

Internship Report on

Causes of Inflation with a Special Reference to Monetary Policy



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Submitted to

A. B. Mirza Md. Azizul Islam
Professor
BRAC Business School
BRAC University

Submitted by

Maisha Tasmia
ID: 10104002
BRAC Business School
BRAC University

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To,
A.B Mirza Md Azizul Islam
Professor and Academic Supervisor
BRAC Business School
BRAC University

Subject: Submission of Internship Report

Dear Sir,

It gives me immense pleasure in presenting the internship report on "Causes of Inflation with a Special Reference to Monetary Policy" which was assigned to me as a partial fulfillment of the BBA program.

Prior making of the report, the three months of internship program at RobiAxiata Limited gave me the opportunity to work in the department of Revenue Assurance and Fraud Management, under Finance division. The work experience there enriched my knowledge about the corporate environment of an organization. However, the report has been made on a topic apart from my field of working and as per the discussion with my respective supervisor. To carry out the report, I have gathered various papers/document periodicals etc. as well as from internet for the purpose of secondary data.. On the basis of these secondary data and practical observation, I have prepared the report later.

I hope that the report would be meeting your expectations and standards. Your kind consideration and cooperation will be highly appreciated.

Sincerely yours,

Maisha Tasmia

ID - 10104002

BRAC Business School

BRAC University

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In preparing the report on, "Causes of Inflation with a Special Reference to Monetary Policy",. Firstly I express my gratitude to my academic supervisor Professor A.B Mirza Md Azizul Islam, for his proper guidance and effective direction for this study.

I want to thank my Supervisor Mr. S.K Shaheen Islam(General Manager, RAFM) who welcomed me into the beautiful corporate world of RobiAxiata Limited, who gave me the opportunity to have an excellent and enduring practical working experience, to go out of my comfort zone and learn to be more creative, challenging and confident.

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Abstract

Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. This paper particularly focuses how a central bank responds while being in an inflationary situation through using monetary policy as a tool and its impact. Monetary policy is referred to as either being expansionary or contractionary, where an expansionary policy increases the total supply of money in the economy more rapidly than usual, and contractionary policy expands the money supply more slowly than usual or even shrinks it. Expansionary policy is traditionally used to try to combat unemployment in a recession by lowering interest rates in the hope that easy credit will entice businesses into expanding. Contractionary policy is intended to slow inflation in order to avoid the resulting distortions and deterioration of asset values. Besides, Monetary policy is used for achieving the objectives of macro-economic management and for providing a sound macro-economic environment which refers to the overall economic measurement of a country with the purpose of achieving a target growth rate of the economy while maintaining price stability, making progress towards poverty alleviation and employment generation and achieving balance of payments viability. Furthermore, this paper also includes an empirical analysis to find out the changes in inflation due to the change the annual money growth rate. However, the findings conclude that, there might remain some dominating other factors along with money supply in the economy to influence the annual inflation rate.

List of Abbreviation

CB	Central Bank
BB	Bangladesh Bank
CPI	Consumer Price Index
GDP	Gross Domestic Product
FSRP	Financial Sector Reform Program
RBI	Reserve Bank of India
MPS	Monetary Policy Statements
SLR	Statutory Liquidity Requirement
CRR	Cash Reserve Requirement
RM	Reserve Money
MTMF	Medium Term Macroeconomic Factor
NSAPR	National Strategy for Accelerated Poverty Reduction (NSAPR)
OMO	Open Market Operation
BOP	Balance of Payment
RAFM	Revenue Assurance and Fraud Management
KWH	Kilo Watt Hour

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Chapter One

1.1 Origin of the Report

For a student of BBA, it is a requirement after the attending all the required courses and completing the credits to attach with a business institution and prepare a thesis report, which is a part of the program. To fulfill this requirement I worked as an intern in Robi Axiata Limited for three months. This not only fulfills the requirement of the program but also facilitates the dissemination of knowledge in the telecommunication sector of Bangladesh. Besides it helped me a lot to compare theoretical knowledge with practical experience. Apart from that, I proposed the topic " Causes of Inflation with a Special Reference to Monetary Policy " and my organization supervisor Mr. S.K Shaheen Islam (General Manager,RAFM,Robi Axiata Ltd) & my institution supervisor at BRAC University , Professor. A.B. Mirza Md. Azizul Islam, duly approved it.

1.2 Objective

The objective of this report is associated with the internship purpose. Although, the internship objective is to acquire practical facts and experiencing the corporate working environment, yet this particular report differs from depicting those purposes and rather subjected to core knowledge. With the set rules and suggestion by the BRAC University and with the generous assistances of the organization and the internship supervisor, this report mainly focuses on illustrating the consequences of inflation on monetary policy chosen by the central bank.

The major objective of project part is:

Give a very short overview of how does the monetary system actually works on confronting inflationary situation and its mechanism to reduce the inflation rate accordingly.

1.3 Scope of the Report

The scope of this report is to represent the inflationary situation and central Bank's approach to reduce the inflation by tool of monetary policy.

1.4 Methodology

To prepare the report information was the most important thing. And to get that information I followed some methods. Firstly, gathering information through internet was very significant. I have tried to collect data primarily from Bangladesh Bank's and Ministry of Finance, Bangladesh governments websites. Along with that, Federal Reserve System, The Bank of England and Reserve Bank of India's websites also provided necessary information while shaping the report. Lastly, some Bangladesh Bank Publications and journals, Bangladesh Institute of Banking Management (BIBM)'s publication also helped in acquiring data.

1.5 Secondary Source:

- My secondary source of collecting information was the website of Bangladesh Bank, Federal Reserve System, The Bank of England, Reserve Bank of India's websites along with other relevant websites.
- Different publication.

1.6 Limitation

The three months of working experience at Robi Axiata Limited was nice. Yet, it was a different kind of experience to work in such an atmosphere. Moreover, Preparing report is an essential part of internship. While my fellow interns made an internship report on their own working experience along with respective department, I chose a topic rather close to subject knowledge. but to get information for preparing the report there were some limitations. Like:

- I was an intern in the Revenue Assurance and Fraud Management. hence the scope of collecting information was narrow because information and data were not disclosed and were quite private.
- As an intern I performed some particular tasks which cannot get associated with the report I made. That is my limitation.

1.7 Significance of the report:

Other than specifying the Impact of monetary policies on inflationary situations, the report also finds the reasons and consequences of inflation on Bangladesh economy which will later can benefit other secondary users. An individual who will keen to know the detailed reasons behind inflation, its consequences, the monetary impact and the anchors of monetary policies , the report can give a brief overview as a whole and thus it will be significant for them.

Chapter Two

2.1: Significance of Macro Economic Indicators:

Macroeconomic indicators are statistics that indicate the current status of the economy of a state depending on a particular area of the economy (industry, labor market, trade, etc.). They are published regularly at a certain time by governmental agencies and the private sector. In other words, An economic indicator is simply any economic statistic, such as the unemployment rate, GDP, or the inflation rate, which indicate how well the economy is doing and how well the economy is going to do in the future

In truth, these statistics in monitoring the economy's pulse; thus it is not surprising that these are thoroughly followed by almost everyone in the financial markets. After publication of these indicators we can observe volatility of the market. The degree of volatility is determined depending on the importance of an indicator. That is why it is important to understand which indicator is important and what it represents.

- **Interest Rates Announcement**

Interest rates play the most important role in moving the prices of currencies in the foreign exchange market. As the institutions that set interest rates, central banks are therefore the most influential actors. Interest rates dictate flows of investment. Since currencies are the representations of a country's economy, differences in interest rates affect the relative worth of currencies in relation to one another. When central banks change interest rates they make the market to experience movement and volatility. In the realm of trading, accurate speculation of central banks' actions can enhance the trader's chances for a successful trade.

- **Gross Domestic Product (GDP)**

The GDP is the broadest measure of a country's economy, and it represents the total market value of all goods and services produced in a country during a given year. Since the GDP figure itself is often considered a lagging indicator, most traders focus on the two reports that are issued in the months before the final GDP figures: the advance report and the preliminary report. Significant revisions between these reports can cause considerable volatility.

- **Consumer Price Index**

The Consumer Price Index (CPI) is probably the most crucial indicator of inflation. It represents changes in the level of retail prices for the basic consumer basket. Inflation is tied directly to the purchasing power of a currency within its borders and affects its standing on the international markets. If the economy develops in normal conditions, the increase in CPI can lead to an increase in basic interest rates. This, in turn, leads to an increase in the attractiveness of a currency.

- **Employment Indicators**

Employment indicators reflect the overall health of an economy or business cycle. In order to understand how an economy is functioning, it is important to know how many jobs are being created or destroyed, what percentage of the work force is actively working, and how many new people are claiming unemployment. For inflation measurement, it is also important to monitor the speed at which wages are growing.

- **Retail Sales**

The retail sales indicator is released on a monthly basis and is important to the foreign exchange trader because it shows the overall strength of consumer spending and the success of retail stores. The report is particularly useful because it is a timely indicator of broad consumer spending patterns that is adjusted for seasonal variables. It can be used to predict the performance of more important lagging indicators, and to assess the immediate direction of an economy.

- **Balance of Payments**

The Balance of Payments represents the ratio between the amount of payments received from abroad and the amount of payments going abroad. In other words, it shows the total foreign trade operations, trade balance, and balance between export and import, transfer payments. If coming payment exceeds payments to other countries and international organizations the balance of payments is positive. The surplus is a favorable factor for growth of the national currency.

- **Government Fiscal and Monetary policy**

Stabilization of the economy (e.g., full employment, control of inflation, and an equitable balance of payments) is one of the goals that governments

attempt to achieve through manipulation of fiscal and monetary policies. Fiscal policy relates to taxes and expenditures, monetary policy to financial markets and the supply of credit, money, and other financial assets.

There are many economic indicators, and even more private reports that can be used to evaluate the fundamentals. It's important to take the time to not only look at the numbers, but also understand what they mean and how they affect a nation's economy.

Chapter Three

3.1: Bangladesh Bank (BB):

The central bank of the country, was established as a corporate body by the Bangladesh Bank Order, 1972 (P.O. No. 127 of 1972) with effect from 16 December, 1971 by acquiring the liabilities and assets of erstwhile State bank of Pakistan in East Pakistan. At present it has ten offices located at Motijheel, Sadarghat, Chittagong, Khulna, Bogra, Rajshahi, Sylhet, Barisal, Rangpur and Mymensingh in Bangladesh; total manpower stood at 4951 (officials 3961, subordinate staff 990) as on November 30, 2012.

3.2: Core Functions of Bangladesh Bank:

BB performs all the core functions of a typical monetary and financial sector regulator, and a number of other non core functions. The major functional areas include :

- Formulation and implementation of monetary and credit policies.
- Regulation and supervision of banks and non-bank financial institutions, promotion and development of domestic financial markets.
- Management of the country's international reserves.
- Issuance of currency notes.
- Regulation and supervision of the payment system.
- Acting as banker to the government .
- Money Laundering Prevention.
- Collection and furnishing of credit information.
- Implementation of the Foreign exchange regulation Act.
- Managing a Deposit Insurance Scheme .

3.3: Inflation:

Inflation is the rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Consequently, inflation also reflects erosion in the purchasing power of money – a loss of real value in the internal medium of exchange and unit of account in the economy. A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the Consumer Price Index, CPI) over time.

Bangladesh has been facing an upward trend in inflation over the last couple of years. Inflation expands the wealth of the asset owners while it reduces the net consumption of the poor as the prices of goods and services go up. If a poor wants to maintain the same level of food consumption, it reduces his or her other consumption, including health, education and investment. Such increments in price without corresponding rise in disposable income restrain the government's goal of reduction of poverty. So, our government tries to control inflation but with little success. For example, the inflation overshoot the target of 8.9% in FY2008 –09.

A list illustrating yearly inflation since last 5 years is given below:

Year	General Inflation(Base year-1995)
2008	8.9%
2009	5.4%
2010	8.1%
2011	10.7%
2012	8.7%
Source: Global Economy Data; The World Bank	

Inflation data from the year 2008 to 2012 is depicted in a graph below:

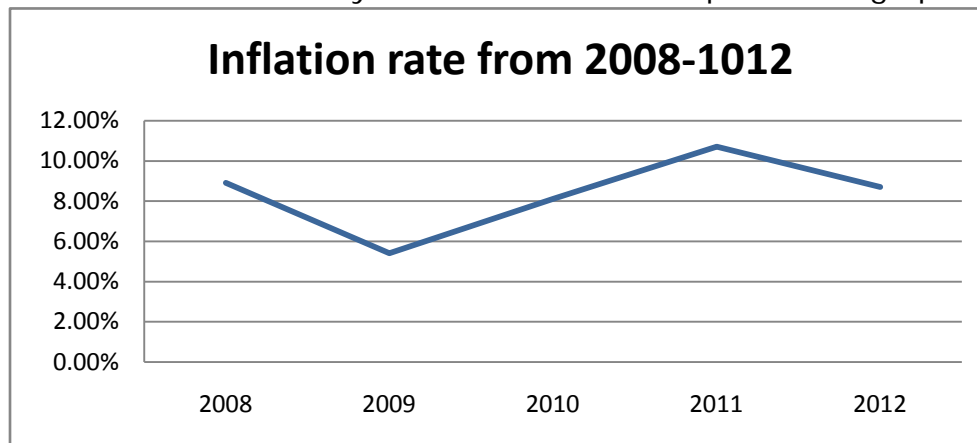


Figure 3.1.1: Inflation rate illustration from 2008-2012

3.4: Sources of Inflation:

The factors that affect the movement of the prices upward in Bangladesh include:

1. Increased prices of inputs

Cost push inflation is inflation caused by an increase in prices of inputs like labor, raw material, etc. The increased price of the factors of production leads to a decreased supply of these goods. While the demand remains constant, the prices of commodities increase causing a rise in the overall price level. This is in essence cost push inflation and it is typically caused by flood, draught and oil price hike or natural disaster.

In this case, the overall price level increases due to higher costs of production which reflects in terms of increased prices of goods and commodities which majorly use these inputs. This is inflation triggered from supply side i.e. because of less supply. The opposite effect of this is called demand pull inflation where higher demand triggers inflation.

2. Upward price movements in the country of origin

Country of origin (COO) , is the country of manufacture, production, or growth where an article or product comes from. There are differing rules of origin under various national laws and international treaties. In other words, Country of origin means the country where goods shipped were produced. Price movement or fluctuation in the country of origin leads inflation as well.

3. Anticipated upward pressure on prices of gas, fuel and power

Unexpected volatility in the prices of internationally traded commodities such as oil, gas copper prices get increased, then manufacturers will either modify output supply or convert the elevated costs into elevated output costs. Consequently, this situation mirrors a decrease in the purchasing power of money. Many countries subsidize the retail price of gasoline to encourage industrial development and to gain the popular support of the people, creating an artificially higher demand for gasoline. Changes in this subsidy will affect the demand for gas similarly to price increases or price decreases.

4. Undervalued exchange rate

A currency with an exchange rate lower than it ought to be. A currency may be undervalued, for example, when its purchasing power, supply and demand are all strong, but its price is still comparatively low. Some governments keep their currencies undervalued deliberately because it makes their exports less expensive, but this is usually an unsustainable policy. Undervalued exchange rate refers to the

exchange rate that has an officially fixed value less than its fundamental value. China's exchange rate is undervalued by 5 percent to 10 percent on an inflation-adjusted basis given the fundamentals of the country's economy. Nevertheless, The fixed, undervalued exchange rate of the yuan to the dollar has helped China boost its exports and alleviate the impact of the global economic crisis.

5. Continuous pile-up of remittances vis-à-vis decreasing import

The remittance inflows that generates surplus in the Balance of payments and operates in the opposite direction of contraction of money supply, is one of the reason which causes inflation. Hence, if the import bill does not increase and the inflow continuous to grow, there is a probability of further expansion as government tries to send more workers abroad. There is a possibility that Central Bank's monetary contraction might be endangered by this surplus.

6. Increased non-development expenditure

Increased non-development expenditures of Government also lead to the inflation. For example, Non developmental expenditures such as expenditure on defense, government official's foreign tours, increase in salaries of government employees etc leads the economy of an inflationary situation. On the other hand in most developmental projects output starts many years after the money has been spent. Such type of developmental projects are also the reasons behind inflation.

7. Lack of prudential management of liquidity

Liquidity is the amount of capital that is available for investment and spending. Capital includes cash, credit and equity. Most of the capital is credit rather than cash. That's because the large financial institutions that do most investments prefer using borrowed money. Even consumers traditionally prefer credit cards to debit cards, checks or cash. Liquidity is measured by the money supply, such as M1, M2, and M3. The Central Bank manages liquidity with its monetary policy tools. The most important tool is the short-term interest rates. The CB also uses open market operations, which affect Treasury bond yields. When rates are low, capital is easily available. Low rates reduce the risk of borrowing, because the return only has to be higher than the interest rate. This makes more investments look good. In this way, liquidity creates economic growth.

On the other hand, high liquidity means there's a lot of capital. A liquidity glut develops when there is too much capital looking for too few investments. This can

lead to inflation. Hence, prudential management of liquidity is very significant in inflationary situation.

3.5: Monetary policy:

Monetary policy is the main macro-economic policy formulated and implemented by the central bank. Bangladesh Bank has the authority to increase or decrease the volume of money in the economy and therefore, is responsible for formulating and implementing the monetary policy for the country. The wheel of development moves by taking forces from this policy. The aim of monetary policy is to keep inflation low and steady. Though, in a developing country like Bangladesh, the effectiveness of monetary policies is always uncertain, but effectiveness of these policies is treated as signal for policy makers.

The Central Bank is the highest authority employed by the government for formulation of monetary policy to guide the economy in a certain country. Monetary policy is defined as the regulation of the money supply and interest rates by a central bank. Monetary policy also refers to how the central bank uses interest rates and the money supply to guide economic growth by controlling inflation and stabilizing currency. Like any other central bank, Bangladesh Bank is performing the role to formulate monetary policy in Bangladesh.

There have been significant changes in the legal, institutional and policy frameworks of the financial system of Bangladesh under the Financial Sector Reform Programmes (FSRP) in the 1990s. These changes enable Bangladesh Bank to conduct monetary policy on the basis of market based instruments along with direct instruments in order to achieve price stability and smooth financial intermediation. Therefore, understanding the distinct active channels of monetary transmission in the economy of Bangladesh would guide the monetary authority in formulating and conducting monetary policy (Ahmed and Islam: 2004).

The monetary policy framework of Bangladesh Bank identifies a logical sequential set of actions for designing and conducting the monetary policy. The framework is based on credible information on the stability of the money demand function, the money supply process, and the monetary transmission mechanism. Monetary policy in Bangladesh is framed using projected real GDP growth rate. The targeted rate of inflation adopts Reserve Money (RM) and Broad Money (M2) as operating and intermediate targets respectively connecting between different policies instruments like repo, reverse repo rates, bank rate, Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR).

The control of money supply is an important policy tool in conducting monetary policy. The success of monetary policy depends on the degree of predictability, measurability and controllability that the monetary authority has over money supply.

The main objectives of monetary policy of Bangladesh Bank are:

- Price stability both internal & external
- Sustainable growth & development
- High employment
- Economic and efficient use of resources
- Stability of financial & payment system

Bangladesh Bank declares the monetary policy by issuing Monetary Policy Statement (MPS) twice (January and July) in a year. The tools and instruments for implementation of monetary policy in Bangladesh are Bank Rate, Open Market Operations (OMO), Repurchase agreements (Repo) & Reverse Repo, Statutory Reserve Requirements (SLR & CRR).

3.6: Monetary Policy and Inflation:

In a market oriented economy, central banks cannot control inflation directly. They have to use different instruments such as open market operation, legal reserve ratio, bank rate etc. Bangladesh Bank wants to stabilize the existing inflationary pressure by putting a break on money supply growth. The suggested tools to influence the growth of money stocks are:

I. Restriction of broad money growth path

In general, broad money includes highly liquid instruments like all physical currency and deposits in checking accounts, but also less liquid deposits like those in savings accounts, certificates of deposit, institutional money market accounts, repurchase agreements and other assets that do not circulate very often. It may also include debt securities with maturities of less than two years, repurchase agreements and other assets. Many central banks had begun targeting the growth of money supply to control inflation. This approach works if the central bank can control the money supply reasonably well and if money growth is stably related to inflation over time.

II. Adjustment in cash reserve ratio (CRR)

The **reserve requirement** (also known as the cash reserve ratio) is the minimum amount of money that banks must hold in reserve, usually given as a percentage of customer deposits. The cash is normally stored in a vault at the bank or with a central bank and cannot be invested or loaned out to businesses or individuals. The requirement is set by each country's central bank and raising or lowering the reserve requirement will subsequently influence the money supply in the economy.

If the reserve requirement is raised, banks will have less money to loan out and this effectively reduces the amount of capital in the economy, therefore lowering the money supply. It will mean less money for investment and spending, and would stunt the growth of the economy. It would also mean that banks earn less interest and could see their share prices fall.

Lowering the reserve requirement will have the opposite effect; banks will be able to lend more which would increase money supply and stimulate economic growth.

Raising reserve requirements can cause an increase in currency value because when banks are restricted in the amount that they can lend out, they may charge borrowers a higher rate of interest. This is bad news for borrowers, but good news for savers who can benefit from a higher rate of return on their savings. If more capital enters the economy to benefit from those higher interest rates, the value of the currency is likely to increase.

The opposite is true if reserve requirements are lowered. Banks will be able to lend more and so may offer lower interest rates, which can in turn cause the value of a currency to decrease.

To curb inflationary pressure on the economy, Bangladesh bank also takes necessary steps to increase CRR.

III. Statutory liquidity requirements (SLR)

SLR (Statutory Liquidity Ratio) is the amount a commercial bank needs to maintain in the form of cash, or gold or govt. approved securities (Bonds) before providing credit to its customers. SLR rate is determined and maintained by the BB. in order to control the expansion of bank credit. SLR is determined as the percentage of total demand and percentage of time liabilities. Time Liabilities are the liabilities a commercial bank liable to pay to the customers on their anytime demand. With the SLR (Statutory Liquidity Ratio), the Central Bank can ensure the solvency a commercial bank. It is also helpful to control the expansion of Bank Credits. By changing the SLR rates, Central Bank can

increase or decrease bank credit expansion. Also through SLR, RBI compels the commercial banks to invest in government securities like government bonds. SLR is used to control inflation and propel growth. Through SLR rate tuning the money supply in the system can be controlled efficiently.

IV. Restriction in the capital accounts

The capital account in a country's balance of payments covers a variety of financial flows mainly foreign direct investment (FDI), portfolio flows (including investment inequities), and bank borrowing—which have in common the acquisition of assets in one country by residents of another. It is possible, in principle, to control these flows by placing restrictions on those flows going through official channels.

In other words, Restriction in the capital accounts refers to any measure taken by a government, central bank or other regulatory body to limit the flow of foreign capital in and out of the domestic economy. This includes taxes, tariffs, outright legislation and volume restrictions, as well as market-based forces. Capital controls can affect many asset classes such as equities, bonds and foreign exchange trades.

Tight capital controls are most often found in developing economies, where the capital reserves are lower and more susceptible to volatility.

All the banks were required to maintain 5% of their total demand and time liabilities to Bangladesh Bank as CRR and no less than 18.5 percent as SLR. But BB has raised the CRR and SLR for scheduled banks by one half percentage point from May 2010 to restrain the expansion of monetary base.

BB plans to continue to support sufficient credit availability to agriculture, small and medium enterprises (SMEs), renewable energy and other productive sectors, but it also intends to strongly discourage lending expansion for wasteful consumption and unproductive speculative investment. It also has stated that workers' remittance growth would settle down and import growth would increase at a moderate level to ease out the inflows driven appreciation pressure of taka and also the monetary expansion, resulting out of such pressures.

3.7: The policy target:

In the backdrop of market economy, it is necessary that the monetary policy framework be articulated for greater clarity and transparency benefitting both the

policy makers as well as the stake holders. The leading central banks in the industrial world have increasingly adopted the unitary goal of fighting inflation.

However, the following objectives are also kept in mind:

I. The promotion of price stability

Monetary Policy the policy adopted by the central bank for control of the supply of money as an instrument for achieving the objectives of general economic policy. With the shifts of the policy stance of the government in various phases, necessary adjustments were made in the country's monetary policy. The Department of Research in the Bangladesh Bank plays an important role in the formulation of economic policies of the country. The monetary policy having an objective of price stability tries to keep the value of money stable. It helps in reducing the income and wealth inequalities.

II. GDP Growth

Monetary policy in a country acts as a tool by which the government or central bank, attain a set of objectives oriented towards the growth and stability of the economy. High rates of inflation cause problems, not just for some individuals, but for aggregate economic performance. For each one percent point increase in inflation, in USA, annual growth rate has reduced by 0.223% (Smyth,1992). At low rates of inflation this relationship is negative but insignificant; however higher rates of inflation have a significantly negative effect on growth. Inflation not only decreases the growth rate but also induces the uncertainty in economy. Government policies, including monetary policy, affect the growth of domestic output to the extent that they affect the quantity and productivity of capital and labor. Monetary policy is only one element of overall macroeconomic policy, and can only affect the production process through its impact on interest rates.

III. Ensuring full or near full employment

Full Employment' stands for a situation in which everybody who wants jobs get jobs. However it does not mean that there is a Zero unemployment. In that senses the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with

cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

V. Supporting national and global economic and financial stability

It is one of the most important objectives of a monetary policy. The monetary policy can influence economic growth and stability by controlling real interest rate and its resultant impact on the investment. Financial stability is a necessary prerequisite for an effective monetary policy. There is a critical chain of linkages from monetary policy to banking and onwards to the real economy. Financial stability is a necessary condition for those linkages to operate effectively. Thus, it is a necessary condition for monetary policy to be able to achieve its economic objectives.

3.8: Inflation target:

Inflation, a rise in the overall level of prices, is often bad news. It erodes savings, discourages investment, stimulates capital flight (as domestic investors put their funds into foreign assets, precious metals, or unproductive real estate), inhibits growth, makes economic planning a nightmare, and, in its extreme form, provokes social and political unrest. Governments consequently have tried to squelch inflation by adopting conservative and sustainable fiscal and monetary policies.

It is the general wisdom that the monetary policy tools are of immediate potency in controlling inflation. However, contemporary evidences imply that monetary policy cannot deal well with the inflationary impacts of external shocks such as the recent international price of oil and related energy products.

Many central banks, as a consequence, focus on the core inflation, which is typically constructed by subtracting the most volatile components from the Consumer Price Index (CPI). Hence, as a policy goal, core inflation may be a more credible target than CPI inflation.

It is quite relevant to set an indicative target band that will be realizable over the medium term.

In a floating rate system, there is no question of a target band for the currency par value and hence the short term adjustments in the exchange rate system are necessary. In order to maintain export competitiveness, one has to keep an eye on

the evolving pattern of sector productivity changes in the competitor countries. If inflation is allowed to slip, the subsequent depreciation in the par value of the currency will fuel further inflation.

Hence, In recent years, many central banks, the makers of monetary policy, have adopted a technique called ***inflation targeting*** to control the general rise in the price level. In this framework, a central bank estimates and makes public a projected, or “target,” inflation rate and then attempts to steer actual inflation toward that target, using such tools as interest rate changes. Because interest rates and inflation rates tend to move in opposite directions, the likely actions a central bank will take to raise or lower interest rates become more transparent under an inflation targeting policy. Advocates of inflation targeting think this leads to increased economic stability.

3.9: Why inflation targeting?

Many central banks adopted inflation targeting as a pragmatic response to the failure of other monetary policy regimes, such as those that targeted the money supply or the value of the currency in relation to another, presumably stable, currency. In general, a monetary policy framework provides a *nominal anchor* to the economy. A nominal anchor is a variable policymakers can use to tie down the price level. One nominal anchor central banks used in the past was a currency peg—which linked the value of the domestic currency to the value of the currency of a low-inflation country. But this approach meant that the country’s monetary policy was essentially that of the country to which it pegged, and it constrained the central bank’s ability to respond to such shocks as changes in the terms of trade (the value of a country’s exports relative to that of its imports) or changes in the real interest rate. As a result, many countries began to adopt flexible exchange rates, which forced them to find a new anchor.

Many central banks then began targeting the growth of money supply to control inflation. This approach works if the central bank can control the money supply reasonably well and if money growth is stably related to inflation over time. Ultimately, monetary targeting had limited success because the demand for money became unstable—often because of innovations in the financial markets. As a result, many countries with flexible exchange rates began to target inflation more directly, based on their understanding of the links or “transmission mechanism” from the central bank’s policy instruments (such as interest rates) to inflation.

3.10: How does inflation targeting work?

Inflation targeting is straightforward, at least in theory. The central bank forecasts the future path of inflation and compares it with the target inflation rate (the rate the government believes is appropriate for the economy). The difference between the forecast and the target determines how much monetary policy has to be adjusted. Some countries have chosen inflation targets with symmetrical ranges around a midpoint, while others have identified only a target rate or an upper limit to inflation. All countries have set their inflation targets in the low single digits. An inflation target of zero is not recommended because it would not allow real interest rates to fall sufficiently to stimulate overall demand when a central bank is trying to boost the economy.

A major advantage of inflation targeting is that it combines elements of both “rules” and “discretion” in monetary policy. This “constrained discretion” framework combines two distinct elements: a precise numerical target for inflation in the medium term and a response to economic shocks in the short term.

Rather than focusing on achieving the target at all times, the approach has emphasized achieving the target over the medium term—typically over a two- to three-year horizon. This allows policy to address other objectives—such as smoothing output—over the short term. Thus, inflation targeting provides a rule-like framework within which the central bank has the discretion to react to shocks. Because of inflation targeting medium-term focus, policymakers need not feel compelled to do “whatever it takes” to meet targets on a period-by-period basis.

3.11: Growth Target:

As long as Bangladesh remains within the National Strategy for Accelerated Poverty Reduction (NSAPR) – Poverty Reduction Growth Facility (PRGF) framework, the growth target is already built in there. The latter is based on the medium term macro-economic framework (MTMF). Hence, inflation targets must be based on level of investment and Balance of Payment (BOP). The major constraint here is the lack of timely data on macro-economic indicators.

3.12: Conduct of Monetary Policy:

Modern practices appear to be a rule based approach to the Conduct of Monetary Policy. John Taylor (1998) defines a monetary policy rule as a description of how the instruments of policy change in response to target economic variables. It routinely monitors the inflationary outlook by examining the evolving pattern of a

broad index namely GDP Deflator and periodically decides to adjust the central bank rate or leave it unchanged. BB puts more emphasis on controlling inflation via the money multiplier, M_2 . The success of targeting broad money in controlling inflation is premised on the long term equilibrium relationship between money and prices.

3.13: Instruments of monetary policy:

BB has moved from regulations and control based monetary instruments towards market based policy. Directed lending has been reduced to minimum level except agriculture sector.

The central bank has, in its disposal, a number of policy instruments. These can affect certain intermediate targets such as reserves, money supply, interest rates etc. The instruments of monetary policy are as follows:

I. **Bank Rate:** The rediscount rate of discounting first class bills such as Treasury Bills. In other words, the interest rate at which a nation's central bank lends money to domestic banks which are very short in duration. Managing the bank rate is a preferred method by which central banks can regulate the level of economic activity. Lower bank rates can help to expand the economy, when unemployment is high, by lowering the cost of funds for borrowers. Conversely, higher bank rates help to reign in the economy, when inflation is higher than desired.

The bank rate can also refer to the interest rate which banks charge customers on loans. To check the credit operation (contractionary monetary policy), central banks increase bank rate. Borrowing becomes more expensive, hence demand for loans will be reduced.

II. **Open Market Operation:** It refers to the buying or selling of securities and treasury bills by central bank in the open market so as far to influence the size of bank deposits. In other words, it means the buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite. In times of inflation, BB will reduce the cash reserves of commercial banks by selling more treasury bills.

III. **Variation in Legal Reserve Requirement:** Reserve Requirements refers to the minimum amount of cash or cash-equivalents (computed as a percentage of deposits) that banks and other depository institutions (credit unions,

insurance companies) are required by law to keep on hand, and which may not be used for lending or investing. Reserve requirements serve as (1) a safeguard against a sudden and inordinate demand for withdrawals (as in a run on a bank), and (2) as a control mechanism for injecting cash (liquidity) into, or withdrawing it from, an economy. It means cash and liquidity ratios or reserve-asset ratios. The central bank has the authority to vary the cash and liquidity ratios in times of inflation. For instance it could increase the cash and liquidity ratios in times of inflation and the policy is reverse in times of deflation.

IV. **Selective Credit Control:** The central bank may resort to credit rationing. It may prescribe absolute limits up to which specific sector of the economy may get credit from the banking system.

V. **Setting Marginal Requirements:** Margin requirement refers to the amount that an investor must deposit in a margin account before buying on margin or selling short. Central bank may insist on marginal requirements. margin requirement is percentage of a security's value that may be used as a collateral for a loan to finance its purchase. For instance, banks may be asked not to give loans exceeding 60% of the goods pledged on a particular good. It may instruct to set different interest rates to be charged on loans of different categories.

VI. **Moral Suasion:** A persuasion tactic used by an authority to influence and pressure, but not force, banks into adhering to policy. Tactics used are closed-door meetings with bank directors, increased severity of inspections, appeals to community spirit, or vague threats. It is sometimes called Jaw Bone Control. BB, in times of inflation, may persuade the commercial banks to restrict their lending policy.

3.14: Monetary Policy and macro-economic management:

Monetary policy is used for achieving the objectives of macro-economic management and for providing a sound macro-economic environment. It refers to the overall economic measurement of a country with the purpose of achieving a target growth rate of the economy while:

I. **Maintaining price stability**

Price stability is a significant objective of monetary policy. When inflation is high, variable or both, it interferes with the efficient operation of the economy and can reduce economic growth. In addition, once inflationary expectations have been set, bringing inflation back down can be painful. Price stability requires a credible commitment by monetary authorities to follow a monetary policy that will keep

inflation low and stable. Inflation creates inefficiency because it forces market participants to find ways to protect themselves from money's declining value. Hence, when inflation is variable, the problems of inflation are amplified because market participants must make pricing and purchasing decisions under uncertain conditions. Thus, the higher inflation rises, the more difficult it is to change inflationary expectations, and the more painful the process of bringing inflation back down. Especially, Countries that have adopted "inflation targeting" regimes have generally enjoyed greater price stability.

II. Making progress towards poverty alleviation and employment generation

The financial sector is the primary conduit through which monetary policy affects real economic outcomes, and monetary policy determines the resources available to financial institutions. Therefore, monetary policy must be coordinated with financial sector reforms in order to improve employment opportunities, reduce poverty and support human development. The structure of the financial sector and the implementation of monetary policy directly impact employment.

III. Achieving balance of payments viability

The balance of payments (BOP) is the method countries use to monitor all international monetary transactions at a specific period of time. Usually, the BOP is calculated every quarter and every calendar year. All trades conducted by both the private and public sectors are accounted for in the BOP in order to determine how much money is going in and out of a country. If a country has received money, this is known as a credit, and if a country has paid or given money, the transaction is counted as a debit. Theoretically, the BOP should be zero, meaning that assets (credits) and liabilities (debits) should balance, but in practice this is rarely the case. Thus, the BOP can tell the observer if a country has a deficit or a surplus and from which part of the economy the discrepancies are stemming.

Basically, the balance of payments is divided into the current and capital account. The capital account is made up of portfolio and direct investment, either long or short term capital and capital transfers. While the current account records all current transactions, which are transactions that include either the export or import of goods and services. They include merchandise and services. The capital account also refers to charges in financial assets and liabilities, portfolio investment, external loan drawings and amortization and charges in short-term capital

movements. However, it should be noted that development in the other sectors – real, monetary and public – has implications for the balance of payments. As a result, current account deficit may not necessarily be an inappropriate policy to pursue especially in a country that is for example, importing to increase domestic investment.

However, in a short-term, import bills may remain unpaid or external reserves could be drawn down. A long-term and more viable solution lies in ensuring balance of payments viability. A viable balance of payments position may be defined as a current account position, which can be financed on a sustainable basis by net capital movements on terms that are compatible with reasonable development, growth prospects and debt servicing capacity as well as macro-economic stability. It can be seen that the balance of payments is linked with the other accounts in a general equilibrium framework. This implies that disequilibrium in one sector; say external sector is transmitted to the other sectors and vice versa. Thus, there is need to achieve both internal and external balance.

As described above, the broad money M_2 can be influenced indirectly by changes in the monetary policy instruments that target and monitor the reserve money via the money multiplier, M . The cash reserve requirement ratio, (CRR) and the statutory liquidity ratio (SLR) are effective means of announcing the monetary policy stance.

3.15: Anchors of the Monetary Policy

Intermediate objectives (anchors) are important for monetary policy. They provide guidelines to policy-makers at times when ultimate objective (inflation or growth or both) responds with a lag. It also reduces the uncertainty and ensures transparency in policy making (Crockett, 2004) and (Lindsey and Wallach, 1989). In this context, three most popular approaches in a monetary policy regime are the following:

I. Exchange rate targeting

Exchange-rate targeting has been an effective means of reducing inflation quickly in both industrialized and emerging market countries. However, exchange-rate targeting results in the loss of independent monetary policy and also means that shocks to the anchor country, to whose currency the domestic currency is pegged, are transmitted to the targeting country because domestic interest rates are determined in the anchor country. Exchange-rate targets thus are likely to lead to higher output volatility. Exchange-rate targeting comes in two basic varieties, "soft pegs," in which the commitment to the peg is not institutionalized, and "hard pegs,"

where the institutional commitment comes either from establishment of a currency board or from dollarization. Soft pegs leave countries open to speculative attacks and currency crises, which can be costly in industrialized countries, but are frequently devastating to emerging market countries, as we have seen recently in Latin America (Mexico and Ecuador), East Asia (Thailand, Korea, and Indonesia) and Turkey. The breakdown of soft pegs in emerging market countries is as damaging as it is because their debt structure is generally short term and is denominated in foreign currency. Thus a successful speculative attack leads to a sharp deterioration in balance sheets, which in turn leads to a financial crisis.

Given the experience with soft pegs, fewer economists now advocate their use as a monetary policy strategy. However, hard pegs may be desirable, particularly in countries whose political and monetary institutions are especially weak: they may be the only way to break inflationary psychology and to stabilize the economy.

To better protect the external competitiveness of Taka and to enhance the resilience of the economy in responding to shocks, Bangladesh formally stepped over to market based exchange rate for the Taka from **31st May 2003 (Annual Report, BB, 2002-03)**. In this new system, the nominal exchange rate is set by the market forces but keeps discretion for the central bank to intervene in the foreign exchange market to keep the rate within certain limit of appreciation or depreciation. This is known as '**managed float**' system. In this system, demand and supply primarily determine the exchange rate on a particular day. But Bangladesh Bank comes forward to keep the exchange rate within a certain limit of appreciation or depreciation by selling or buying the foreign currencies or by adopting some other measures.

II. Monetary aggregate targeting

Monetary aggregates are financial assets that either function directly as money and as the medium of exchange or they are extremely liquid and easily converted to money. The three monetary aggregates are labeled M1, M2, and M3. M1 is the official money supply, consisting of currency and checking account balances, that is used for transactions. M2 adds savings accounts to M1 and is considered by many as a more accurate measure of the "spendable assets." M3 broadens M2 by adding other, slightly less liquid assets.

The weak relationship between money and nominal income implies that hitting a monetary target will not produce the desired outcome for a goal variable such as inflation. Furthermore, the monetary aggregate will no longer provide an adequate signal about the stance of monetary policy. Thus, except under very unusual

circumstances, monetary targeting will not help fix inflation expectations and be a good guide for assessing the accountability of the central bank. In addition, an unreliable relationship between monetary aggregates and goal variables makes it difficult for monetary targeting to serve as a communications device that increases the transparency of monetary policy and makes the central bank accountable to the public.

Bangladesh Bank puts greater reliance on monetary targeting focused on the reserve money (RM, consisting of currency in circulation and the balances of other banks with the Bangladesh Bank), and thus via the money multiplier, on broad money, i.e., M2, which is the sum of currency in circulation, demand deposits and time deposits. BB programs the required limit of monetary expansion, broad money in this case, based on estimates of GDP growth, CPI and changes in the income velocity of money. The simple relationship between broad and reserve money allows the latter to be used as an intermediate target, which is convenient since the policy instruments may directly target RM effectively.

IV. Inflation targeting

It is the general wisdom that monetary policy tools are of immediate potency in controlling inflation. However, contemporary evidence amply illustrates that monetary policy cannot deal well with the inflationary impact of external shocks such as the recent international price of oil and related energy products. Many central banks as a consequence focus on the *core inflation*, which is typically constructed by subtracting the most volatile components (e.g., food and energy prices, indirect taxes etc) from the consumer price index (CPI). The Bank of Canada argues that it is the core concept that better predicts the underlying price stability in the economy. Hence as a policy goal, core inflation may be a more credible target than CPI inflation. While there is no standard measure of core inflation in the Bangladesh context at this time, the construction methodology is made complex by two facts. First is that food items constitute nearly 60 percent of the CPI index, and while the appropriate commodity group weights may require a re-think, to ignore food entirely in defining the core inflation may render the construction a bit like 'throwing the baby away with the bath water'.

Secondly, in the Bangladesh context, the volatility of the international energy prices appear not to filter down to the CPI since the relevant domestic prices are subsidized by the state. Periodic adjustments in administered energy prices have always lagged the world market changes in both the time line as well as in magnitude often most dramatically. While it may be useful to focus on the non-food component of the index (which occupies only 41.6 percent of the full CPI) in order to gauge at the build-up of underlying inflationary forces in the economy, it would be unwise to treat this alone as a valid measure of core inflation.

In Bangladesh all of these approaches have been practiced for quite some time. While exchange rate targeting will be continued to keep the balance between the interests' of the exporters and consumers, monetary aggregate targeting will be the intermediate objective to promote growth without dampening the macroeconomic stability in the present context.

3.16: Central bank independence and Inflation:

The studies on whether increased central bank independence lead to a lower inflation show that countries with legally more independent central banks tend to have lower inflation which in the long run is not at the expense of lower economic growth.

A widely held view suggests that politically independent central banks bring about relatively low and stable inflation rate. In general, Inflation has two malignant effects. Firstly, it generates distributive conflict between social groups and secondly, it imposes welfare losses on society as a whole. Distributive conflict arises because unexpected inflation redistributes wealth. Central bank independence might reduce the degree to which distributive conflict determines monetary policy , and thereby reduces the welfare losses imposed by inflation.

Almost all independent central banks are free to choose the instruments with which they want to pursue their ultimate goal(s). But almost no central bank is allowed to arbitrarily set its targets. Central banks are usually charged with pursuing price stability (or more practically a low rate of inflation) and given freedom to pursue this goal as they consider best. There is hence no goal independence but only instrument independence (Debelle and Fischer 1994). For instance, the Bank of England, even after being made independent from the Ministry of Finance is still given its inflation target from the Minister (and must publicly explain why it failed to reach that goal).

3.17: Consequences of the Monetary Policy:

1. Increase in the Average Interest Rate

According to the theory of liquidity preference espoused by the IMF, the interest rate rises when the central bank decreases the money supply. Since the average commercial lending rate in Bangladesh is almost close to 12.75% (FY 2010) and further raise may hamper the aggregate demand because the cost of borrowing would increase and firms spending on new factories and equipment would also reduce. This may also discourage them to hire more workers. Thus less hiring means lower employment.

2. Devaluation of BDT against U.S. Dollar

In FY 2008-2009 and FY 2009-2010, continuous depreciation of Bangladeshi taka was observed due to the negative growth in the export sector. On an average, in 2008-2009 taka was depreciated by -0.066 points and in 2009-2010 taka was depreciated by -0.046 points. That is why the weighted average exchange rate against the U.S. dollar was 69.006 taka (on average) in FY 2008-09 and 69.4410 taka (on average), with Tk.0.435 difference and .63 percentage change in a year. Thus this undervalued exchange rate favors the export sector at the cost of inflation. Because the devaluation of money creates excess demand of domestically produced goods and thus shortage of supply increases the market prices.

3. Credit squeeze to private sector due to monetary contraction

According to the MPS of FY2011, credit to the private sector will be squeezed by 28.25% at the end of FY 2011. Increase in govt. expenditure, mainly financed through borrowing, by 19.6 % to BDT 1321.7 billion will also result in crowding out of private sector. Thus unavailability of credit and unfavorable investment may hamper the growth generated by the private sector, there by impacting on the overall GDP growth. As Bangladesh economy is in need of higher investment, the average increase in the interest rate from the existing rate may not only increase the capital inflow but also dampen the business confidence of the investors as they would face credit squeeze due to the MPS's instruments.

4. Impact on the Employment Generation

In recent year, the unemployed population in Bangladesh has increased by 28.57% and the shifting of employed population from agriculture to non-agriculture has also increased by 4.50%. Poverty reduction is not possible without employment generation. If the service and industry sector cannot increase labor absorption capacity, the monetary policy may fail to fulfill one of its dual objectives.

5. Impact on Agriculture

The credit disbursement rate of agriculture for the recently completed FY 2009-10 is 97% of the target which is satisfactory in terms of disbursed amount. The disbursement record shows mismatch in disbursement time which in turn force the agricultural growth to shrink, with lower contribution to GDP.

6. Impact on Industry

The contribution of the industrial sector in GDP was 29.95% in FY2009-10. The aim is to raise this contribution in GDP to 40% by 2021. In order to keep the RMG sector alive, availability of credit must be ensured. As this sector holds a huge number of labors, the government should also pay attention about the employment condition of the labor forces.

The availability of loan must be strictly ensured for the proper growth of SME sector by the local private and state-owned banks. NBFIs must also be encouraged for more contribution.

7. Impact on Power Sector

Bangladesh is facing severe power crisis in recent times. The per capita energy consumption is one of the lowest (165.32 kWh) in the world. Only 47% of the total population has access to electricity. Due to rental power plants with high per unit cost, the government has to bear huge cost per year for buying electricity from the private operators. The amount is almost BDT 5,000 crore per year.

The government may avoid huge subsidy by increasing the power tariff for the consumers. If the government provides the entire amount of extra payment, this might be resulted as higher budget deficit with higher borrowing for the government. On the other hand if the government decides to make higher the tariff level for avoiding higher subsidy, this might result with an inflationary pressure.

3.18: Assessing Annual Money Growth (M2) and Inflation rate in the context of Bangladesh

Inflation in Bangladesh and other countries is usually calculated as the percent change in the Consumer Price Index (CPI) from one year to the next. The CPI represents the prices paid by the average urban consumer in each respective country. The Laspeyres formula is generally used. Inflation can also be calculated with other price indexes such as the Produced Price Index or the so-called GDP deflator.

Most countries try to keep inflation somewhere around 2-3 percent per year. That is too low to cause any problems for the businesses and households. At the same time, it is comfortably away from negative inflation, i.e. from deflation. Of course, this target is often missed.

Money and quasi money comprise the sum of currency outside banks, demand deposits other than those of the central government, and the time, savings, and foreign currency deposits of resident sectors other than the central government. This definition is frequently called M2. Average annual growth rate in money and quasi money refers to the change in the money supply is measured as the difference in end-of-year totals relative to the level of M2 in the preceding year.

A table representing Inflation and Annual Money Growth (M2) Rate from the year 2008 to 2012 is given below:

Year	Inflation Rate(Base year 1995-1996)	Annual Money Growth (M2)
2008	8.9%	16.43%
2009	5.4%	20.26%
2010	8.1%	21.09%
2011	10.7%	16.91%
2012	8.7%	17.02%
Source: The global Economic Data: The World Bank		

The table shows that, Bangladesh has experienced highest inflation rate in the year of 2011. Theoretically, Central banks use contractionary monetary policies to reduce inflation level. Here, in the context of Bangladesh, not all five years shows coherence with the theory. Rather, it can be assumed that, that there might remain other dictating factors in the economy to impact strongly on the inflation.

An illustration with a graph is given below:

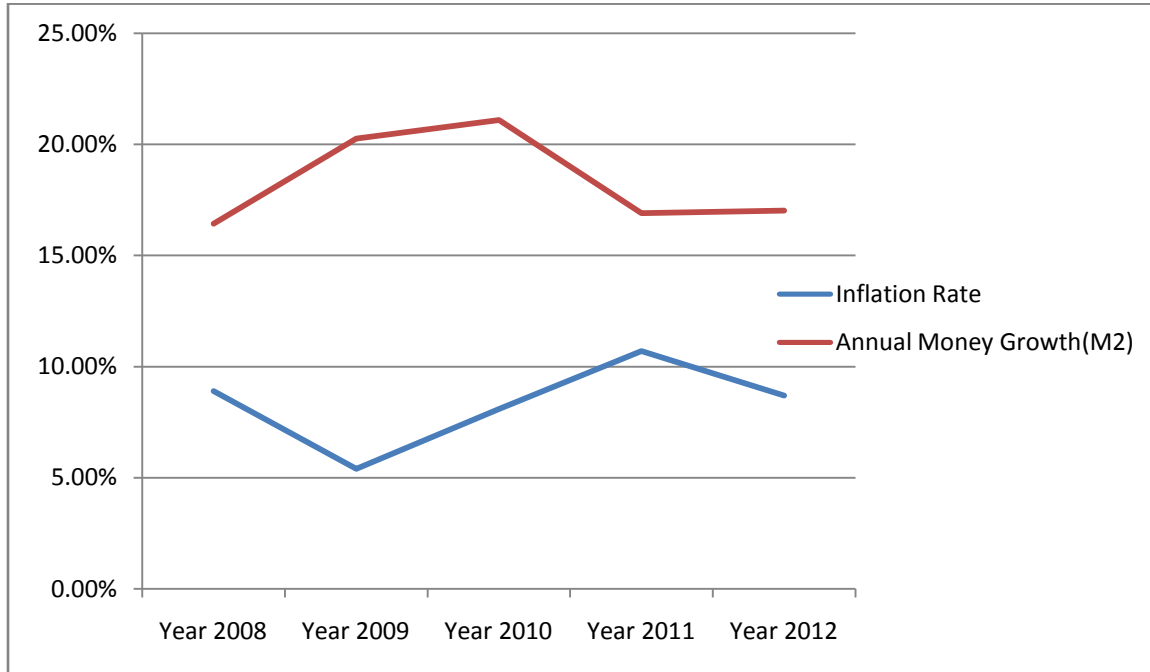


Figure 3.18.1: Empirical relationship between money supply growth and inflation rate

The predicted association between money and inflation remains disputed. Yet, The historical record shows that rapid monetary growth does fuel high inflation. That was very clear during Germany’s hyperinflation in the 1920’s and Latin America’s in the 1980’s . In Bangladesh, Money growth increased in 2009 than 2008 where as the inflation got decreased. In 2010, Annual money growth got increased and so did the inflation rate. Very Unlikely, Annual Money growth rate decreased in 2011 while inflation reached its highest value. A slight increase in money growth and a decrease in inflation rate took place in the year of 2012. Hence, a findings can be derived that, there might be some other factors that might dominates inflation other than money supply, particularly in Bangladesh.

Chapter Four

4.1: Conclusion:

As the ultimate goal of the macro-economic policy is to achieve optimal social welfare, instrument independence can ensure the requisite transparency, accountability and long term benefit in controlling inflation. An explicit declaration of inflation target can be instrumental.

In a fiscal dominant country Bangladesh, where the fiscal authority sets its budget independently of public sector liabilities fiscal policy can affect monetary policy in different ways: Firstly through the impact of government inter-temporal budget constraint on monetary policy, secondly through the effect of fiscal policy on a number of monetary variables, such as interest rates, interest spreads and exchange rates.

In the backdrop of easing inflationary pressure, the famous trade-off between growth and inflation may have taken a back seat for the moment. However, as global economic development continues to show signs of recovery, BB needs to be vigilant to maintain macroeconomic stability. The effectiveness of this monetary policy statement will largely depend on the capacity of BB to carry out its stated objectives and the effectiveness of related policy implementation. A pragmatic mix between fiscal and monetary policy can help us achieve that goal.

Chapter Five

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