Inquiry: Design of a Sustainable Financial System

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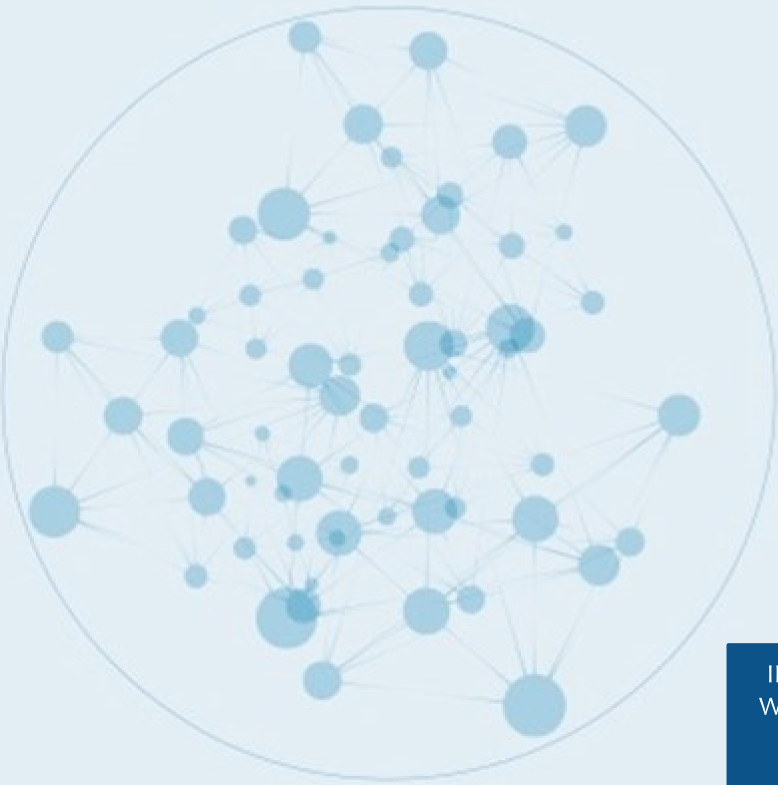
UNEP

MONETARY POLICY AND SUSTAINABILITY

The Case of Bangladesh



INQUIRY WORKING PAPER

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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it will publish its final report in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

Council on Economic Policies (CEP)

CEP is an international nonprofit nonpartisan economic policy think tank for sustainability focused on fiscal, monetary and trade policy.

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More information is available from *www.cepweb.org*.

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Comments are welcome and should be sent to** abarkawi@cepweb.org **and** simon.zadek@unep.org**.

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Executive Summary

Central banks have wide ranging effects on the economy and society as a whole. Their decisions on monetary policy and sustainability are closely intertwined. Nonetheless, the links between the mandates, objectives and instruments of central banks and a broad sustainability agenda are rarely reflected in policy debates. Bringing light to this blind spot is critical.

The impact of monetary policy is shaped by a myriad of factors — many of which are country-specific. A case in point for this is the key role of a country's financial system in the transmission of policy decisions to the real economy. The structure of the banking sector, the depth of capital markets, as well as the legal and governance frameworks in which financial transactions take place, are central aspects in that context. Understanding these building blocks and how they define policy space is indispensable for a sound analysis of the connections between central bank actions and sustainability.

Against this background, this report focuses on monetary policy and its sustainability impacts in Bangladesh. It lays out areas for exploration and provides initial insights into Bangladesh's economic development, its sustainability priorities as well as its financial system, and the relationship between these aspects and the country's monetary policy. It also reviews the mandate, objectives, targets, and instruments of Bangladesh Bank (BB), the country's central bank, as well as the effectiveness of the transmission channels at its disposal. At the same time, it highlights that knowledge gaps on the topic remain significant. Further analysis will be needed to draw a more complete picture of the country's monetary policy-sustainability nexus.

Bangladesh has a population of 158 million people of which 70% live in rural areas. Gross domestic product (GDP) in FY2014 was US$174 billion. Real GDP growth amounted to 6.1%, and real GDP per capita grew by 4.7% in FY2014. Jobs are mainly distributed between agriculture (48%) and the services sector (40%). The number of migrant workers is estimated at 9 million. As a result, remittances play a significant role in the country's economy, and amounted to US$14 billion in FY2014.

The country has made impressive progress in poverty reduction over the last decade. The poverty rate is estimated to have dropped from 31.5% in 2010 to below 23% today. The government's goal is to reduce this number to 15% by 2021. Job creation while at the same time reducing inequality will be key in this context. Food security as well as the transition towards a sustainable energy future are equally important goals on that path.

Banks are the dominant pillar in the financial system with outstanding credit to the private sector amounting to more than US$67 billion as of November 2014. In comparison, the microfinance sector, as of June 2013, served 33 million clients and accounted for US$4.4 billion in outstanding loans. At the same time, in particular in rural areas, informal funding sources such as relatives, friends as well as village moneylenders continue to play an important role.

The banking sector continues to suffer from high default rates. With the ratio of non-performing to total loans at 9.7%, confidence in the financial system remains subdued. Substantial spreads between deposit and lending rates — as observed in many low income economies and currently above 5% in Bangladesh — add to these frictions, and make the sector less sensitive to monetary policy changes.

The transmission of monetary policy into the real economy is also hampered by an underdeveloped capital market. In particular, insufficient liquidity in the secondary market for government debt and the overall lack of a market for corporate bonds constitute a further impediment for the transmission from short-term policy rates to market rates along the yield curve. Moreover, the limited supply of long-term funding instruments poses particular challenges to close the country's infrastructure gaps. According to the central bank, "effective transmission of monetary policy requires strengthening credit and debt markets, and this will remain a key focus of BB". The authorities have taken important steps in this direction — including tightening regulations on related lending, strengthening monitoring of banks' stock market exposures, as well as recapitalization of state-owned commercial banks.

Bangladesh Bank's mandate is to "[stabilize] domestic monetary value and [maintain] a competitive external par value of the Bangladesh Taka towards fostering growth and development of [the] country's productive resources in the best national interest." Within this legal context, the central bank focuses on "achieving price stability along with moderate inflation while providing sufficient space in its monetary program for domestic credit which supports broad-based investment and inclusive growth objectives." In case of trade-offs between these goals, the bank prioritizes growth over inflation as long as the latter remains tolerable. In addition, and in particular under the leadership of its current governor, Dr Atiur Rahman, Bangladesh Bank emphasizes the important role central banks play in pursuing sustainability priorities including poverty alleviation and environmental stability.

The key inflation measure used by Bangladesh Bank is the annual increase in the national Consumer Price Index (CPI). In December 2014, following a steady decline from 7.6% in January 2014, overall inflation stood at 7.0% with food inflation amounting to 7.9% and non-food inflation at 5.6%. For FY2015, the central bank targets an inflation rate of 6.5% and expects GDP to grow between 6.5-6.8%.

Bangladesh Bank follows a monetary targeting strategy. In that context, it seeks to control the growth of broad money (M2) at a rate it deems consistent with its objectives for output growth and price stability. It pursues its M2 target based on the view that broad money is largely determined by reserve money (RM) through the money multiplier and by setting an operational target for RM accordingly. The success of such monetary targeting depends i) on the existence of a strong and reliable relationship between objectives (e.g. high output growth with moderate inflation) and intermediate targets (e.g. broad money), ii) on the capacity of the central bank to steer their intermediate target variables (e.g. broad money) through the operational target variables (e.g. reserve money) it can influence directly, and iii) on a stable money demand function. These conditions seem to be met in Bangladesh only partially.

To reach its reserve money target, Bangladesh Bank controls liquidity in the market on a day-to-day basis. The instruments it uses for that include repo and reverse repo auctions, Bangladesh Bank bill auctions, Treasury bill and bond auctions, as well as adaptations in the cash reserve requirement ratio and the statutory liquidity ratio. Bangladesh Bank also intervenes in foreign exchange markets to reduce volatility in the Bangladesh Taka (BDT) exchange rate to other currencies. In addition, the central bank's toolbox includes targeted refinancing lines and mandatory credit targets to steer credit allocation in the economy, as well as a variety of regulatory measures to promote financial inclusion, inclusive growth and environmental stability.

Targeted refinancing lines offer banks refunding at reduced interest rates for loans given to priority areas such as renewable energy. In contrast to outright subsidies, they rely on the private sector as a gatekeeper in the allocation of capital. The default risk remains with the banking sector. Bangladesh Bank provides several refinancing lines for various sectors and segments of the economy. Its BDT2 billion (US$25 million) refunding scheme for green finance is a case in point. Launched in 2009 with an initial focus on solar energy, biogas, and effluent treatment projects, its scope has continuously been expanded and now covers 47 items. Bank loans for projects in the included fields can be refinanced by

Bangladesh Bank at 5% provided that the interest charged to bank customers does not exceed 9%. Similar schemes with a focus on the country's sustainability priorities are also available to provide collateral-free credit to sharecroppers, for loans to increase the energy efficiency of brick kilns, as well as to expand funding possibilities for small and medium sized enterprises.

Moreover, Bangladesh Bank, in its regulatory capacity, is enforcing differentiated ceilings on loan growth, maximum loan sizes, minimum loan ratios, as well as maximum debt-to-equity ratios. Ensuring that these ceilings and floors and the underlying criteria are aligned with sustainability objectives is critical.

The country's central bank has also taken various measures to promote financial inclusion. The obligation for banks to open a rural branch for every new branch in urban areas, guidelines for mobile financial services and agent banking, as well as the introduction of "10 Taka accounts" — bank accounts that can be opened with the deposit of BDT10 (US$0.13) — are among the instruments that Bangladesh Bank has applied in this context.

The reflection of sustainability priorities in the definition and pursuit of monetary targets is critical in two ways. On the one hand, as described above, monetary policy may have important effects on a country's sustainability goals. On the other hand, sustainability developments may have critical impacts on core monetary policy targets. Bangladesh Bank's focus on both the traditional objectives of price stability and growth alongside a broader sustainability agenda may thus allow for effective and positive feedback loops.

For a thorough exploration of the links between monetary policy and sustainability in Bangladesh, yet alone for making policy recommendations, additional research is essential. Nonetheless, the following suggested directions for further analysis may provide initial guidance for future action of Bangladesh Bank:

1. Conduct research to expand the knowledge base about the links between price stability, money and credit growth, and the country's sustainability priorities.
2. Assess the impact of interest rate changes on green investments.
3. Expand reflection on sustainability considerations in Bangladesh Bank's key reports — for example by sharing analysis in its half-yearly Monetary Policy Statement on the impact of Bangladesh Bank's core decisions (e.g. its inflation target) on sustainability priorities (e.g. poverty reduction).
4. Review the possibility to add data on monthly changes in the Basic Need Price Index (BNPI), or on other measures of the inflation rate faced by the poorest segment of the population, in addition to the standard inflation indicators (i.e. CPI) into Bangladesh Bank's key reports.
5. Add an overview on Bangladesh Bank's targeted refinancing lines including capacity, cumulative disbursements and outstanding loans to its Monetary Policy Statement and its website.
6. Evaluate the impact of targeted refinancing lines, credit quotas and ceilings, as well as maximum debt-to-equity ratios on sustainability objectives, and identify scope for further alignment.
7. Build up monitoring and evaluation capacity to assess current targeted refinancing lines.
8. Ensure the reflection of sustainability criteria in a possible future diversification strategy for the investment of Bangladesh Bank's foreign exchange reserves.

1 Introduction

Central banks have wide-ranging effects on the economy and society as a whole. Their decisions on monetary policy and sustainability are closely intertwined. Interest rate levels, inflation targets, money supply and exchange rates are key factors for investments. They play a critical role in the distribution of wealth and income. They have significant influence on the ability of households to secure adequate real income over their lifetime. And their impacts on asset prices in general and real estate as well as commodity markets in particular have considerable social and environmental repercussions.

Nonetheless, the links between the mandates, objectives and instruments of central banks and a broad sustainability agenda are rarely reflected in policy debates. The nexus between their decisions and poverty alleviation is seldom on top of agendas; their impact on inequality is only discussed at the margins; and the environmental effects of their policies often go unnoticed.

This is particularly striking as the current crisis has significantly increased the influence of central banks and the policies they enact. Bringing light to this blind spot is critical. As central banks transfer billions of dollars into the global economy on a monthly basis, we urgently need a solid understanding of the effects their actions have on sustainability. We need a thorough analysis of policy alternatives and their impacts. And we need to build a community of experts from academia, business, policymaking, NGOs and the media to reflect these alternatives in policy debates moving forward.

Research at the country level will be critical in this context. The impact of monetary policy is shaped by a myriad of factors — many of which are country-specific. The key role of a nation’s financial system in the transmission of policy decisions to the real economy is a case in point for this. The degree of competition in the banking sector, the depth of capital markets, as well as the legal and governance frameworks in which financial transactions take place, are central aspects in that context. Understanding these building blocks and how they define policy space is indispensable for a sound analysis of the connections between central bank actions and sustainability.

The initiatives of Bangladesh Bank (BB), the country’s central bank, in integrating sustainability considerations into its activities offer valuable insights in this regard. They also provide a strong basis to explore further opportunities for the alignment of monetary policy and financial regulation with a broad sustainability agenda in Bangladesh and other countries.

Against this background, this report lays out areas for exploration and provides initial insights into Bangladesh’s economic development, its sustainability priorities as well as its financial system, and the relationship between these aspects and the country’s monetary policy. It also reviews the mandate, objectives, targets, and instruments of Bangladesh Bank as well as the effectiveness of the transmission channels at its disposal. At the same time, it highlights that knowledge gaps on the topic remain significant. Further analysis will be needed to draw a more complete picture of the country’s monetary policy-sustainability nexus.

2 Economic Development

Bangladesh is a country in South Asia with a population of 158 million people[1] of which 70% live in rural areas.[2] The nation's gross domestic product (GDP) in FY2014 (ending in June 2014) was US$174 billion. In 2013, in the run-up to general elections in January 2014, the country suffered its worst political violence since independence in 1971, leaving more than 500 dead, and causing severe disruptions in economic activities. Political uncertainty continued to dampen the investment climate in the first half of 2014. Nonetheless, real GDP growth amounted to 6.1%, and real GDP per capita grew by 4.7% in FY2014.[3] Real GDP growth for FY2015 is projected to be 6.5-6.8% provided political stability prevails.[4]

The services sector makes up more than half of economic output, followed by industry (2012: 29%) and agriculture (2012: 18%).[5] Goods and services exports in FY2014 amounted to US$33 billion. Readymade garments accounted for US$19 billion of that total.[6] Further key export items include agro-processed goods, footwear, and non-perishable consumables such as ceramic and light engineering products.[7]

The number of migrant workers is estimated to stand at 9 million.[8] As a result, remittances play a significant role in the country's economy, and are its second largest source of foreign exchange — after the garment industry — amounting to US$14 billion in FY2014.[9]