Review

Burning Monetary Policy Issues of Bangladesh: An Empirical Analysis

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Abstract: *Following the Monetary Conditions Index (MCI), Bangladesh's monetary policy is moving through continuous balancing between interest rate and exchange rate to address the GDP and inflation in a pragmatic manner. Considering the diagnostic tool, the recent oversubscription in government treasury bills and bonds of different tenure reveals that although banks liquidity condition is tight with higher call money rate but due to magnetizing Currency in circulation (CIC)in the government securities auction the individuals' noncompetitive bid or weighted average rate (WAR) is crucial. As a result, Bangladesh Bank (BB) has recently increased the policy rate in the interest rate targeting monetary policy regime, depending on the optimum CIC. At the same time, to mitigate the business loss arising from higher lending rates related to policy rate, the government is trying to compensate through judicious devaluation of Taka, enhancing export and wage earners remittances against import and other current account outflow of balance of payment (BOP), for instance, under crawling peg system. Underlying the mentioned root cause the theoretical money demand function and monetary and fiscal policy, different school of thought on inflation-output adjustment considering demand and supply, sectoral interactions of Bangladesh economy, monetary and conventional financial sector recent issues and Islamic banking in brief in terms of financial stability through monetary policy are shaded in this paper. To ensure financial stability with lower inflation, considering the current lower foreign exchange reserves policy mix, the government's borrowing from the banking system for deficit budget financing needs to be lowered as expected revenue collection is not enough.*

Keywords: Price level, Demand for money, Interest rate**,** Money supply (M2), Monetary policy, Central bank, Exchange rate.

JEL classification: E31, E41, E43, E51, E52, E58 and F31.

1. Introduction

The total liquid assets of banks comprise cash in tills plus balance with Sonali Bank, plus local currency and foreign currency balance with BB, plus unencumbered approved securities minus CRR and SLR. As a burning issue, the provisional total liquid asset of banks at the end of July 2024 was Tk.4570.83 billion compared Tk.4744.43 billion of June 2024, resulting in liquidity tightening. CIC was Tk.3159.00 billion at the end of July 2024, which was Tk.3203.09 billion at the end of June 2024, according to the Major Economic Indicators of BB, August 2024. The lowering amount of CIC by the individuals play a role in subscription in the government treasury bills and bonds auction, as a significant amount of noncompetitive bids asking WAR for paying against the discounted and coupon rate. In order to lower the CIC and improve banks' liquidity, the ongoing policy rate hike is playing a significant role in reducing inflation. In this regard, to

minimize the investment cost arising from higher lending rates is compensated through the devaluation of Taka under the crawling peg system boosts export and expatriate remittances following MCI. Therefore, underlying factors of the money demand function and monetary and fiscal policy, classical/neo-classical/ Keynesian aggregate demand and supply relating to inflation and output, sectoral interactions of the Bangladesh economy, monetary and conventional and Islamic banking, and financial recent consequences can be dealt with. Noted that Canonical New Keynesian Dynamic (NK) Stochastic General Equilibrium (DSGE) Model apart from Real Business Cycle (RBC) with shocks (technology), the NK model basically addressing friction deals with three equations termed as 1) IS curve (demand side) pointing inter temporal elasticity of substitution depending on higher or lower sigma (in inverse form) derived from equation (lower sigma has strong effect), amplify consumption and interest rate adjustment by the individuals related to Euler equation and shocks of disposable income and consumption patterns and stickiness of output gap and interest rate as well, 2) the Philips curve shed light for supply side and here mainly higher value of Kappa (constant) relates to strong adjustment of prices taking care of change in output gap considering stickiness of prices and 3) Taylor rule representing monetary policy changing nominal interest rate considering change in expected inflation and deviation in output gap. Moreover, systems of equations related to household, firms and central bank, calibration with stability incorporating Bayesian essence (prior, even and posterior), steady state of observed parameters and impulse response of the desired control variables, dynamic out sample forecast and scenario analysis modifying parameters considering actual and expected inflation deviation and output gap trend and cycles are the agenda of this theoretical model. Consequently, the inflation parameter is more prominent in terms of interest rate change (1.5) comparing treatment of output gap interest rate (0.5) based on Fed rate for counter cyclical measures matching the moments and standard deviation of the real data of inflation deviation and output gap and estimation of equations of the benchmark model as well. Considering the transmission mechanism, a central bank change in interest rate impacts the IS curve (demand) and Phillips's curve (supply) equations in the case of the short run, as money is neutral in the long run. Allowing for the friction of variables in the system of equations, in reality, it is hard to estimate the exact coefficients in relation to a dependent variable, for instance, like the scientific separation of oxygen from air. Bearing in mind parametric and nonparametric (Data Envelopment Analysis) issues related to monetary policy, the financial ratios, indicators and economic consequences are analyzed meticulously, considering the pace of automation and the environment for maintaining the ecosystem. Finally, for example, the NK DSGE Model is mentioned as canonical, resulting in the fundamental analysis conducted in this paper that bears due importance considering reality.

Literature review, methodology, underlying factors of money demand function and monetary and fiscal policy, classical/neo classical/ Keynesian aggregate demand and supply relating to inflation and output adjustment, monetary and conventional financial sector recent issues, Islamic banking, results, discussion and conclusion are elaborated in the next.

2. Literature Review

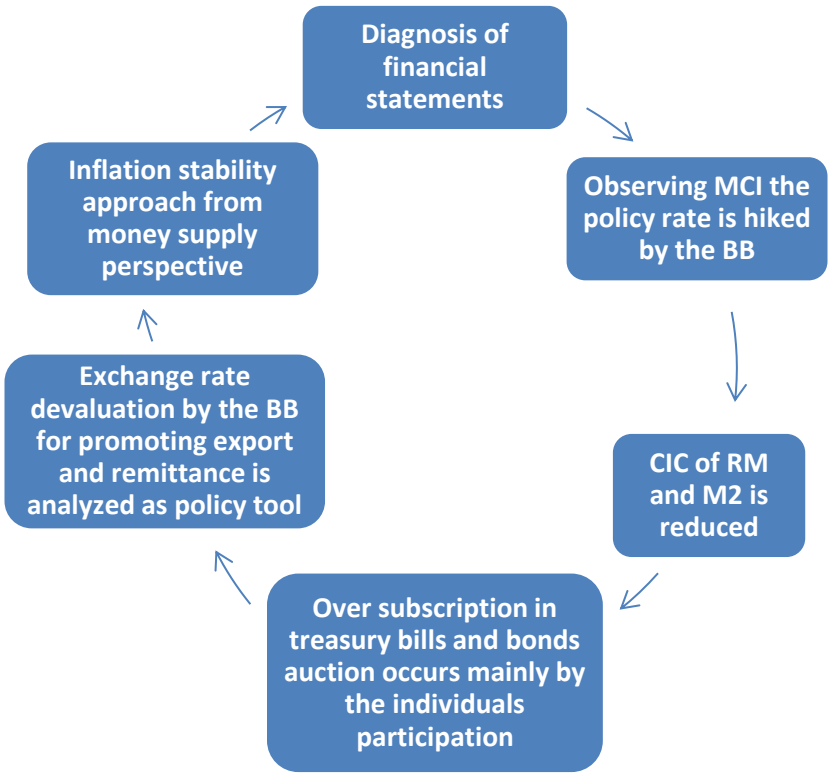
Alam (2015) quantitatively analyzed monetary policy effectiveness in Bangladesh using vector auto regression models while imposing different restrictions. The paper infers that an exogenous increase in the T-bill rate is followed by a fall in output, a rise in the price level, and appreciation of the exchange rate, and the statistical insignificance of the impacts implies that in Bangladesh,

monetary policy is not effective in controlling short-run economic fluctuations. Chowdhury and Afzal (2015) argue that in relation to the effectiveness of fiscal and monetary policy, Keynesian and monetarist theorists have been debating for a long time. None of the policies can be thought of as superior to the other based on the outcomes of several empirical studies, which is open to further studies. Chowdhury et al. (1995) advocate that Bangladesh's monetary policy should be carried out with extreme caution. He suggests that tight money may put a short-term halt to inflation, stabilizing the foreign sector, causing a slowdown of the economy of Bangladesh. Hossain's (2015) paper provides an overview and examines the key issues in rule-based monetary policy for price stability, implying low and stable inflation, in this country, considering the trends and movements of CPI-inflation. Abdullah et al. (2012) pointed out that to control inflation, there are a number of methods. Central banks, through setting interest rates and through other operations, can affect inflation to a significant extent. To prevent inflation, high interest rates and slow growth of the money supply are the traditional ways through which central banks fight, though they have different approaches. Hossain and Ibon (2020) suggested that monetary policy appears to be less effective in Bangladesh, mainly due to structural weakness of the financial system and lack of dynamic adjustment of policy rates. Hossain (2003) argues that in the absence of flexibility in interest and exchange rates, under monetary targeting, originating from domestic real and external shocks, there could be an in-built instability in inflation. Hoque et al. (2020) reveal that monetary policy is the policy by which a country controls supplies of money in an economy announced by the central bank for every six months. The Central Bank uses cash reserve ratio, open market operations and bank rate to control the availability of funds in an economy. The cash reserve ratio is directly linked to the commercial bank's profitability, among others, considering these three instruments of the central bank. The research gap and objective of the study is to ensure financial stability with lower inflation, considering the current lower foreign exchange reserves policy mix, which involves borrowing from the banking system by the government, and the deficit budget financing needs to be lowered, as expected revenue collection is not enough (Bazaluk et al., 2024; Zayed, 2018).

3. Methodology

Central bank burning operational financial statements in relation to monetary policy interaction is diagnosed in this paper as a tool. Fundamental and technical analysis of the BB policy matters is deployed to address the realistic outcome. The policy interactions with theoretical and pragmatic perspectives in terms of qualitative and quantitative analysis are examined empirically to form better rationality by the stakeholders. Root cause identifying attempt in brief to balance the policy rate and interest rate crucially received momentum in this article with due diligence. Figure 1shows the research framework.

Figure 1: Research Framework



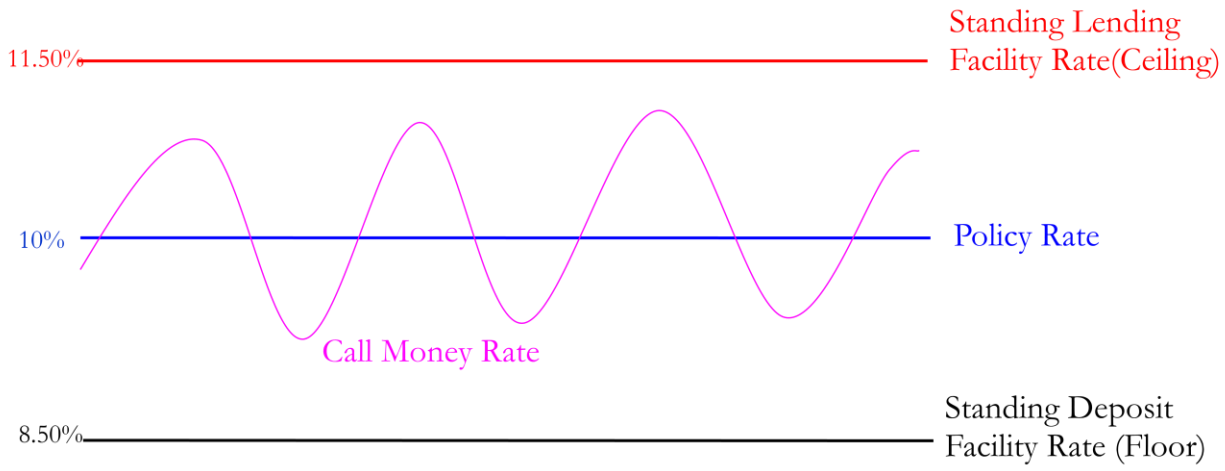
Source: Author's Compilation.

4. Underlying Factors of the Money Demand Function, Monetary and Fiscal Policy

Considering the evolution of the money demand function includes CIC, following classical economic thought, Fisher's equation deals with transaction demand for money and precautionary demand for money, addressing the Cambridge equation as well. The monetarist approach to inflation is the arena of Friedman, which consequently receives momentum addressing speculative demand for money (increased holding of treasury bills and bonds by individuals)in terms of interest rate by the Keynesian economist. Broadly, these doctrines reflect in the money demand function of the Bangladesh economy arising from real GDP growth, inflation and average percentage change in income velocity of money supported by the fiscal frontier accommodating two arms of the economy. Relatively open economy agenda of Mundell Flemming, taking into account the crawling peg exchange rate system, which is currently being followed by BB, can be fully operational, accommodating the demand and supply issues of the neoclassical approach. However, among others, government subsidy and incentives supplies liquidity to the economy, impacting demand. In this regard, imprudent expansionary policy augments liquidity to the banking system, which eventually may need to park in the central bank at their cost. Excessive borrowing from ways and means and overdraft account of BB by the government due to lower revenue collection may cause inflation. Accordingly, the central bank and government balance is required for maintaining banks' liquidity, and the CIC impacts the interest rate and exchange rate. Classical economics approach assumptions and limitations are- full employment, the invisible hand and the long run. Here, features are: a) Say's (1803) law that is, supply creates its own demand. b) Wage price flexibility model- wage cuts reduce the cost of

production and lower price increases output with full employment. c) Interest rate flexibility model balancing saving equal investment and goods market equilibrium, and d) Money market equilibrium dealing with quantity theory of money, Fisher's equation, Cambridge equation and Friedman monetarist approach. This is the case of our fundamental monetary policy. Keynesian economics approach assumptions and limitations are- short run, perfect competition, resource constraint and closed economy. The aggregate demand (AD) and aggregate supply (AS) are derived by summing individuals' need. AD is the maximum amount that individuals are ready to pay. AS is the minimum amount the producers are expecting. Here, the government has a role in impacting the AD. Effective demand matching AD and AS occurs before the full employment level, as among others, wage and inflation adjustments are not instantaneous, that is, 1 to 1. The country's fiscal policy derives from the Keynesian approach, and it introduces the interest rate with speculative demand for money in relation to the investment multiplier (1/1-MPC) times I (investment).Both mentioned brief monetary (BB) and fiscal policy (government) are used for creating and reducing demand, addressing consumption (C), investment (I) and government expenditure (G) in terms of output, income and employment of Bangladesh. Considering n number of variables, the call money rate can be anchored, addressing liquidity demand broadly for balancing interest rate, exchange rate, inflation and GDP. In this regard, Figure 2 shows the interest rate corridor under interest targeting monetary policy.

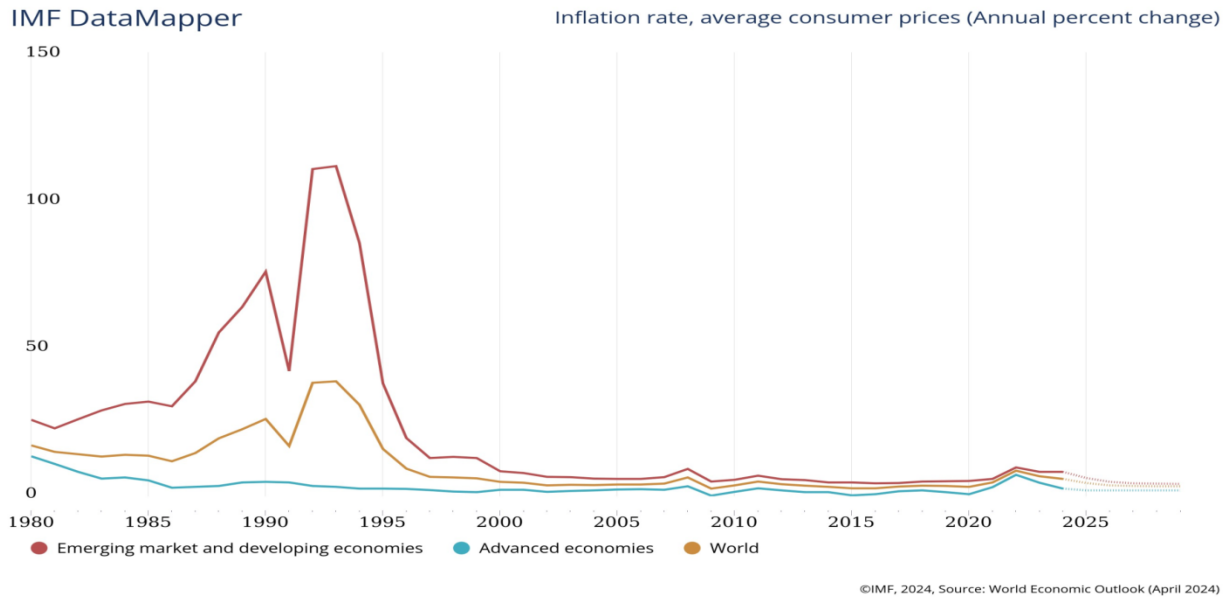
Figure 2: Interest Rate Corridor



Source: Author's Compilation.

Before proceeding with domestic monetary policy, we need to consider the global development, especially taking care of inflation (Figure 3).

Figure 3: Inflation Rate, Average Consumer Prices (Annual Percent Change)

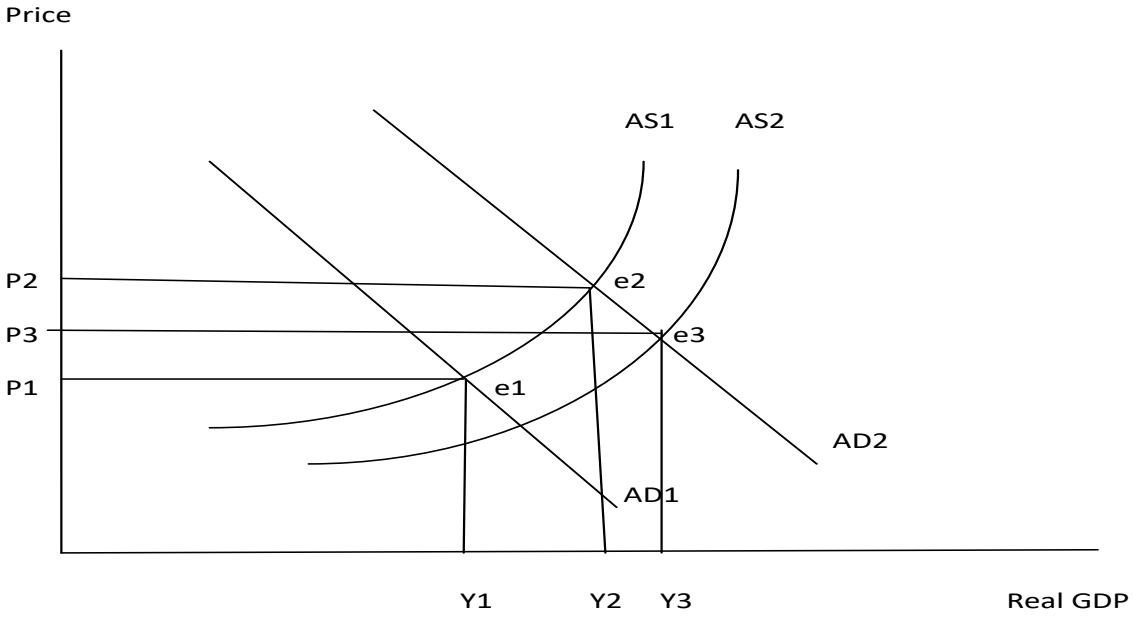


Source: World Economic Outlook (2024).

5. Classical/Neo-Classical/ Keynesian Aggregate Demand and Supply Relating to Inflation and Output Adjustment

Inflation is basically the outcome of a supply shortage of goods, a drawback, an imprudent money supply and inflation expectation. Here, we will briefly analyze the crucial factor of inflation expectation and its adjustment in different economic cases. In classical economics rise in inflation expectation and labor wage rate is instantaneously adjusted with 1 to 1 relation, showing P1 price level and Y1 real GDP (Figure 4). Keynesian economic adjustment between price hike and wage rate is 0 with P2 price and Y2 output. While in the case of neoclassical or general Keynesian economic approach, the adjustment between expected inflation and labor wage rate is moderate (0 to 1) with P3 price level and the highest real GDP (Y3), which provides policy insight regarding inflation and output (Figure 4) adjustment. This is the case of neoclassical or general Keynesian, which the Bangladesh economy is experiencing, relating to the incremental capital output ratio (ICOR) and the concept of utility maximization and marginalism, requiring more investment for double-digit GDP growth and containing inflation at a required level.

Figure 4: AS-AD Curve



Source: Author's Derivation.

6. Sectoral Interactions of the Bangladesh Economy

Balance among real, fiscal, monetary and external sectors and a couple of years' projection (Table 6 - Appendix) acts as a pivotal element for economic growth and development of the country. In sectoral interactions, the BOP overall surplus increases the foreign exchange reserves, impacting reserve money (RM) and broad money (M2) net foreign assets (NFA) with proper money supply in the private and public sector (fiscal side), enhancing output of the real sector in a particular direction. However, assuming contemporary stability in the agriculture sector, shock is prominent in the service and industry sectors, arising from higher lending rates related to policy rate and other domestic and global factors, in order to lower the inflation of the country. Shock in the service and industry sector may lower the real GDP growth, taking into account the alternative scenarios of monetary tightening. Considering ICOR, the increased investment may contribute to higher growth, containing inflation. Moreover, higher net present value (NPV) and internal rate of return (IRR) of the financial and social projects will contribute to rapid poverty alleviation with needed infrastructure.

7. Monetary and conventional Financial Sector Recent Issues

To reduce the CIC (Tk.3203.09 billion of end June 2024 to Tk.3159.00 billion at the end of July 2024) at moderate level with policy rate hike (9% effective from 27 August, 2024 to 9.50%effective from 25 September, 2024) justifying to identify the root cause of monetary and financial consequences of increase of noncompetitive bids by the individuals in the treasury bills and bonds auction (Table 1 and 2) as well taking into account liquidity crunch of banks reflected

in the call money rate (Table 3) as a monetary policy operating target (Table 3) guiding principle of policy rate (Table 4) and exchange rate (Table 5) broadly in crawling peg system.

Table 1: Auction of 91-Day Government Treasury Bill as on 4 August, 2024

Notified amount	Received amount	Noncompetitive bid (WAR) amount	WAR rate	Cutoff rate
Tk.40.00 billion Accepted amount Tk.54.40 billon	Tk.99.47 billion	Tk.9.74 billion	11.5917%	11.6001%

Source: Monetary Policy Department, Bangladesh Bank (BB)

Table 2: Auction of 2-Year Government Treasury Bond as on 6 August, 2024

Notified amount	Received amount	Noncompetitive bid (WAR) amount	WAR rate	Coupon rate
Tk.35.00 billion Accepted amount Tk.35.00 billon	Tk.76.13 billion	Tk.15.79 billion	12.5917%	12.2379%

Source: Monetary Policy Department, BB

Table 3: Call Money Rate

4 August, 2024	End June	End July
8.72%	9.01%	8.78%

Source: Monetary Policy Department, BB

Table 4: BB Interest Rate as on 4August, 2024

Policy rate (Repo rate)	Standing Deposit Facility	Standing Lending Facility
8.50%	10.00%	7.00%

Source: Monetary Policy Department, BB

Table 5: BAFEDA and BB US Dollar Price in Taka

End June	End July	Surge in mid-rate by BB as on May 08, 2024
Tk. 118	Tk. 118	From Tk. 110 to Tk. 117

Source: Monetary Policy Department, BB

In order to better shield the interest of depositors treated as the prime concern of banks, better liquidity management with CIC and Taka rate against the US dollar, the capital adequacy against risk-weighted assets, for example, needs to be strictly maintained. Provisioning of assets against classified loans considered as capital adequacy, can be dealt with prudently in terms of forbearance. The moratorium issue is also crucial to protect the depositors' interest and the clean balance sheet of banks. Distressed loans (nonperforming loans, rescheduled loans, restructured

write-offs) impact the duration gap in terms of assets and liabilities, compelling banks to raise capital from the owner and capital market, issuing bonds and shares bearing risk and timing. In case of loan classification, international best practice, overdue term loan, on top of 90 days, reducing from 180 days can be observed meticulously. Proper collateral valuation against an asset-backed loan can be rightly observed following the Basel accord. At the same time, Risk Based Supervision (RBS) and International Financial Reporting Standards (IFRS) 9 for public companies' financial transparency can gain momentum. BB's moral suasion matters like investment of foreign currency from the gross international reserve (GIR) to international Islamic Trade Finance Corporation (ITFC) syndication and utilization of funds by the Bangladesh Petroleum Corporation (BPC) may impact the net international reserve (NIR), prompting unsecured exposure. Digitization through core banking software (CBS) is needed to extend all the sectors, including trade financing, by banks as an example. To enhance adaptation relating to climate change, green financing plays a significant role. Through inclusive and sustainable finance, a multi-dimensional agenda can be dealt with.

8. Islamic Banking

Islamic banking modes of finance: a. Partnership taking care of musharakah along with mudarabah and al-wadiah, b.Trade/sale (bai-murabah, bai-muajjal, bai-salam, bai-istasna), c. Ijarah/lease (hire-purchase, hire-purchase under shirkatulmelk, sukuk) and corjehasana are done considering efficient uses of goods and services, bearing in mind morality and profit-share ratio (PSR) for optimum inflation and real GDP, ignoring conventional intrinsic value and speculative demand of money and balancing liquidity, CIC and exchange rate. In a broader spectrum, Islamic insurance or takaful (family, institutional, micro, general) and shariah-basedcapital market is addressed with due diligence. Islamic banking prohibits interest (riba), gambling (maysir) and uncertainty (gharar), comprising the Islamic financial system for all. Like conventional banks, in Islamic banking for monetary expansion, the inflation, real GDP and income velocity of money are considered, taking into account deposit and lending growth and associated risk matrix. Macro prudential policy, for instance, loan classification and provisioning, calculation and maintenance of capital against risk-weighted assets, and advance deposit ratio lending to economic priority sectors in Islamic banks are largely similar to those of conventional banks.

Some open market operations (OMOs) tools for Islamic banks:

- Liquidity support facility using SUKUK for 14 days.
- Mudaraba liquidity support against government foreign currency incentives (2.5%) for 7, 14, 28 days.
- Liquidity support facility against government bond holding for fertilizer, power, etc., incentive (no interest charge and haircut apply).
- Financing against receivable (promissory note) for overnight financing.

8.1 Shed Light on Islamic Banking Operations in Bangladesh under the Current Monetary Policy Regime for Maintaining Shariah-Based Financial Outcomes

Holy Quran, Hadis, Ijma (Consensus), and Qiyas (Analogical Reasoning) are the guiding principles of Islamic banks. The primary source of Shariah is the holy Quran and Sunnah.

8.1.1 Miqasid Shariah

The concept of Maqasid Shariah provides clear guidance and framework to the process of ijtihad, solving the issues conforming to the human interest elated institutions for Islamic banking are the Islamic Financial Services Board (IFSB), the Islamic Bank Consultative Forum and the OIC countries' norms and the Islamic Sharia Board.

Some features of Islamic banks in brief:

- Bank rate (4% interest) is not accommodated for Islamic banks.
- CRR 4% and SLR 5.5% for an Islamic bank. ADR is 92%.
- Lack of an Islamic bank interbank call money market following interest rate targeting monetary policy.
- Lack of open market operations (OMOs) tools like BB Bills.
- SUKUK and conventional bonds with a haircut are used for borrowing by the Islamic bank from BB.
- Bangladesh Government Islamic Investment Bond (BGIIB) operates following PSR for maintaining SLR, which needs to be broadened.

9. Results and Discussion

Analyzing the root cause using government treasury bills and bonds over subscription by the CIC holders, the relation has been found between policy rate hikes arising from call money rate, which is the operational target of interest targeting monetary policy. The participation in the WAR bid by the individual highlights the Keynesian speculative demand for money apart from the discussed transaction and precautionary demand for money of the classical school of thought. Another important segment that is Islamic banking fundamentals and OMOs with BB for greater financial stability, considering monetary policy, is also articulated in this paper. To compensate for the business loss due to higher policy and lending rates, ensuring real return balancing inflation and deposit rate in the WAR bids of government securities by individuals has been secured and devaluation of Taka has also been performed to promote export and remittance. Mundell Flemming model articulated by Rubio (2003) leads a relatively open economy to incorporate crawling peg by the BB. Sectoral economic balance has mentioned the relationship among BOP overall surplus, NFA of RM and M2, credit expansion to the private and public sector and enhancement of GDP, containing inflation in particular dimension. Monetary policy MCI tools are used in this paper to ensure financial stability and to form better rationality among the stakeholders.

10. Conclusion

For plain, fair and true financial exposure, due diligence and fiduciary responsibility have emerged as a catalyst role to deal with, especially post-Keynesian moral hazard, agency problem and information asymmetry of banks. Realistic financial diagnosis of monetary policy can contribute to better outcomes enhancing the nation's welfare. Consequently, calculated risk of the banking sector can be meticulously dealt with, subject to uncalculated risk, which is hard to diversify. This study 9 basically highlights the concern of monetary policy along with financial stability for forming better rationality by the stakeholders. The findings of the study infer that accommodating the MCI rise in policy rate clearly reduces the CIC as an important factor of

money supply, causing inflation. But the other two factors, commodity supply drawback and inflation expectation, are still prominent in explaining the inflation dynamics of Bangladesh. On the other hand, export and workers remittance from abroad in recent times received momentum in relation to the devaluation of the Taka against the US dollar by the BB, which is the diagnostic outcome of this paper examining relevant financial statements.

10.1 Limitations and Future Research Directions

Basically, fundamental analysis is performed in this paper, ignoring the economic model, which may be incorporated for further research.

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Appendix

Table 6: Medium-Term Macroeconomic Framework (Key Indicators)

	Actual				Projection		
Indicators	FY20	FY21	FY22	FY23[RB]	FY24	FY25	FY26
1	2	3	4	5	6	7	8
Real Sector							
Real GDP Growth (%)	3.5	6.9	7.1	6.0	6.5	7.8	8.0
CPI inflation (%, 12-month average)[$]	5.7	5.6	6.2	7.5	6.0	5.5	5.4
Gross investment (% of GDP)	31.3	31.0	32.0	27.8	33.8	35.1	36.0
Private	24.0	23.7	24.5	21.8	27.4	28.8	29.4
Public	7.3	7.3	7.5	6.0	6.3	6.3	6.6
Fiscal Sector (% of GDP)							
Total Revenue	8.4	9.3	9.5	9.8	10.0	10.4	11.2
Tax Revenue	7.0	7.6	7.6	8.7	9.0	9.5	10.2
Of which NBR Tax Revenue	6.8	7.5	7.4	8.3	8.6	9.1	9.7
Non-Tax Revenue	1.4	1.7	0.9	1.0	0.9	0.9	1.0
Public expenditure	13.0	13.0	13.1	14.9	15.2	15.4	16.2
Of which ADP	4.8	4.5	4.9	5.1	5.3	5.5	5.9
Overall Balance	-4.7	-3.7	-4.6	-5.1	-5.2	-5.0	-5.0
Financing	4.7	3.7	4.6	5.1	5.2	5.0	5.0
Domestic Financing	3.3	2.3	2.8	3.2	3.1	2.9	2.9
External Financing (net)	1.4	1.4	1.8	2.0	2.1	2.1	2.1
Monetary and Credit (Year-on-Year% change)							
Domestic Credit	14.0	10.1	16.2	18.5	16.0	17.0	17.0
Credit to the Private Sector	8.6	8.3	13.7	14.1	15.0	16.0	16.0
Broad Money (M2)	12.6	13.6	9.5	11.5	13.0	13.0	13.0
External Sector							
Exports f.o.b (% change)	-17.1	12.4	33.4	10.0	12.0	14.0	14.0
Imports f.o.b (% change)	-8.6	19.7	35.9	-9.0	8.0	12.0	12.0
Remittances (% change)	12.4	36.1	-15.1	4.0	10.0	13.0	13.0
Current Account Balance (% of GDP)	-1.3	-1.1	-4.1	-1.5	-0.93	-0.62	0.06
Gross Foreign Exchange Reserve (billion USD)	36.0	46.4	42.7	34.6	25.8	41.1	48.9
Forex Reserve in Months of Imports	7.2	7.8	5.3	4.5	4.3	4.4	4.7
Memorandum Item							
GDP at Current Market Prices (billion BDT)	31705	35302	39718	44392	50067	56296	63413

[RB] Revised Budget.

Finance Division, Ministry of Finance and Bangladesh Bureau of Statistics.

Source: Bangladesh Bank Annual Report FY 2022-23.