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Bangladesh Bank Reform

Changes and Challenges

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Background Paper
for
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Bangladesh Bank Reform

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Abstract: The Bangladesh Bank, the central bank of Bangladesh, has been subject to an ongoing series of reforms. This paper provides an analytical description of the structure of the Bangladesh Bank; it reviews the reforms from their inception in 1982 through the current Central Bank Strengthening Project and assesses their impact on the Bank's performance and autonomy. The Grilli-Masciandro-Tabellini (GMT) indexes for political and economic autonomy are calculated. The Bangladesh Bank ranks below its peers in both GMT measures.

Table of Contents

1. Introduction 1

2. Methodology 1

3. Chronology of Financial Sector Reform 2

4. Autonomy 4
4.1 Central Bank Autonomy in Literature 5
4.2 Autonomy of Bangladesh Bank 12
4.3 Credibility 14

5. Legal Framework Reforms 14

6. Regulation and Supervision 17
6.1 Loan Classification and Provisioning 17
6.2 Corporate Governance of Banks 20
6.3 Anti-Money Laundering Measures 20

7 Human Resources and Recruitment 21

8 Automation 22

9 Role of Media 23

10 Conclusion 24

Appendix A: List of Bangladesh Bank Governors 25

Appendix B: Measuring Autonomy 26

References 27

Tables and Figures

Table 1: Ratio of Gross NPL to Total Loans by type of bank 18

Figure 1: Government borrowing from the Banking Sector 12

Figure 2: GMT Index for Bangladesh Bank 13

Acronyms

AMLU	Anti-money Laundering Unit
ACR	Annual Confidential Report
BB	Bangladesh Bank
BRC	Bank Reform Committee
CPI	Consumer Price Index
CBA	Combined Bargaining Agent
CIB	Credit Information Bureau
CRR	Cash Reserve Requirements
CBSP	Central Bank Strengthening Project
DFI	Development Finance Institutions
FSAC	Financial Sector Adjustment Credit
FSRP	Finance Sector Reform Project
FCB	Foreign Commercial Bank
GoB	Government of Bangladesh
GMT Index	Grilli, Masciandro and Tabellini index
GDP	Gross Domestic Product
IMF	International Monetary Fund
IT	Information Technology
MP	Member of the Parliament
MPD	Monetary Policy Department
NPA	Non-Performing Assets
NPL	Non-Performing Loan
NCB	Nationalized Commercial Bank
NBFI	Non Bank Financial Institutions
PAU	Policy Analysis Unit
PCB	Private Commercial Banks
PMS	Performance Management System
SAP	Structural Adjustment Program
SLR	Statutory Liquidity Ratio
SAPRI	Structural Adjustment Program Review Initiative
SMA	Special Mention Account
WB	The World Bank

1. Introduction:

Bangladesh Bank is the key player for the financial sector of Bangladesh as well as for the economy. Bangladesh Bank is the banker to the government as well as to other banks. It formulates and implements monetary policy, manages foreign exchange reserve and is the authority to supervise and regulate other banks and non-bank financial institutions. The financial sector of Bangladesh has gone through a lot of reforms in the past two decades and central bank reform was a key element of the reform agenda. This study maps the various reforms that have taken place so far. Bangladesh Bank has improved in certain areas and yet there are avenues where more can be done. The bank plays a dual role in the economy. Bangladesh Bank supervises and regulates the country's banking sector where it has significant improvements. On the other hand, the bank underachieves in terms of autonomous formulation and implementation of monetary policy in coordination with the government.

This paper is designed with the following objectives:

- identify the most significant institutional reforms within Bangladesh Bank and their significance towards improved governance in financial sector,

- identify significant policy changes of the monetary sector which reinforced and/or improved Bangladesh Banks capacity in governing the financial sector

2. Methodology:

The literature on Bangladesh Bank is fairly limited. However, there exists a large literature on certain issues related to the country's banking sector. Studies were also conducted on the central bank to identify its weakness. A number of studies were conducted to evaluate the reforms of the financial sector.

The paper is based on a qualitative survey research and both primary and secondary data are used for the study. For secondary data past literature and existing government sources are consulted. However, for primary data semi structured open-ended interviews were conducted with former and present central bank employees and experts[1].

The rest of the paper outlines the major reforms and changes that have taken place so far. We first discuss autonomy followed by legal framework issues, regulations and supervisions, human resources, automation and the role of media. The paper refers Bangladesh Bank as "the central bank" in the rest of the paper.

[1] Interviews were conducted between July-August of 2006. A total of 13 former and present people were interviewed with follow-ups.

3. Chronology of Financial Sector Reform:[2]

Bangladesh, after independence in 1971, inherited an undiversified and undeveloped financial system dominated by commercial banks. The then government nationalized all financial institutions except for a few foreign banks. Bangladesh Bank was established in 1972 and the financial sector was under a regime of rigid government control. Government dictated the interest rates, direction of credit to Public Sector Enterprises and priority sectors with little regard to loan quality. Bank branches were expanded with an objective to increase access of the rural people to the formal banking sector. The government till 1982 owned all the financial institutions. Bank branches were opened ignoring the viability aspects and socio-economic considerations were given more priority in credit analysis and decision. Lending rates were low and did not cover the risk and actual cost factors. Unsophisticated and immature accounting and poor banking standard coupled with poor loan recovery started to afflict the banking sector. The operational efficiency declined and the customer service also deteriorated during this period (Chowdhuy & Raihan, 2000).

The reform process was first initiated in 1982 when two of the six nationalized commercial banks were denationalized and a number of licenses were awarded for private sector commercial banks. The objective on part of the government was to show its desire to encourage the private sector and create competition in the banking sector. The customer service of the banking sector has shown signs of improvement but the credit management was observed to have deteriorated. It transpires from various studies that denationalization and the privatization process failed to create desired impact due to lack of central bank's capacity of strict supervision and rigid economic regulation for the sector (Bhattacharya and Chowdhury, 2003).

The reform measures failed to create an impact, as the operational efficiency did not improve. Vested interest groups emerged influencing the credit decision of the banks, both national and private sector banks. Accounting standard and practices of the commercial banks were not standardized and the reporting requirements were not up-to-date. As a result, profitability of the banks came down (Chowdhuy & Raihan, 2000).

The second phase began hand-in-hand with IMF/WB Structural Adjustment Program (SAP) as the government appointed the National Commission for Money, Banking and Credit. In 1986, the commission submitted a long list of recommendations to address problems in the banking sector. Among other findings and recommendations, Bangladesh Bank's supervisory handicap, overall structure of the banking sector and Non-Performing Assets (NPA) were given due importance. Subsequently, recovery targets were set for the banks to improve the NPA situation along with barring defaulters getting fresh loans (Chowdhuy & Raihan, 2000).

[2] This section largely draws from "*The Financial Sector Reforms in Bangladesh: The Next round*," Bhattacharya and Chowdhury, 2003 and " Structural Adjustment Participatory Review Initiative Study Theme (2): Implications of Financial Sector Reform", Chowdhury & Raihan, 2000

At the beginning of the 1990s a wide range of reforms in the banking sector were initiated under Financial Sector Adjustment Credit (FSAC), the World Bank consultative mission. The Finance Sector Reform Project (FSRP) was also initiated in 1990 to assist in the implementation of the reform measures, which ended in 1996. In this attempt measures were taken to liberalize interest rate, enhance the capacity of loan classification and provisioning, capital restructuring and risk analysis, strengthening central bank and improving the legal system and framework for loan recovery. It an attempt to increase efficiency of the financial market, the FSAC of the WB came up with the following: gradual deregulation of interest rate, improvement in the debt recovery climate, strengthening the Capital market, adoption of appropriate monetary policy, making subsidies more transparent. The FSRP ended in 1996 but the reform measures continued to be pursued (Chowdhuy & Raihan, 2000).

The six-member Banks Reform Committee followed FSRP in 1996, which presented its report to the government in 1999. The committee gave highest priority in improving the regulatory and supervisory capacities of the central bank, along with strengthening legal framework and effective restructuring of central bank. Issues related to Bangladesh Bank Board, NCB boards and political influence on these were also addressed (Bhattacharya and Chowdhury, 2003).

In March 2003, the parliament passed three bills in its attempt to bring massive reforms in the banking as well as the financial sector. The key one was the Bangladesh Bank Amendment bill 2003, which gave the central bank autonomy in terms of its own operations and monetary policy formulation. This issue will be discussed in detail in the following section on autonomy.

Introduction of the Central Bank Strengthening Project (CBSP) in 2003 jointly funded by the World Bank and GoB is another important phase in the reform process. The objective is to achieve a strong and effective regulatory and supervisory system for Bangladesh's banking sector. The project intends to assist BB in three broad areas[3]:

(i) Strengthening the legal framework,

(ii) Reorganizing and modernization of BB by focusing on
   (a) Functional reorganization
   (b) Automation
   (c) Human Resource Development

(iii) Capacity building of BB by focusing on
   (a) Strengthening the research department
   (b) Strengthening prudential regulations and bank supervision
   (c) Strengthening Accounting and Auditing

[3] Central Bank Strengthening Project: Gains Its Pace and Hope for Better Financial Sector Management, Information Note, The World Bank

4. Autonomy:

Central bank autonomy refers to the extent to which the bank can carry out its operations independent of executive and legislative control. Generally, the degree of autonomy largely depends on the political will of the government.

The Bangladesh Bank, since its inception, was not free of government influence. It was under the Ministry of Finance till 2003. Bangladesh Bank Order of 1972 cited (a) price stability, (b) exchange rate and (c) economic growth and employment among major goals. According to this charter the broad objectives of the Bank were[4]:

(a) to regulate the issue of the currency and keeping the reserves
(b) to manage the monetary and credit system with the view of stabilizing domestic monetary value
(c) to preserve the per value of taka
(d) to promote and maintain a high level of production, employment and real income
(e) to foster growth and development of the country's productive resources

The central bank has a dual role in the economy. On one hand, it has regulatory and supervisory authority on the country's financial sector and also has a role to play in economic development. Throughout the 70s and early phase of 80s all the financial institutions were nationalized. The central bank lacked proper check and balance facilities to maintain financial sector discipline.

The central bank is awarded with autonomy through legislative measures and it is a significant reform of this decade. In March 2003, the parliament passed three bills in its attempt to bring massive reforms in the banking as well as the financial sector. The key one was the Bangladesh Bank Amendment bill 2003, which gave autonomy in terms of bank's own operations and monetary policy formulation and implementation. It is conceived that this will ensure greater independence to the central bank in maintaining financial sector discipline. The 2003 order mandates the central bank:

(a) to formulate and implement monetary policy
(b) to formulate and implement intervention policy in the foreign exchange market and also maintain the official foreign exchange reserve
(c) to advise the government on the interaction of the monetary with fiscal and exchange rate policy, on the impact of various policy measures on the economy and to propose legislative measures Bangladesh Bank considers necessary or appropriate to attain its objectives and perform its functions
(d) to promote, regulate and ensure a secure and efficient payment system, including issue of bank notes
(e) to regulate and supervise the banking companies and financial institutions

In line with the international practice for strengthening corporate governance, an Audit Committee comprising four members of the non-executive directors was formed in 2002.

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[4] Notes on Monetary Policy Strategy of the Bangladesh Bank, PN0602, Vol. 1, Number 2, October 2005

The Audit Committee will assist the Board of Directors in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control over financial reporting and audit process (Bangladesh Bank Annual Report 2004-05).

4.1. Central Bank Autonomy in Literature:

The literature on central bank autonomy largely concentrates on the central bank's ability to formulate and implement the monetary policy and on how much discretion it has in doing so. Schiffman (2004) argues that the concept of central bank autonomy has prevailed, the last decade has focused on transparency and accountability, but recently, the focus has moved towards good governance. Fischer (1995) and Guitian (1995) argue that strong accountability provisions should accompany central bank autonomy, to ensure that the authority delegated to the central bank is actually used as intended. Lybek (2004) opines that accountability of the central bank should be designed to ensure that the central bank uses its authority delegated to it effectively and efficiently. Ojo (2000) argues that the effectiveness of the autonomy decreed by legislation to conduct monetary policy in a credible way depends critically on the professionalism of the governor and the Board of Directors and also on whether the government allows the bank to perform free of political influence.

A large section of literature distinguishes two types of central bank autonomy- goal/target autonomy and instrumental autonomy (e.g. Debelle and Fischer-1994). Lybek (2004) defines four broad types of central bank autonomy-

(a) *Goal autonomy:* the central bank has the authority to determine its monetary policy and/or exchange rate regime. In case of the floating exchange rate regime it has the sole responsibility to determine the monetary policy. This type of autonomy in principle gives the central bank the authority to choose its objective from the core objectives defined in the central bank law. Or even has the liberty to decide one in the absence of any precise objective defined by the central bank law. This is the broadest type of central bank autonomy.
(b) *Target autonomy:* This also entrusts the central bank with responsibilities to determine the monetary policy and exchange rate regime or simply the monetary policy when the exchange rate is floating. But the difference is, in such case, the central bank has clearly defined objectives in the central bank charter.
(c) *Instrumental autonomy:* The executive branch or the legislature decides the monetary policy target and/or the exchange rate regime in consultation with the central bank. But the central bank retains sufficient authority to choose its policy tools, which it sees fit to achieve its target.
(d) *Limited or no autonomy:* The central bank is a government agency; the government determines the policy objectives and targets as well as influences the implementation.

The goal and target autonomy are considered to be the strongest forms of central bank autonomy. The European Monetary Institute uses the following attributes to verify whether a central bank has sufficient autonomy or not: institutional independence, functional independence, organizational independence and financial independence. Ahmed (1997) argues that autonomy of central bank has many attributes, such as: independence of the central bank in its decision to give credit to the government, independence in meeting its expenses without depending on the government, independence of the Board of Directors in decision making, independences in formulating, choosing monetary policy tools and implementing them, independence in regulating and supervising the financial sector. Of all the above, the most important is independence in its decision to give credit to the government. Lybek (2004) argues that these are not types of autonomy but various elements of central bank autonomy.

Grilli, Masciandro and Tabellini (1991), and Cukierman (1992) define central bank autonomy as having two main dimensions- political autonomy and economic autonomy. Grilli, Masciandro and Tabellini (1991) define political autonomy as the authority and ability of the central bank to select the objectives of the monetary policy. The authors employ the following criteria to measure "*political autonomy*"-

- Appointment of the central bank governor is independent of government influence
- The governor is appointed for tenure of more than five years
- Members of the Board of Directors are appointed without government involvement
- Board members are appointed for tenure more than five years
- There is no mandatory participation of government representatives in the board
- No government approval is required in formulating the monetary policy *
- There are requirements in the central bank charter forcing the central bank to pursue monetary stability amongst its primary objectives *
- There are provisions of legal protection that strengthens the central bank's position in the event of a conflict with the government

Economic autonomy is defined as the ability and authority in selecting the instruments. Similar to political autonomy the authors examine [5]the following attributes to measure *"economic autonomy"* –

- There is no automatic procedure for the government to obtain direct credit facilities from the central bank
- Direct credit facilities are extended to the government at market interest rate
- The credit is extended on a temporary basis
- The credit is for a limited amount
- There exists a limit on government borrowing from the central bank
- The central bank does not participate in the primary market for public debt
- The central bank sets the discount rate*
- The central bank has no role to oversee the banking sector or shares this role with another separate organization

[5] * indicate Bangladesh Bank satisfies these criteria

1 point is assigned for each the above criteria except for the last one of economic autonomy, where 2 points are assigned for no role and 1 point for sharing the responsibility. Summing the two sets of points yields two indices of the central bank autonomy. The stars indicate that Bangladesh Bank has fulfilled these categories. Based on this we can see that the bank has two points out of eight on political economy scale and one point out of eight on economic autonomy scale.

We use the Lybek (2004) definition and also construct an index using the Grilli, Masciandro and Tabellini (1991) definition to investigate Bangladesh Bank's autonomy. The following sections elaborate on issues related to the criterion designed for the GMT index.

4.1.1 The Board of Directors:

The Board of Directors for the central bank has nine members along with a secretary. The bank governor is the chairman of the Board with four members from civil society, three members from the Executive branch of the government along with one deputy governor. Participation from the Executive branch of the government in the Board is very high for the Bangladesh Bank in comparison to the central banks of India, Sri Lanka and Pakistan. In the above three countries only the Secretary for the Ministry of Finance is appointed as a Board member. The governor, deputy governors and the Board members all have a fixed tenure in the above countries.

4.1.2 Appointment and Tenure:

The government selects and appoints the governor, deputy governors and the members of the Board of Directors as per the central bank charter. The practice is very much centralized and ad hoc. The governor is selected and appointed by the government for tenure of 4 years and is eligible for re-appointment provided that the governor shall not hold office beyond the age of 65 years. The governor is the Chief Executive Officer and, on behalf of the Board, directs and controls the affairs of the central bank. The government can also appoint one or more deputy governors but their tenure is not specified in the charter. Government also nominates one of the deputy governors as a member of the Board. The tenure of the Board members who come from the Executive branch is discretion of the government. It is worth mentioning that Bangladesh Bank Order, 1972 had a fixed tenure for the deputy governor but the 2003 amendment order does not specify any tenure for the position. The members of the Board, who do not come from the Executive branch, are appointed by the government for tenure of three years and are eligible for re-appointment. The whole process is indicative of the role government has in selecting the Board as well as the governor and deputy governors and shows that government has enough discretion to control and influence the Board.

Past trend shows that the central bank governor is changed with a regime change especially since 1991. While appointing a governor, government maintains secrecy and there is no formal selection procedure. Respondents during the interviews informed that there is no formal selection committee, which would officially select a number of competent candidates and than make a formal suggestion. The incumbent government makes the decision, which usually comes from the top end. This again indicates to a highly centralized, non-transparent and ad hoc selection process.

A more recent trend shows that the central bank governors are usually chosen on the basis of their academic qualification, preference is given to candidates with a PhD in Economics. Only one governor in the history of the central bank was a career central banker[6]. Informants told us that there are instances where the governor and the deputy governors lobby to remain in the current office.

The government also appoints the deputy governors as per the central bank charter and the trend indicates to a degree of inconsistency. There were deputy governors, who were appointed from the commercial banks and also from the executive branch of the government. Informants told us that appointment of bureaucrats as deputy governors took place as a result of politics amongst the bureaucrats and this also indicates the control of the government on the central bank. One of the existing deputy governors[7] is appointed from the private sector commercial banking sector. He is the first one to join the central bank with banking background in a foreign commercial bank. This appointment is perceived as an attempt to inject new thinking & practices, transfer of know how from the commercial sector in the working environment of the central bank.

4.1.3 Accountability of the Bangladesh Bank:

According to Bangladesh Bank Order 2003 the governor reports to the Parliamentary Standing Committee for the Ministry of Finance instead of directly reporting to the Ministry of Finance. A ruling party MP chairs the committee and most of the committee members are incumbent government MPs along with the finance minister. As per the parliamentary rules and procedures all the standing committees should sit at least once a month but the Parliament Watch report published by the Transparency International, Bangladesh shows that it is not a regular practice. As per this report of 2005, the standing committee for Ministry of Finance has sat only 7-9 times in 2005. This indicates that the parliamentary committee is not free of criticism in its own performance. It seems the parliamentary standing committee is not fully effective and lacks transparency and accountability.

Leadership is a key element in the effective functioning of the central bank. The autonomy largely depends on the governor and the deputy governors' capability to handle both outside and inside interference. There are political, administrative and business pressure groups that lobby the incumbent government on various aspects of the financial sector, which often falls within the jurisdiction of the central bank. For example, the Employee Union of the central bank has shown defiance of the management. The union has political connections both with the incumbent government and opposition. There is

[6] Mr. AKN Ahmed, Governor, Bangladesh Bank, from 18/12/1974 to 13/07/1975
[7] Mr. Rumee A Ali, Deputy Governor

limited evidence of a strong stance taken by the top management in such situations and such failures can be attributed to political connection of the unions[8].

An independent source of income is another aspect of central bank autonomy. The central bank has its own source of income sufficient to meet operational expenses. However, it cannot re-structure the pay scale without prior approval from the Ministry of Finance.

4.1.4 Monetary Policy Formulation:

The ability to formulate and implement monetary policy free of influence from the government is a key indicator of central bank autonomy. The Bangladesh Bank (amendment) Order of 2003 gives greater independence to the central bank in pursuing the monetary policy. A separate unit for this was established within the central bank in 2003 known as the Monetary Policy Department (MPD). Previously the department was known as the Monetary Management and Technical Unit.

The broad objectives for monetary policy are outlined in the Bangladesh Bank Order, 1972 which comprises the goal of achieving price stability, maintaining high levels of production and employment and economic growth. As per the central bank charter, the Policy Coordination Council, this is headed by the finance minister, coordinate monetary and fiscal policy. The governor of the central bank is a member of the council and the charter clearly sets out the role of the central bank in the council. The charter also defines the role of Ministry of Finance and Commerce in the monetary policy formulation process. This policy coordination council in effect could limit the central banks independence to formulate and implement monetary policy.

In the 70s and 80s, monetary policy was conducted with full direct control of the central bank on interest rates and exchange rates. The central bank used to dictate the deposit and lending rates with a pegged exchange rate regime that served as nominal anchor for prices. The central bank also controlled the volume and direction of credit as per government instruction. The situation began to change in the 90s through the Financial Sector Reform Programs (FSRP). Interest rate liberalization, privatization of the banking as well as non-bank financial sector, introduction of the Securities & Exchange Commission are related to the efforts to financial sector deepening in Bangladesh. A market oriented interest rate policy was adopted in 1990s under the Financial Sector Reform Program. The central bank changed its stance from directly dictating the market rates, both for deposits and advances, to indirect means. The process was gradual, as a number of sectors were kept beyond these reforms in the initial years. On 31st March 2003 Taka was floated as central bank adopted the flexible exchange rate regime. Since both the interest rate and exchange rate are market driven an ex-ante monetary policy stance has assumed importance in anchoring inflation expectations and dictating the monetary aggregates to the target level. Since January 2006 central bank started to publish the *"Half-yearly Monetary Policy Statement*" in its attempt to create ex-ante influence on the money market as well as on inflation.

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[8] The Daily Star, "CBA men besiege BB governor", 29 October 2003, "BB axes ten unionists", 31 October 2003, "BNP-backed CBA defies BB orders to relocate office" 26 December 2003

In recent years, central bank has been using indirect tools of monetary policy rather than directly dictating them. Key policy rates, that is, Treasury bill/bond auction yields, *repo* and *reverse repo* interest rate have been raised and maintained on upward trend. This, in turn, had affects on other banking sector rates. The structure of the financial sector in Bangladesh is such that interest rate intervention cannot alone influence the aggregate monetary variables and due to low level of financial sector deepening, the market rates are yet to gain sufficient depth and liquidity to respond to these changes. To compensate for this inadequate responsiveness to interest rate changes, the interest rate policy is supplemented with changes in the Cash Reserve Requirements (CRR) and the Statutory Liquidity Ratio (SLR) in an attempt to influence volume as well as the cost of funds. Recently, the above two rates were raised from 4.5 percent and 16.0 percent to 5.0 percent and 18.0 percent respectively (Half-yearly Monetary Policy Statement, Jan. 2006). In pursuit of monetary policy the central bank puts greater reliance on monetary targeting on variables such as broad money (M2), reserve money etc. In so doing, estimates of GDP growth, CPI are also used. However, aggregates like the GDP is calculated annually but many of the evaluations are done quarterly using quarterly values of the other variables. During the interviews it came out that the data obtained from other government agencies lack reliability and there is a lag, which affects the aforesaid analysis required for monetary policy formulation. Informants also indicated that there is also a lack of specialized personnel for conducting such high level analytical and empirical tasks necessary for formulating monetary policy.

The policy stance (especially, the cautionary stance to curb inflation) taken by the central bank is not free of criticism and informants opined that at times they are government and donor dictated. In light of shortcomings in financial sector deepening, there is an element of doubt as to the efficacy of interest rate elasticity's on private savings and money demand behavior (Policy Notes Series, 2005, Bangladesh Bank). Investment credit is a small share of total private sector credit and Ahmed & Islam (2006) argue that aggregate investment spending is not responsive to interest rate changes. In the disaggregate level it is still non-responsive except for private sector investment category which is only moderately responsive from the lenders' point of view in the short run. The stance to curb inflation is not free of criticism as many argue that the current inflationary pressure is due to supply side problems and is not a monetary phenomenon. In a recent television interview, the Finance Minister also agreed to the fact that current inflationary pressure is due to market distortions created by the rent seeking behavior of the business sector[9]. Rising fuel prices also has a role to play in inflation situation in Bangladesh[10]. The central bank stance is based on the 'Quantity Theory of Money' assumption that is to restrain money demand through increasing the cost of holding money and thus affecting excess demand arising from inflationary expectations. But the cause of current inflation

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[9] The Daily Star, "Pricey Shocks" (Star Weekend Magazine) 29 October 2004, "Effective TCB needed to control Price hike", 27 August 2006, "Power and Price", 23 Sept. 2006, "Pricey essentials remained people's permanent plight" 03 November 2006, "Only 7 or 8 Importers keep Market Hostage"- Source: UNB, Article published in www.bangladeshinfo.com,

[10] The Daily Star, "Fuel price hike again" 25 May 2005, The New Age, "MPs opt for leaving diesel, kerosene out of price hike", 07 Sept. 2007

invalidates such transmission mechanism implemented through contractionary monetary policy.

Ministry of Finance and multi-lateral donor organizations are criticized for influencing monetary policy formulation. In fact, a number of changes within the monetary sector, namely the interest rate deregulation, exchange rate regime change, ex-ante monetary policy statement etc. are donor dictated. Many believe, including both former and current central bankers, that the central bank does not have freedom in formulating the monetary policy independently.

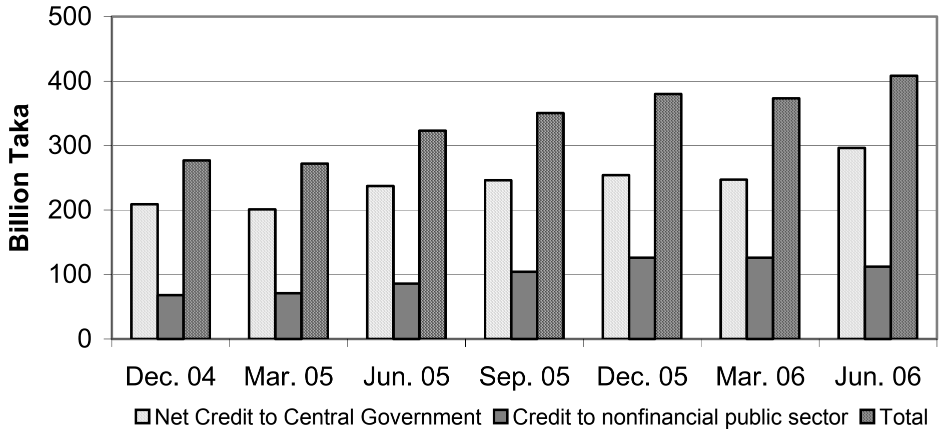
It came out during the interviews that the research department of the central bank lacked the analytical capacity to conduct in depth research on the economy. The research department under the central bank was not an attractive job placement for bright researchers because of low pay scale and low career profile. Policy Analysis Unit (PAU) has been established within the Research Department of the central bank to enhance the research capacity. PAU was establishment as an initiative of capacity building within the central bank under the CBSP, which is again a donor dictated change. Although the inception of this unit created a new impetus and the unit started producing proper research reports on the economy as well as on the financial sector, there are some problems associated with PAU. Its research findings do not directly contribute to the monetary policy formulation by the central bank. The Monetary Policy Department is a separate unit and there is a lack of proper coordination between the two in terms of feedback. The researchers recruited for the PAU have a separate pay scale, which is higher than the regular central bank staff. These new breed of researchers, however, do not consider this is as a permanent placement for their career. Further, there is no mechanism to transfer their skills to the regular research department staff members. In this circumstance, the long run sustainability and capacity building of the Research Department will depend on the ability of the central bank to integrate PAU and MPD.

4.1.5 Government borrowing & the Central Bank:

A key element in determining central bank autonomy is *whether or not* the central bank can refuse the government credit. This decision crucially affects the volume of money available to the central bank. Bangladesh Bank directly participates in the primary market for government bonds and the central government borrows from the bank to finance its budget deficit. The government borrowed a total of Taka 256.33 billion (approximately US$ 4175.45 million)[11] in 2005 from the banking sector through T-bill auctions of various durations, government savings certificates and prize bonds. This also includes various advances made to various ministries (Bangladesh Bank Annual Report 2004-05). The bank is compelled to lend to the government to finance its budget deficit, which limits the money supply. The government borrowing from the banking sector has two effects. On one hand it raises interest rate and reduces economic activity and, on the other hand, it reduces available funds for the private sector. The latter further reduces economic activity through crowding out effect. Hence, the central bank loses the freedom to choose monetary policy tools independently.

[11] Annual average exchange rate US$ 1= Taka 61.39, Source: Bangladesh Bank

Figure 1 – Government borrowing from the Banking Sector



Source: Monetary Policy Statement, July 13, 2006, Bangladesh Bank

Figure 1 shows the amount borrowed by the government in the past seven quarters. In FY05, the government borrowed Taka 36.0 billion (1 percent of GDP) from the banking sector to finance its deficit (Bangladesh Bank Annual Report, 2004-05: 65). Shortfalls in revenue targets coupled with decline in foreign aid compel the government to borrow from the banking sector. Besides, various state-owned enterprises borrow from the banking sector and many of these credits become classified. As a result, the share of non-performing loans (NPL) goes up.

Government borrowing from the banking sector for financing budget deficits has been an occasional shock to the credit market equilibrium (Financial Sector Review 2006: 74, Bangladesh Bank). Informants opined that this is a window of government influence on central bank operations and the central bank should have the courage and authority to deny such credit to government. A limit can also be imposed on such borrowings.

4.2 Autonomy of Bangladesh Bank:

The argument presented so far allow us to determine the type of autonomy of the Bangladesh Bank as per the two definitions described earlier. The analysis of the Bangladesh Bank Order (1972) and Bangladesh Bank (amendment) Order, 2003 along with the "*Half Yearly Monetary Policy Statements*" of Bangladesh Bank suggest that the bank has "Target Autonomy". This is considered to be one of the strongest forms of central bank autonomy in terms of the monetary policy formulation. Now it is important to investigate the operational aspects as well. Hence we use the Grilli, Masciandro and Tabellini (1991) index. The calculated GMT index, based on the above analysis, indicates poor operational freedom for Bangladesh Bank. The GMT score for Bangladesh Bank are compared with Arnone *et al* (2005) estimates. The latter define GMT index for three broad categories: advanced economies, emerging markets and developing nations and take the mean scores for political, economic and overall autonomy.

Figure 2 – GMT Index for Bangladesh Bank[12]

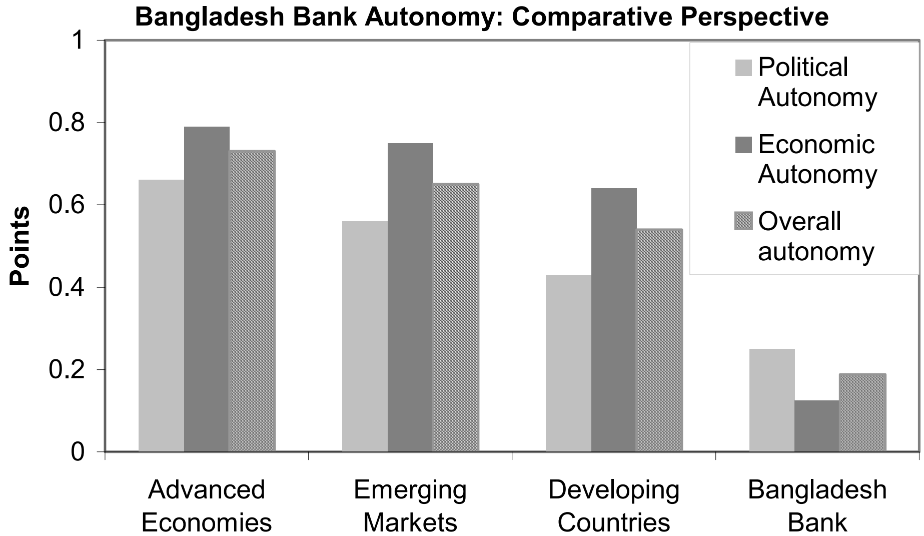


Figure 2 shows that Bangladesh Bank scores lower on both political and economic autonomy indicating lack of operational freedom despite legislature suggesting "Target Autonomy". Comparisons with the autonomy scores of the rest of the world (Arnone *et al* 2005) suggest Bangladesh Bank's scores are lower than the mean score for developing countries. The scores indicate that all the three regional scores have lower ranking for political autonomy compared to that of economic autonomy. But for Bangladesh Bank political autonomy is higher than economic autonomy. This makes the Bangladesh Bank's score inconsistent with that of developing countries' mean score and others. Low ranking in the political autonomy may indicate that there is high political influence in central bank's operation.

It is to be noted that the central bank autonomy for Bangladesh Bank has similar scenario in the pre-reform era i.e. prior to 2003. The central bank charter indicates Target Autonomy and the GMT score remains the same. It seems that the changes in the central bank charter are not enough to create a significant impact on the autonomy and failed to bring about qualitative improvements in terms of central bank autonomy. In this connection, it is worth mentioning that some definitions (tenure of governor and board of directors) used for constructing the GMT scores have higher benchmark criteria and could not incorporate the changes in the charter.

The informants, during the interviews, had similar views on the efficacy of the autonomy and opined that the legislation is not enough for the autonomy. Dr Fakhruddin Ahmed, ex-Governor of Bangladesh Bank, opined autonomy of Bangladesh Bank had to be earned and cannot be simply decreed[13]. A change in the central bank charter is not

[12] Please see Arnone,Laurens, Segalotto and Sommer (2005) for details on this.
[13] Please visit the World Bank-Bangladesh site (www.worldbank.org.bd) report on 'Session V: Financial Sector and Development and Growth' of the workshop on 'Bangladesh:Strategy for Growth and Employment', December 12-13, 2005.

enough to bring about qualitative change. The role a central bank plays with respect to monetary policy formulation and implementation, governing the financial sector and interacting with government with respect to monetary and fiscal policy coordination overtime helps the bank to create confidence among the economic agents. The central bank itself needs to practice autonomy in terms decision-making and implementation, which would enhance its credibility.

4.3 Credibility:

Credibility of the central bank is another important aspect. It has to be credible in its operations and actions. The central bank has a dual role in the economy. On one hand it has to supervise and regulate the commercial banking sector and on the other hand it has to formulate and implement monetary policy. Credibility crucially depends on these two aspects. The Central bank has not yet obtained such credibility in its actions and decisions. Factors, such as- high degree of autonomy, leadership and willingness of the central bank to overcome outside pressure, political will of the government to enable central bank to operate independently, contribute to the central bank credibility. Credibility has to be earned and it takes time for a central bank to achieve this.

5. Legal Framework Reforms:

A sound banking system requires an effective legal framework, which enables the central bank to supervise and/or regulate the money market with sufficient authority to maintain money market discipline. This should also enable the central bank to maintain an honest and disciplined lender-borrower relationship to facilitate loan recoveries and discourage defaults with provisions of punishment when default is willfully made. A strong and effective legal framework would enable the central bank to function properly and with confidence that there would be prompt and effective recourse in case any party feels wronged and aggrieved.

Legal weaknesses and/or constraints are considered to be a key drawback of the Bangladesh Bank's efficacy in terms of maintaining a sound-banking sector. The World Bank study titled "Strategy for Establishing a Sound and Competitive Banking Sector" identified three basic problems afflicting the financial system in Bangladesh. These are (a) a weak central bank, (b) poor governance and (c) a deficient legal framework. A key objective of the CBSP, initiated by the World Bank and Bangladesh Government, is to strengthen the legal framework for Bangladesh Bank.

The major pieces of legislations concerning the banking sector are-

- *Bangladesh Bank Order, 1972*
- *Bangladesh Bank (nationalization) Order, 1972*
- *Negotiable Instruments Act, 1981*
- *Bank Companies Act, 1991*
- *Securities and Exchange Commission Act, 1993*
- *Financial Institutions Act, 1993*

- *Deposit Insurance Act, 1999*
- *Money Laundering Prevention Act, 2002*

Impetus created by competition among the financial intermediaries and the fast changing banking environment along with the financial sector developments require more appropriate regulatory and supervisory framework.

Poor loan recovery or loan default can be attributed to the legal weakness of the banking sector. Bangladesh Bank annual report 2004-05 cites *"……….the banks were reluctant to write off the historically bad loans because of poor quality of underlying collaterals and to avoid any possible legal complication due to lacunas in the judicial framework".* Chowdhury (2002)[14] found the existing and newly formulated legislative measures, in light of the experience of their application, inadequate to deal with the problems of the banking sector.

The following section largely draws from the Financial Sector Review (2006) that maps the recent reforms on the legal framework for the banking sector. Bangladesh Bank was given regulatory power by the Bangladesh Bank Order (1972) and the Bank Companies Act (1991). In order to provide greater operational and policy autonomy amendments of the Bangladesh Bank Order (1972), Bangladesh Bank (Nationalization) Order (1972) and Bank Company Act (1991) were ratified by the parliament in 2003. Amendment of the Bangladesh Bank Order (1972) redefined central bank functions in a more focused way by awarding enhanced authority and making it accountable for its performance. Bangladesh Bank (nationalization) order amendment was done with a view to improving governance of the NCBs. Amendment of the Bank Company Act (1991) gave Bangladesh Bank more authority and increased powers to regulate and supervise the banking sector. In addition, a new Financial (Money) Loan Court Act (2003) was setup to deal with problem of bad loans or loan default; and Money Laundering Prevention Act was formalized in 2002 to deal with the problem that has severe impact on the country's money reserves. Financial Institutions Act (1993), Deposit Insurance Act (1999), Securities and Exchange Commission Act (1993) were designed to improve the money market discipline.

Bangladesh Bank has hired a local law firm, which has international cooperation, to strengthen the legal framework of the bank and to enhance capacity building of the in-house counsels. The firm is reviewing existing related laws and started compiling and rationalizing the circulars, directions and legal instruments issued by the bank. Human resources with law background are hired and are groomed to give legal counsel as well as to train the staff on legal matters associated with the financial sector (Bangladesh Bank Annual Report 2004-05, Chapter 11).

However, the weaknesses in the legal framework persist and can broadly be defined into two categories based on the review of the existing literature and the information obtained during the interviews. The first one is *lack of enforcement* on part of the central bank and

[14] Politics, society and financial sector reforms in Bangladesh, Anis Chowdhury, International Journal of Social Economics, Vol. 29, No. 12, 2002

the second one is *lack of compliance* on part of the commercial banks and other financial institutions. The banking and financial sector in Bangladesh is currently very diverse and changing fast. The informants opined that the laws associated with this sector should change accordingly and-if necessary- new tools, and procedures and laws should be developed. The banking law permits the central bank to punish any commercial bank for any malpractice or non-compliance with current rules and procedures. There are examples where the central bank has fined commercial banks for such things but the amount is so meager that it often fails to create an impact: the central bank has fined Islamic Bank and Jubok Finance for irregularities. But newspaper report suggests such actions failed to create any impact[15]. The central bank dissolved the Board of Directors of the Oriental Bank and appointed an Administrator very recently. It was considered as a problem bank since 1994 and the central bank has been overseeing it from the beginning. Newspaper report indicates lack of compliance on part of Oriental Bank[16]. During the interviews, some informants indicated that there exists some form of collusion between the central bank officials and the commercial banks to overlook such anomalies. Another dimension to this problem is that a number of the private sector commercial banks have current or ex lawmakers and influential business people with political contacts in their Board of Directors. Loan default or bad loans are afflicting the banking sector and the issues of politicization are often considered as one of the root causes of loan default or bad loans.

Bangladesh Bank has put into place rules and procedures to improve off-site and on-site supervision of the commercial banks and non-bank financial institutions. In the recent years, the central bank has formulated new corporate governance guidelines, prudential regulations and some other guidelines for the commercial banks and non-bank financial institutions, guidelines for core areas of risk management under the jurisdiction of the central bank. These are designed to structure the banking sector and harmonize them with international standards. The system is yet to become full proof, as there are loopholes. There are issues with lack of compliance on part of the commercial banks. One such area is the insider-borrowing problem. Collusion between corrupt commercial bank officials and businessmen also contribute to the problem of bad loans. Political interference, rampant insider borrowing, lack of impunity and frequent examples of arrogance by the defaulters towards the regulators/supervisors caused the decay of the system. Nationalized commercial banks (NCBs), owned by the government, have different governance structures. These new rules and procedures have limited applicability and effectiveness on the NCBs. However, the central bank has introduced new procedures on loan classification and provisioning along with other aspects of this problem to be discussed in detail in the following section.

The Money Loan Court was established as per the Money Loan Court Act of 1991. It is yet to make a mark on the loan default scenario. Raihan and Chowdhury (2000) in the SAPRI study found that the settlements of suits have increased but amount recovered has

[15] "BB Slaps Taka 1 Lakh fine on Islami Bank"- The New Age, April 06,2006,
"Jubok asked to return money to depositors"- The Daily star, July 07, 2006
[16] Prothom Alo, "Oriental bank kelenkari- Oporadhi der birudhdhey foujdari ain e bebostha nite hobe", 06 October 2006

been stagnant. They also indicate that suits with small amounts were settled but the powerful large borrowers were out of reach, which points to the political influence. Islam (1999) revealed empirical evidence of collusion between politics and loan defaulters. The analysis shows that prior to implementation of SAP, the degree of political affiliation of the key person of the defaulted organization was higher than in the post-SAP period.

6. Regulations and Supervision:

Supervision and regulation are the functions of the central bank and an effective legal framework provide the central bank with necessary power to supervise and regulate the banking sector. Bangladesh Bank, the watchdog for the banking and financial sector, has formulated new guidelines and also introduced some acts in its attempt to improve its supervision of the financial sector. The main objective of such reforms is to improve the soundness of the banking sector. The central bank also has the authority to give new licenses for new banks and no existing bank can open a new branch in or outside the country or shift any branch from one place to another without obtaining a license/permission.

Prudential regulation guidelines are developed to improve both on-site and off-site supervision and regulatory capacity of Bangladesh Bank. We discuss these issues in the following sections.

6.1 Loan Classifications and Provisioning:

Gross and/or net non-performing assets or loans (NPA/NPL) are considered the most important indicators identifying problems with asset quality. The high concentration of NPL's is a major problem inflicting the banking system. Government dictated the credit disbursement in the early years and political influence also played its part in the decision making for loans from the banking sector. Besides, State Owned Enterprises also borrowed from the banking sector and these loans were never fully repaid[17]. In the recent past the NPL situation has worsened partially due to borrowing by the Bangladesh Petroleum Corporation from the NCBs[18]. Some steps were taken by the central bank to improve the scenario and the share of NPL has been coming down in the past few years yet there are issues that require immediate attention.

[17] Bangladesh Petroleum Corporation and Bangladesh Jute Mills Corporation are the two biggest defaulting state owned entities.

[18] The Prothom Alo, "BPCr karone banking khate khelapi rine boro obonoti, khelapi rin 23 hajar koti taka o mot riner 16.59%", 31 August, 2006

Table 1 – Ratio of Gross NPL to Total Loans by type of bank

Bank Type	1997	1998	1999	2000	2001	2002	2003	2004
Nationalized Commercial Banks	36.6	40.4	45.6	38.6	37	33.7	29	25.3
Development Finance Institutions	65.7	66.7	65	62.6	61.8	56.2	47.4	42.9
Private Commercial Banks	31.4	32.7	27.1	22	17	16.4	12.4	8.5
Foreign Commercial Banks	3.6	4.1	3.8	3.4	3.3	2.6	2.7	1.5
Total	37.5	40.7	41.1	34.9	31.5	28	22.1	17.6

* without adjustment for actual provision and interest suspense.

Source: Bangladesh Bank Annual Report 2004-05

The decline in NPL is not explained in detail, as the amount rescheduled or provisioned and the amount actually recovered or the amount written off are not specified. The table above indicates a higher concentration of the NPL/NPA in the state owned financial institutions. A recent newspaper article claims that total borrowing from the banking system totals Taka 8836 crore (US$ 1327.33 million approximately)[19] and around Taka 4109 crore (US$ 617.25 million approximately) is default loan. The article also claims that of the top 20 twenty defaulter firms, both state owned and private, 11 of them are not operating at the moment. The owners of these firms include influential political leaders as well as top business sector leaders[20]. For the PCBs, the Oriental Bank is an example of massive irregularities, which contributed to making bad loans. Bangladesh Bank has appointed an administrator and dismantled the Board of Directors of the Oriental Bank[21].

There is a tendency of provisioning of the existing default loans before the elections because loan defaulters are not allowed to participate in the parliamentary election. According to a newspaper report, there are instances where a few default loans were provisioned several times. As the regular repayments were not done in a timely manner they become classified again. Few requests of provisioning were turned down by the banks and the defaulters have rescheduled their loans by repaying an amount[22].

The loan classification system that used to be in operation in Bangladesh was more lenient than the international standard. They were not sufficient or even up-to-date with the rest of world in maintaining credit discipline and improving the recovery scenario. In literature, the problem of bad loans or loan default is considered to be a major problem

[19] Annual average exchange rate as US$1= Taka 66.57, Source: Bangladesh Bank

[20] The Prothom Alo, “Shirsho 20 Rin khelapir egaroti prothisthan dirgho din dhore bondho”, 13 August 2006,

[21] The Daily Star, “BB appoints administrator of Oriental Bank”, 23 August 2006

[22] The Prothom Alo, “Voter agey khelapi rin punoh topshil korte netara besto”, 23 August, 2006

afflicting the country's banking sector. In its attempt to strengthen credit discipline and to bring loan classification in line with the international standards, Bangladesh Bank has introduced new guidelines. Credit Information Bureau (CIB) was set up, in 1992 under FSRP, to maintain the credit discipline. The objective was to minimize the extent of further loan defaults by providing more accurate information about the loan applicant to the banks. At present, a certificate from the CIB is necessary to obtain new loan from any commercial bank (Bangladesh Bank Annual Report 2004-05).

As part of strengthening the prudential regulations and supervisions Bangladesh Bank has introduced a new loan ledger and an International Loan Ledger (IAS-30) for the scheduled banks. An attempt has been made to improve the loan classification and provisioning system and to harmonize this with the international standards. Bangladesh Bank has revised "Large Loans Rules" in 2002 to improve the loan classification situation. The new rule prescribes that the banks with net classified loan of up to five per cent will be allowed to sanction a maximum of 56 percent of the total loan and advances as "large loans". Earlier, with a comparable classified loan (<5 percent), a bank could lend up to 80 percent to large loan category. The banks with net classified loans between five percent and ten percent can now lend 52 percent of their portfolio as large loans against the previous allowable limit of 70 percent. The banks with net classified loans between 10 and 15 percent can lend up to 48 percent as against the previous 60 percent of their portfolio. For the next slot of up to 20 percent, the allowable large loan is 44 percent instead of the previous 50 percent (Bhattacharya & Chowdhury, 2003). In a recent Bangladesh Bank circular on loan classification both the objective and qualitative criterions are used to evaluate the loans and advances[23]. Interest earnings are evaluated separately and are included for classification and provisioning. Loans are categorized as (a) Continuous loans, (b) Demand loans, (c) Fixed term loans and (d) Short-term agricultural and micro-credit loans. Broadly, the loans and advances are categorized as unclassified and classified loans. Unclassified loans are further categorized as standard or under the Special Mention Account. A continuous credit, demand loan or term loan, which will remain overdue for a period of 90 days or more, will be put into SMA. Interest accrued from this loan will be credited to interest suspense account instead of the income account. However, this will not be reported to the CIB. The loans in SMA should be reported to the CIB. However, it is also reiterated that loans mentioned under the SMA will not be treated as default loan as per the Bank Companies Act, 1991. The classified ones are categorized as Sub-standard, Doubtful and Bad loans using repayment time as the criterion.

Qualitative judgments are also introduced for classifications. If loans are illogically or repeatedly re-scheduled or the norms are violated or if a propensity to frequently exceed the loan limits are noticed or if legal action is lodged for recovery of the loan or if the loan is extended without the approval of the competent authority, or if situational changes occur on the part of the borrower- qualitative judgment will have to be used in classifying such loans or advances.

[23] BRPD Circular No. 05 of June 05, 2006. Bangladesh Bank, www. Bangladesh-bank.org

6.2 Corporate Governance of Banks:

The banking sector is a highly regulated industry all over the world, as the interest of the depositors as well as the shareholders needs to be protected. In countries where separate institutions are not in place to regulate and supervise commercial banks the central bank does the job. In Bangladesh, corporate governance of commercial banks has been a problem area for many years. In the recent past many significant reforms have taken place to improve corporate governance of banks. For example, the number of directors in a board has been reduced to 13 and one person can be a board member for only one bank. Near relations can not be in the board of the same bank and the roles of the advisor, board members and chief executives are redefined and restructured in a more pragmatic manner. *"Fit and Proper Test"* criteria are developed for board members, chief executive and advisors. Audit standards are developed and banks need to submit key information about their financial statement at least in two of the prominent newspapers. The effort is made to improve on the transparency and accountability in the private sector banking industry.

Guidelines to manage the core risk for banks and financial institutions were introduced by the Bangladesh Bank. These guidelines lay out policies, procedures, processes and structures to core risks. Information Technology security guidelines, prudential regulations for banks and procurement guidelines were also put into place to improve supervision.

Even with all the provisions at hand, during the interviews many experts opined that there could be separate agencies to regulate and supervise the private sector banking activities in Bangladesh. A number of agencies can be set up and each would look into a number aspects related to private sector banking. Under the current system, the commercial banks and financial institutions have to report to and are to a certain extent supervised by the Securities and Exchange Commission, when they register with the stock exchange.

6.3 Anti Money Laundering Measures:

The formal banking channel was often used for transactions related to illegal activities. The international "*Financial Action Task Force"* formulated 40+9 requirements, which are to be followed by the banking sector of any country. Any country that does not comply is considered under the *"Non-compliant countries and Territories"* and eventually affects the country's banking sector adversely. The Anti-money Laundering Unit (AMLU) of Bangladesh Bank was established in 2002 under the Anti Money Laundering Act (2002). The unit has the authority to investigate a suspicious account with acquisition of money laundering. If found guilty a written complaint from the money laundering unit is required to prosecute the accused by the money laundering court. The AMLU itself did not prosecute rather referred cases to the Anti-corruption Bureau. However, once the Anti-corruption Bureau was dissolved and replaced by the Anti-corruption Commission in November 2004, the latter refused to prosecute such activities. The Criminal Investigation Department of Police is now handling money-laundering cases despite the fact that AMLU can do the same as per the act. An amendment of the current act is proposed along with a proposal to create a separate organization to handle these activities with officers from the central bank, police and the attorney general's office.

To closely monitor money laundering and illegal financing and to prevent such activities Bangladesh Bank has instructed all commercial banks to report through Suspicious Transaction Report. Furthermore, all commercial banks are instructed by the central bank to submit a Cash Transaction Report of both deposit and withdrawal of BDT 0.5 million or above (US$ 7500 approximately)[24] in a single account after reviewing the daily transaction. The central bank made *"Know Your Client"* policy mandatory for all commercial banks and financial institutions and has also instructed them to preserve all contact details of the customer along with a transaction profile (Bangladesh Bank Annual Report 2004-05, Bangladesh Bank Financial Sector Review-2006).

Since the establishment of this unit bank supervision has gained a new dimension. But experts still believe that legal weakness might limit the efficacy of this unit, as it cannot prosecute any person under the current system. Any suspected account or person has to be surrendered to the law enforcement agency for prosecution. (Annual Bangladesh Bank Report 2004-05, Bangladesh Bank Financial Sector Review-2006)

7. Human Resources and Recruitment:

The administrative capacity of the central bank has been limited due to a shortage of specialized and efficient human resource. When the central bank was first established recruitment was not merit based. The scarcity of meritorious personnel to run the operations lead to ad hoc recruitment of people without proper expertise or even without proper academic qualifications. Informants told us that there are examples of people joining central bank as clerks but were promoted to higher positions even though they were not sufficiently qualified. The nationalization order of 1972 also created with stroke of pen central bank employees out of contract personnel without proper qualifications. There were little direct recruitment in the past three decades and most of the recruitments took place sporadically. However, in the past few years central bank has been recruiting regularly at the Assistant Director level and has also decided not to recruit below this level. During the interviews informants viewed the decision of recruiting officers at the Assistant Director level related to the automation of the central bank. They opined that automation would create redundancy. When the automation is completed the central bank would have relatively a small share of employees who would become redundant. This would help the central bank to decide effectively and quickly as redundancy often creates problems. This would also reduce employee union activities within the central bank.

Informants further told us that the promotion policy was not based on performance; rather it was seniority driven and like other government organizations; politics also played a dominant role for promotions. There is also grievance amongst the employees as they feel that there is no uniform promotion policy for all divisions of the central bank. The "Status Quo" between promoted officers and directly recruited officers was also an issue. The

[24] Annual average exchange rate as US$1= Taka 66.57, Source: Bangladesh Bank

employee union (CBA) leaders often intervened in the management's decision on postings. The central bank has introduced newly formulated *"Performance Management System (PMS)"* under the Central Bank Strengthening project. This system demarcates the delegation of work by each level of employees in a more systematic manner and sets out objectives and targets to be achieved in a year. This new procedure is put into place to make the evaluation of the staff more transparent unlike the previous system known as the Annual Confidential Report (ACR).

Some current and past top management of the central bank opined that the training and grooming of central bank officials has not been satisfactory. Recently the central bank initiated an overhaul of the training procedure for newly recruited personnel. As per new training procedures, newly recruited staff members undergo a one-year long training, which was previously six-months long. During this one year, first six months is assigned for academic training at the Bangladesh Bank Training Academy and than spend the next 4 months at various departments under the central bank. The last two months are spent in a private commercial bank to get a hands-on experience of commercial banking. Training uses better tools and the central bank has also initiated specialization of some personnel in various aspects of commercial banking.

Informants told us that in the past, overseas training was awarded on the basis of seniority and creation of future knowledge base amongst the newly recruited ones was not considered as a priority. Not many central bank officials got the opportunity to go for higher studies abroad. One can find many executive officers with higher academic training, especially PhD in Economics or Finance or Management, but at the central bank it is still a rarity. Recently, some of the donor countries are providing opportunities for higher education and training to Bangladesh Bank officials.

Bangladesh Bank has outsourced its entry examination process. Usually, the Institute of Business Administration or the Finance Department of Dhaka University or the Bangladesh Institute of Bank Management conducts the test, to set the questionnaires and evaluate the answers. The process has been working well and it helps to identify meritorious candidates. However, similar specialized recruitments for departments like Research, Statistics and Monetary Policy Department would also be useful.

The pay scale is a key issue for the central bank employees. The pay scale offered is much lower than in the private sector commercial banks. The informants ranked low pay scale as a key reason for not having enough talented and meritorious Bangladeshis joining the central bank service.

8. Automation:

A key objective of the Central Bank Strengthening Project is to modernize and reorganize the central bank. Automation is one of the means designed to achieve this. It is widely accepted that the automation of the central bank would increase efficiency through proper utilization of the facilities that will be available through better networking.

The private sector commercial banks were the first to introduce automation in the banking industry. In the early 90s, some of the private sector commercial banks (especially foreign banks) in Bangladesh introduced IT and communication technology in the banking business. The local private commercial banks soon followed the trend. Although, not all private banks went for a complete automation the use of computers and IT increased in the past decade. The state-owned commercial banks (Nationalized Commercial Banks) are yet to be automated but several private sector banks are now successfully using the automated banking system. The central bank has recently introduced the IT Guideline for the Commercial Banks.

The central bank itself is yet to adopt its own automated network. As mentioned earlier under the CBSP, the central bank has taken initiative to introduce IT and communication technology to improve its operations. The project is still in progress and has been divided into six different packages. A network integrator will be hired to integrate the whole system. Sources said the project was divided due to political influence. It was also opined that this splitting up would make the integration difficult in the future.

9. Role of Media:

The print and electronic media, by giving due coverage on central bank activities have definitely improved the transparency and accountability of the central bank. Newspapers have been regularly reporting on various issues related to central bank supervision and regulation of the commercial banking sector. This has contributed significantly to improving the accountability and transparency in the banking sector.

The information about the central bank also improved. In the past, the governor needed approval from the Ministry of Finance to meet the press. The rule has been abolished and the governor is more open to the public both through print and electronic media.

The bank has developed a new website and has been posting a lot of information about its activities bringing a welcome change from the past. All the information and manuals related to the commercial banking are uploaded on to the website. The *"Repo"* and *"Reverse-Repo*" auction results are also available on the web. The annual and monthly reports are published regularly and are made public through the website. All the research reports of various departments of central bank are now made public as well and accessible on the website.

A very recent innovation is the publication of *"Half Yearly Monetary Policy"* statement, which is a standard practice by the central banks of other countries. It is expected that this would act as a catalyst in improving transparency and accountability of the central bank in Bangladesh.

The Official Secrecy Act, if replaced by Right to Information Act, would definitely improve accountability and transparency of central bank operations. This would reinforce the central bank autonomy sought through legislative changes back in 2003.

10. Conclusion:

The reforms that have taken place over the past two decades helped the central bank to evolve to a stronger position compared to the past. These reforms enabled the central bank to govern the financial sector in a more focused and objective manner. It has gradually developed the rules and procedures along with the fit and proper test criteria to maintain financial sector discipline. These changes can increase financial intermediation and enhance financial deepening. However, it seems that many of the changes are donor dictated rather than to be domestically formulated. The chronology of the reforms and the evaluation of the various reforms associated with central bank and financial sector suggest and indicate donor participation.

The privatization process along with the financial sector reforms and with globalization necessitated further impetus in the process of reform. The reforms should continue as new nuts and bolts are required for a smooth functioning of the financial market. Steps are taken by the government but are slow and are often not complete. It came clear in the interviews with the stakeholders that some of the reforms and proposed guidelines and laws are not getting through as they might hinder the interests of vested groups such as employee union, corrupt business men and even bank employees. These vested groups have political connections and often exert political pressure, which can result in a lack of discipline in the financial sector. The situation has become more complex as business and politics have joined hands with businessmen entering politics.

The government borrowing from the central bank and the formal banking sector is opined to be detrimental to the financial sector. This is a window of government influence on the central bank. A remedy for it could be a limit on the borrowings or directed to some pre-defined sectors rather than abrupt borrowings by the government.

Loan default is a major problem afflicting the country's banking as well as financial sector. Strict steps are expected from the central bank to facilitate recovery of non-performing loans.

The regulation and supervision activities of the central bank should be decentralized and outsourced by creating new agencies. Many countries have adopted this and experts in the country think that this possibility should be explored. The central bank can thus work on monetary policy in a more focused manner and in a credible way.

An autonomous central bank could be more credible in its decisions and actions. Less government influence reduced mandatory participation from the executive wing in the central bank affairs and most importantly less politicization would help create a more autonomous and professional environment for the central bank.

Appendix A

List of Bangladesh Bank Governors

Dr. Salehuddin Ahmed	May 2005 to
Dr. Fakhruddin Ahmed	November 29, 2001 to April 30, 2005
Dr. Mohammed Farashuddin	November 24, 1998 to November 22, 2001
Mr. Lutfar Rahman Sarkar	November 21, 1996 to November 21, 1996
Mr. Khorshed Alam	December 20, 1992 to November 21, 1996
Mr. Shegufta Bakht Chaudhuri	April 12, 1987 to December 19, 1992
Mr. M Nurul Islam	July 13, 1976 to April 12, 1987
Mr. A K N Ahmed	November 18, 1974 to July 13, 1976
Mr. A N M Hamidullah	January 18, 1972 to November 18, 19784

Appendix B: Measuring Autonomy

Political autonomy is defined as the authority and ability of the central bank to select the objectives of the monetary policy. The authors employ the following criteria to measure "*political autonomy*"-

Criteria	Yes	No
Appointment of the central bank governor is independent of government influence		
The governor is appointed for tenure of more than five years		
Members of the Board of Directors are appointed without government involvement		
Board members are appointed for tenure more than five years		
There is no mandatory participation of government representatives in the board		
No government approval is required in formulating the monetary policy	1	
There are requirements in the central bank charter forcing the central bank to pursue monetary stability amongst its primary objectives	1	
There are provisions of legal protection that strengthens the central bank's position in the event of a conflict with the government		
Total (out of 8)	**2**	

Economic autonomy is defined as the ability and authority in selecting the instruments. Similar to political autonomy the authors examine at the following attributes to measure *"economic autonomy"* –

Criteria	Yes	No
There is no automatic procedure for the government to obtain direct credit facilities from the central bank		
Direct credit facilities are extended to the government at market interest rate		
The credit is extended on a temporary basis		
The credit is for a limited amount		
There exists a limit on government borrowing from the central bank		
The central bank does not participate in the primary market for public debt		
The central bank sets the discount rate	1	
The central bank has no role to oversee the banking sector or shares this role with another separate organization		
Total (out of 8)	**1**	

The central bank gets 1 point for every yes i.e. the bank has fulfilled the criteria.

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