growth in Net Foreign Assets (NFA) due to the sharp increase in the current account deficit. The latest MPS has reduced targets for M2 and RM growth to 12.0% and 7.0% respectively. The reduction in M2 and RM growth targets will help to restrain inflation, but are expected to lead to heightened interest rates. Increased sales of National Savings Certificates (NSCs) have also led to M2 growth declining, as NSC stock is not reflected in the M2 aggregate while bank deposits are.

Chart: Pvt. Sector Credit Growth (%)

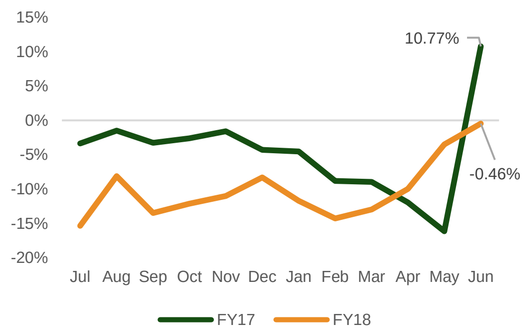


Source: Bangladesh Bank

Private Sector Credit Growth Target Unchanged

The FY18 period saw significantly increased private sector credit growth compared to FY17, as an uptick in investment climate led banks to race to lend. As a result, excess liquidity in the banking system reduced to very low levels. However, after the revision of the Advance-Deposit Ratio (ADR) from 85% to 83.5% at the end of January, banks have cut back their lending activities leading to a decline in private sector credit growth rates from a high of 19.06% in November 2017 to a rate of 16.95% in June 2018. This was still higher than the target of 16.80% set in the H2FY18 MPS. The target is kept unchanged in this MPS for December 2018 and June 2019. Going forward, lower M2 growth is expected to lead to higher interest rates and lower private sector credit growth. Greater BB monitoring is also expected restrain lending activities of banks.

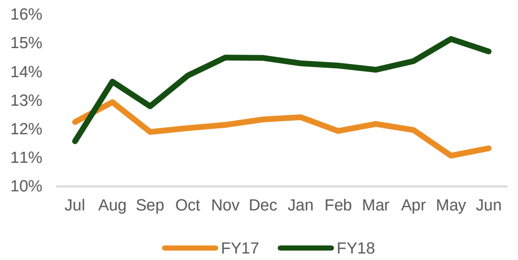
Chart: Public Sector Credit Growth (%)



Public Sector Credit Growth slightly increased

Credit to public sector has been on a continuous declining trend since Feb'15 owing to reliance on borrowing through National Savings Certificates (NSCs). Growth in credit to public sector stood at -2.5% in June 2018. This was well below the previous MPS target of 8.3%. The current MPS has raised the target slightly to 8.5%. The government has set an ambitious bank borrowing target of BDT 420.29 billion in the FY19 budget. If this target is fully realized, public sector credit growth will stand at 36.80% in June 2019. This highly ambitious target is unlikely to be met. However, greater bank borrowing by the government will likely lead to higher interest rates amid a restrictive monetary situation.

Chart: Total Domestic Credit Growth (%)

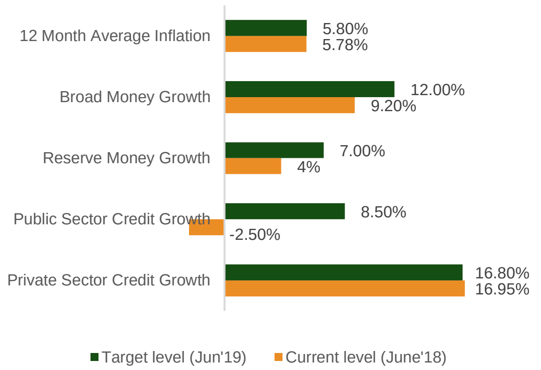


Source: Bangladesh Bank

Domestic Credit Growth target slightly increased

Total Domestic Credit growth registered 14.6% growth in June 2018 against the MPS target of 15.80%. Negative growth in credit to public sector offset higher than programmed growth in credit to private sector. The current MPS has slightly increased the target to 15.90%. This target will be achieved if growth of credit to public and private sectors proceed as programmed. Whether or not the target is reached depends on government's choice of borrowing from banks and non-banking sources (which mainly include NSCs).

Chart: Current Status vs June'19 Targets

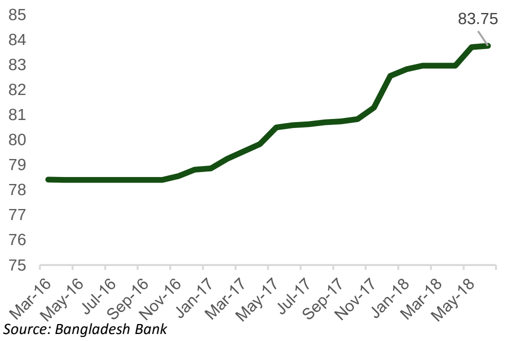


Source: Bangladesh Bank

Policy Rates unchanged

Bangladesh Bank cut the Cash Reserve Ratio (CRR) from 6.5% to 5.5% with effect from 15 April 2018. At the same time, repo rate was cut from 6.75% to 6.0%. These measures were taken in order to address the liquidity crunch caused by the earlier reduction of the Advance-Deposit Ratio (ADR) from 85% to 83.5%. The current MPS keeps those rates unchanged. The moves of restricting the ADR and lowering of CRR and repo rates moved monetary policy in opposite directions. Bangladesh Bank is likely to keep interest rates and liquidity situation under monitoring and intervene with interest rate instruments for overall demand management as needed.

Chart: Exchange rate (BDT/USD)



Source: Bangladesh Bank

Exchange Rate Outlook

The BDT depreciated by 4% in FY18, from a level of 80.6 in June 2017 to 83.75 in June 2018. The spiralling current account deficit shows no sign of slowing and the MPS indicates that Bangladesh Bank will increase foreign exchange flexibility to manage external stability. Since a large current account deficit exists at present, increased flexibility will mean further depreciation of the BDT. A weaker BDT will then lead to higher exports and remittances on one hand and lower imports, which might bring the current account deficit under control.

Table: External Sector

Indicator	FY14	FY15	FY16	FY17	FY18*
Export Growth Rate	11.70%	3.40%	9.80%	1.70%	-3.09%
Import Growth Rate	8.90%	0.20%	6.00%	8.70%	25.50%
Remittance Growth Rate	-1.60%	7.70%	-2.50%	-14.40%	13.74%
Current Account Balance (USD mn)	1,406	2,875	4,382	-1,480	-9,379

* - Latest available figures, Source: Bangladesh Bank

External Sector

The current account deficit was USD 1,480 million in FY17. In FY18, the deficit widened each month, until it stood at USD 9,379 million in May 2018, equal to 3.3% of GDP. This is the highest deficit ever recorded in the history of the Bangladesh economy. This deficit was caused mainly due to high import growth due to the undertaking of a large number of infrastructural projects, increased food grain imports due to floods and increased capital machinery imports. Allegations exist that a large amount of money has been laundered abroad under the guise of capital machinery imports, by over-invoicing imports. Export growth has remained restrained due to factory remediation work and relocation of leather industries. Remittances also fell in FY17 due to fall in oil price affecting the economic conditions in the Middle Eastern countries which are the source for most remittances received in Bangladesh. The current account deficit makes it very likely that the BDT will depreciate in the near future, which might boost exports and remittances while restraining import growth. However, it will cause inflation to increase as non-food inflation will increase due to increased fuel costs. The introduction of imported LNG to the country's gas supply network will negatively affect the current account balance as the LNG will have to be paid in dollars.

In contrast to the current account balance, the financial account registered a positive balance of USD 8,190 mn reflecting foreign investments in the country. The capital account registered a surplus of USD 301 mn, for an overall balance of payments (BoP) deficit of USD 691 million.

NSC rates need to be market-linked for increased financial efficiency

The high risk-free rates of National Savings Certificates (NSCs) remain an important barrier to monetary transmission mechanism efficiency, which are required for interest and foreign exchange rate flexibility. The higher rates offered by NSCs continue to attract depositors, depriving the financial system of much required deposits. On the other hand, the increased cost of borrowing of NSCs over that of bank borrowing also increases the interest rate expense of the national budget. The MPS mentions that introduction of market-rate-linked pricing of NSC rates is required for effective monetary policy implementation. However, the decision to revise NSC rates lie with the government, which faces significant opposition in cutting NSC rates. Keeping the elections in mind, it is unlikely that the government will move to cut NSC rates until the next government is in power.

Greater monitoring stressed

The MPS focuses on intensive and intrusive inspection and risk-based supervision of banks by the central bank in order to ensure that credit flows reach the intended productive sectors and also to improve internal risk management and capacity to evaluative and monitor loan projects. The MPS stresses information sharing among banks to help reduce concentration risks in the portfolio fo individual banks and the banking system as a whole.

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