



TECHNICAL ASSISTANCE REPORT

BANGLADESH

Interest Rate Corridor Adoption

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PREFACE

The IMF South Asia Regional Training and Technical Assistance Center (SARTTAC) undertook an in-person Technical Assistance (TA) Mission during August 13–17, 2023, to Bangladesh Bank (BB). The aim of the mission was to assess progress in implementation of previous TA recommendations on the transitioning from reserve money targeting to an interest rate-focused monetary policy framework (MPF), with a view to identify additional capacity development (CD) actions to support the transition.

The mission was led by Oleg Churiy (SARTTAC Monetary and Foreign Exchange Operations Advisor) and included Bernard J. Laurens (short-term external expert).

The mission held discussions with the Kazi Sayedur Rahman, Deputy Governor; Dr. Md. Habibur Rahman Chief Economist; Monetary Policy Department (MPD), Research department as well as Finance division of Ministry of Finance (MoF). The mission would like to express its gratitude to Dr. Md. Ezazul Islam, Executive Director; Md. Abdul Kayum, Director, MPD and his colleagues for the preparatory groundwork for the mission and for the constructive engagements in several of its meetings. The mission also met with the Additional Secretary in the Finance Division at the MoF. Meetings also took place at the Bangladesh Institute of Bank Management and with a broad representation of representatives from commercial banks.

This report incorporates comments from the relevant departments at the IMF as well as from BB.

LIST OF ACRONYMS

BAFEDA	Bangladesh Foreign Exchange Dealers' Association
BB	Bangladesh Bank
BBO	Bangladesh Bank Order
BDT	Bangladesh Taka
BR	Bank Rate
CB	Conventional Bank
CiC	Currency in Circulation
CRR	Cash Reserve Ratio
DOS	Department of Off-site Supervision
FX	Foreign Exchange
FCY	Foreign Currency
FOB	Foreign-owned Bank
GOB	Government of Bangladesh
IMF	International Monetary Fund
IB	Islamic Bank
IRC	Interest Rate Corridor
LCBM	Local Currency Bond Market
MM	Money Market
MoF	Ministry of Finance
MPF	Monetary Policy Framework
MPS	Monetary Policy Statement
MPD	Monetary Policy Department
NPD	Non-Primary Dealer
OMO	Open Market Operations
O/N	Overnight
PD	Primary Dealer
REPO	Repurchase Agreement
RMP	Reserve Maintenance Period
SARTTAC	IMF South Asia Regional Training and Technical Assistance Center
SDF	Standing Deposit Facility
SF	Standing Facility
SMART	Six Months Moving Average rate of Treasury bill
SLF	Standing Lending Facility
TA	Technical Assistance

EXECUTIVE SUMMARY

Bangladesh Bank's (BB) announcement in its July–December 2023 Monetary Policy Statement (MPS) to transition from a monetary targeting to an interest rate targeting monetary regime offers a unique opportunity to assess the alignment of BB's governance and operational frameworks with the new monetary policy regime. While the mission focused its work on BB's monetary policy operational frameworks with a view to identify a possible TA program to be delivered by SARTTAC, it is also critical to take a look at BB's governance arrangements to identify broader reforms that may be warranted to ensure the robustness and long-term effectiveness of the newly announced monetary policy regime.

Bangladesh Bank Order (BBO), which holds the effective power of law, needs to be substantially amended so that price stability is the overriding objective of the new monetary policy regime, and governance arrangements are aligned accordingly. Most importantly that would mean: (i) enshrining in BBO a primary objective for monetary policy in the form of price stability over the medium term; (ii) enhancing the de jure autonomy of BB; (iii) enhancing BB's accountability arrangements; and (iv) eliminating BB's direct lending to priority sectors. Amendments to the BBO should be considered as soon as possible, taking advantage of the momentum provided by BB's announcement of the transition to an interest rate targeting monetary regime.

The mission a number of technical adjustments to the operations of the recently introduced Interest Rate Corridor (IRC) in order to incentivize interbank market trading and therefore enhance monetary policy transmission. The following key measures are recommended for the immediate Stage 1 of monetary policy modernization: (i) introduce a weekly 7-days main Open Market Operation (OMO) at the policy rate and with full allotment; (ii) increase the level of Cash Reserve Ratio (CRR) averaging; (iii) ensure an automatic access to the Standing Facilities (SF)s; and (v) uniformize the legal framework for collateralized liquidity providing monetary operations. Some additional technical measures are summarized in Table 1. For a subsequent Stage 2, and as BB's short-term liquidity forecasting capacity is enhanced, and trading in the interbank market has increased, BB could shift to fixed-quantities, variable prices OMOs calibrated in the context of an enhanced short-term liquidity forecasting exercise.

BB should also consider a number of supporting measures as follows:

Eliminate the backward-looking features of the Six Months Moving Average rate of Treasury Bill (SMART). Adopting BB's policy rate as the base for setting the SMART would reinforce the signaling role of BB's policy rate.

- *Normalize the foreign exchange (FX) market.* Adopt a clear exchange rate policy together with a transparent and aligned BB's FX intervention policy to allow for a proper coordination of monetary and FX policy, in particular to allow interest rates to play their role in the FX market.

Actively participate in money market (MM) development initiatives, in particular the development of Islamic finance instruments to facilitate the free flow of liquidity between Conventional Banks (CBs) and Islamic Banks (IBs).

Take an active part in the Local Bond Market development (LBCM) project in those areas where BB has a distinctive role and responsibility. These reforms, by facilitating the emergence of a robust and reliable yield curve would greatly enhance the transmission of BB's policy rate to financial markets and ultimately the economy.

- *Review BB's communications policy and tools with a view to enhance the transparency of the newly announced monetary policy regime. Active BB communications to enhance bank treasurers' understanding of the new market environment will allow a smooth transmission of BB's actions on the MM.*

Table 1 below summarizes the mission's key recommendations. Table 2 proposes a program of technical assistance to be delivered by SARTTAC during FY24 and FY25.

Table 1. Key Recommendations

	Recommendations	Priority	Timeframe
Bangladesh Bank Governance Arrangements			
1	Amend BBO to ensure an alignment with the new monetary regime (¶19, 10): - Enshrine a de jure primary objective of price stability over the medium term for monetary policy in BBO. - Enhance the de jure autonomy of BB. - Enhance BB's accountability frameworks. - Eliminate BB's involvement in provision of credit to priority sectors. - Adopt the Bank Rate (BR) as BB's Policy Rate.	High	Medium-term
Modernization of the monetary operations framework: 1st stage			
2	Introduce a weekly 7-days main OMO at policy rate and full allotment (¶ 22).	High	Short-term
3	Conduct fine-tuning OMO as needed towards the end of (Reserve Maintenance Period) RMP (¶ 22).	High	Short-term
4	Increase the level of CRR averaging (¶ 22).	High	Short-term
5	Align the main OMO with the RMP (¶ 23).	High	Short-term
6	Ensure an automatic access to the SFs (¶ 24).	High	Short-term
7	Uniformize the legal framework for collateralized liquidity providing operations and include haircuts and margin requirements (¶ 27).	Medium	Medium-term

	Recommendations	Priority	Timeframe
8	Upgrade the liquidity monitoring and forecasting framework (¶ 31).	High	Medium-term
9	Adopt BB's policy rate as the base for setting the SMART (¶ 32).	High	Short-term
Modernization of the monetary operations framework: 2nd stage			
10	Shift to fixed quantities, variable rate OMOs (¶ 28).	Medium	Once BB has upgraded its liquidity forecasting capacity
11	Increase the CRR ratio on foreign currency deposit at least to the level of the CRR on local currency deposits (¶ 26).	Low	Medium-term Avoid too many changes at the same time
Supporting Measures			
12	Active BB communications to enhance bank treasurers' understanding of the new market environment that is needed to allow a smooth transmission of BB's actions on the money market (¶ 34).	High	Short-term
13	Normalizing the FX market to facilitate a proper coordination of monetary and FX policies and allow the exchange rate to respond to market forces (¶ 36).	High	Short-term
14	Actively participate in the development of Islamic finance instruments to facilitate the flow of liquidity between CBs and IBs ((¶ 28).	High	Medium-term
15	Take an active part in the LCBM project in those areas where BB has a distinctive role and responsibility (¶ 38-39).	Medium	Medium-term
	1/ Priority	High	Medium
	2/ Timeframe	Short-term	Long-term

Table 2. Proposed Technical Assistance by SARTTAC

TA Action	Comments
<p>TA Scope: Monetary operations framework, including liquidity forecasting.</p> <p>Objectives: Support the mission’s recommendations related to the reform of BB’s policy instruments in relation to the IRC (standing facilities, OMOs, CRR), and enhancements to the liquidity forecasting framework with a view to facilitate the calibration of OMOs at variable rates fixed quantities.</p>	<p>Could be done in conjunction with the support to Money market benchmark rate.</p>
<p>TA Scope: Foreign exchange market and operations: design a FX intervention strategy supportive of FX market development.</p> <p>Objectives: Design and calibrate a reaction function to guide BB in its FX interventions.</p>	<p>Once BB has clarified the exchange rate regime it wishes to implement.</p>
<p>TA Scope: Modernization of the collateral framework for liquidity providing monetary operations.</p> <p>Objectives: Develop operational arrangements for collateral valuation, haircut, and margin requirements.</p>	<p>Could be done in conjunction with the support to develop an ELA framework.</p>
<p>TA Scope: Developing a money market benchmark rate.</p> <p>Objectives: Develop money market benchmark rate based on IOSCO Principles.</p>	<p>Could be done in conjunction with the support on monetary operations and liquidity forecasting.</p>
<p>TA Scope: Developing an emergency liquidity assistance (ELA) framework.</p> <p>Objectives: Help develop an ELA framework consistent with current best central bank practices.</p>	<p>Could be done in conjunction with the support to modernize the collateral framework.</p>

I. INTRODUCTION

1. **Modernizing monetary policy is a focus under the Extended Credit Facility /Extended Fund Facility arrangements for Bangladesh approved by the IMF’s Executive Board in January 2023.** The aim is to help promote macroeconomic stability, support financial development, and enhance monetary policy transmission. Reforms include the adopting of an IRC, and implementation of a policy rate as operational target by the end of the program period.

2. **BB’s July-December 2023 MPS announced a transition from a monetary targeting to an interest rate targeting framework.** The policy move involves: (i) introducing an IRC centered on BB’s policy rate currently set at 6.5 percent, with a corridor width of +/-_200 bp; (ii) adopting the overnight call MM rate as the intermediate objective; and (iii) replacing a ceiling on banks’ lending operations by a market-driven reference rate for all types of bank loans (indexed to the six months moving average rate for T-bill): the “SMART”.

3. **The announcement to transition to an interest rate targeting monetary regime offers a unique opportunity to assess the alignment of BB’s governance and operational frameworks with the new monetary policy regime.** The mission focused its work on BB’s monetary policy operational frameworks with a view to identify a possible TA program to be delivered by SARTTAC. However, it is also critical to take a look at BB’s governance arrangements to identify broader reforms that may be warranted to ensure the robustness and long-term effectiveness of the newly announced monetary policy regime.

II. GOVERNANCE ARRANGEMENT AT BANGLADESH BANK

A. Current Situation and Assessment

4. **Monetary policy continues to be guided by the double objective of ensuring economic growth and price stability, with no formal primacy assigned to price stability.** While not explicitly stated in BBO, 1972, recent policy documents have stated that BB’s monetary and financial sector policies are designed to foster price stability while supporting economic growth. In particular, BB’s Strategic Plan 2020-2024 includes as Strategic Goal 01 to “*Conduct of accommodative monetary management to ensure inclusive economic growth and price stability*”. BB’s monetary policy is expected to maintain the right balance between containing inflation and supporting economic growth. It is also expected that BB’s supportive credit and financial policies will contribute to supporting the government’s pursuit of sustainable growth.¹

5. **In recent policy communications, BB has signaled price stability as monetary policy primary objective.** In particular, the July-December 2023 MPS states that “Containing inflation will be the first and foremost objective of *this MPS*”. This led to adopting a contractionary monetary policy stance (50 basis points upward move of the policy rate), while also recognizing the importance of ensuring the flow of funds to productive sectors.

6. **During the mission’s discussions, with BB counterparts have indicated that no changes had occurred to BB’s governance arrangements regarding its autonomy, transparency and accountability, since the assessment undertaken in the context of the September 18-30, 2018, SARTTAC TA mission (Table 2).** BB *de jure* autonomy, while much improved by the 2003 amendments to BBO, 1972, could constrain BB actions in times of pressures. In particular, the provisions BBO Sections 10, 15 and 77 give the Government powers which, while they do not appear to have not been utilized so far, could constrain BB’s ability to “do whatever it takes” to achieve its objectives, in particular if and when BB is assigned a primary or overriding objective of price stability specified in a numerical medium-term inflation objective. BBO Section 82 also places BB under the *de facto* control of the Government of Bangladesh (GOB).

¹ See BB’s Strategic Plan 2020-2024. https://www.bb.org.bd/en/index.php/about/strategic_plan

Table 3. Bangladesh Bank Current Governance Arrangements

Autonomy	<p>- BBO Section 9A. (1) establishes a Council for the co-ordination of fiscal, monetary and exchange rate policies made of the MoF, the Minister of Commerce (Chairman), BB Governor, the Secretary of the Finance Division, the Secretary of the Internal Resources Division, and a member of the Planning Commission. BB <i>"shall ensure that the macro-economic framework as coordinated by the Co-ordination Council is reflected in the policies of BB"</i>.</p> <p>- BBO Section 77 allows the GOB to declare BB Board to be superseded and the affairs of BB placed in an agency, if GOB is of the opinion that BB fails to carry out obligations imposed on it by GOB. BB indicated that, so far, this provision has never been activated by GOB.</p> <p>- BBO Section 15. (1) allows GOB to remove the Governor/Deputy Governor if he <i>"has done any act which is a breach of the trust reposed on him, or if his continuance in office is regarded as manifestly opposed to the interests of BB"</i>.</p> <p>- BBO Section 10 authorizes the Governor to direct and control BB; the Governor is appointed for a term of 4 years and is eligible for re-appointment.</p> <p>- BBO Section 82. (2) places BB under the de facto control of GOB as the budget, salary & compensation of employees are subject to GOB approval.</p> <p>Assessment: <i>the de jure autonomy of BB is not guaranteed by BBO.</i></p>
Transparency Accountability	<p>- BBO, Section 38A makes BB accountable to Parliament.</p> <p>- BB publishes a MPS twice a year.</p> <p>Assessment: <i>Absence of a primary objective for monetary policy and BB's eclectic monetary regime (elements of exchange rate, monetary, and inflation targeting) complicates BB's transparency, communication, and accountability.</i></p>
<p>Source: <i>Bangladesh: Monetary Policy Modernization at BB's: Challenges, Next Steps, and SARTTAC Support</i>, by Bernard J. Laurens, Supriyo Bhattacharjee, Rodrigo Cano, and Stefaan Ide, November 2018.</p>	

7. **Furthermore, while close macroeconomic policy coordination is not only desirable, but also indispensable to support sound policies, the establishment under BBO of a dedicated body chaired by the MoF to perform such coordination, if inadequately used, could also constrain BB actions in times of pressures.** BBO Section 9A (1) establishes a Council for the co-ordination of fiscal, monetary and exchange rate policies consisting of the MoF, the Minister of Commerce (Chairman), BB Governor, the Secretary of the Finance Division, the Secretary of the Internal Resources Division, and a member of the Planning Commission. In that context, BB *"shall ensure that the macro-economic framework as coordinated by the Co-ordination Council is reflected in the policies of BB"*. While policy coordination is critical, arrangements outside of the BBO, therefore less likely to undermine BB autonomy, would be preferable.

8. **In addition, BBO's provisions related to financial vehicles for lending to priority sectors (Rural Credit Fund, Industrial Credit Fund, Export Credit Fund) need to be reconsidered.** Such activities of a quasi-fiscal nature are inconsistent with the new monetary regime, as they can complicate liquidity management, and obstruct monetary policy transmission. Furthermore, any subsidy that may be associated with these schemes would be better handled via the fiscal accounts.

9. **Finally, the coexistence of de facto three types of BB rates can be a source of confusion regarding BB's monetary policy communication.** These are: (i) the BR mentioned in Article 21 of the BBO, made public from time to time and applied by BB to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the BBO. The BR serves also as the base for penalties in the event of non-compliance with the CRR (see below); the Policy Rate introduced via the new monetary policy regime; and the SMART, also introduced in the context of the transition to the new monetary policy regime. Such a multiplicity of BB "official" rates can complicate communications on the stance of monetary policy, and therefore undermine monetary policy transmission.

B. Recommendations

10. **The transition from a monetary targeting to an interest rate targeting regime offers a unique opportunity to better align the BBO with the new monetary policy regime.** The mission recommends that the Bangladesh authorities consider amendments to the BBO with a view to align BB governance with best central bank practices. This would involve the following measures²:

- **Enshrine a de jure primary objective of price stability over the medium term for monetary policy in the BBO.** While the July-December 2023 PMS rightly identifies "*containing inflation as the first and foremost objective*" of monetary policy, it does so only for "*this MPS*", suggesting that other objectives (i.e., advancing economic development and supporting GOB's growth policies) may take precedence in the future. Therefore, such a framework does not allow BB to have a forward-looking monetary policy, in particular when assessing the level of its policy rate.
- **Enhance the de jure autonomy of BB.** While BB may currently enjoy an appropriate level of de facto autonomy, BBO's provisions regarding the role of the GOB in the conduct of monetary policy creates a degree of uncertainty that can be damaging regarding BB's long-term credibility vis-à-vis market stakeholders. These provisions of the BBO should be modified.
- **Enhance BB's accountability frameworks.** While the BBO makes BB accountable to Parliament, the absence of a primary objective of monetary policy complicates BB's transparency and, ultimately, accountability. Once the primary objective of monetary policy has been clarified, BB should comply with the current accountability provisions included in the BBO.

² The mission's recommendations set in Chapter II of the report are in line with the recommendations in FIN's Safeguards Assessment Report (Jan 10, 2022) related to objectives and autonomy.

- **Eliminate BB's involvement in the provision of direct credit to priority sectors.** Government policies in this domain are better handles in a transparent way through the fiscal policy.
- **Adopt the BR as the Policy Rate of BB.** Having only one official rate will facilitate communications and would be consistent with central bank practices. Until such a reform is implemented, BB communications should be focused on the Policy Rate newly introduced and the role of the BR should be downplayed.

11. **While these reforms may be difficult to achieve in the short-term, launching this reform should not be delayed.** The mission appreciates that BB is currently giving the highest priority to price stability in its monetary policy deliberations and decisions. However, enshrining the primacy of price stability in the BBO would facilitate BB's communications and accountability. Therefore, this is a reform that deserves to be launched without delay, including outreaches toward all stakeholders so that a broad-based consensus can be established with regard to the most desirable role and responsibilities of BB with regard to macroeconomic management.

III. LIQUIDITY MANAGEMENT

A. Current Situation and Assessment

Monetary operations

12. **Along BB's announcement of the adoption of a symmetric IRC centered on its Policy Rate, BB also announced the adoption of the interbank call rate as its operational target.**

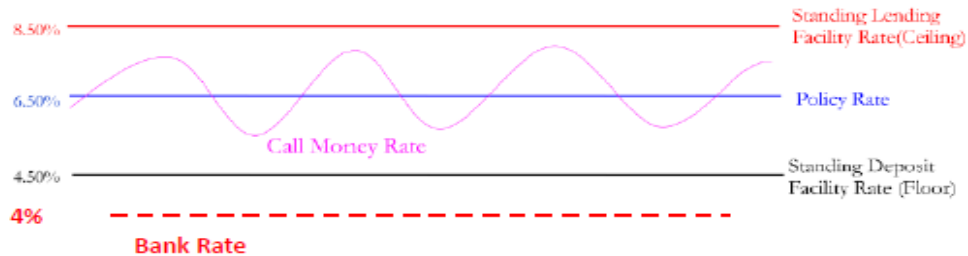
Within that framework, BB's monetary operations aim at aligning the interbank call money rate with the policy rate. So far banks have made limited recourse to the SFs for three main reasons:

- *First, banks can easily satisfy their short-term liquidity needs using OMOs offered by BB on a daily basis, and with different maturities.*
- *Second, the IRC is quite wide, leading to a high opportunity cost of using the Standing Lending Facility (SLF) instead of OMOs.*
- *Third, access to the SFs has not been automatic.* BB has routinely declined bank's request to tap the Standing Deposit Facility (SDF), instead advising them to place their excess liquidity in the interbank market. Yet, due to banks' low risk appetite, this has forced some banks to keep funds as involuntary excess reserves, therefore weakening monetary policy transmission.

13. **Despite the adoption of an IRC centered on a policy rate, BB has maintained a BR which is not part of a single MPF (Figure 1).** Currently set at 4 percent, the BR is not linked to the policy rate and it has therefore a life of its own (i.e., change to the policy rate will not affect the BR). The BR has been utilized for the pricing of BB's refinancing facilities to support certain sectors, and it serves to set the penalty rate in case of banks' under fulfillment of the CRR (BR plus 500 pb). Under current circumstances, a penalty rate of 9 percent appears however rather low, or could even easily be lower

than the SLF, should BB tighten further its monetary policy stance, something that could complicate BB's liquidity management.

Figure 1. Bangladesh Bank Monetary Operations Design

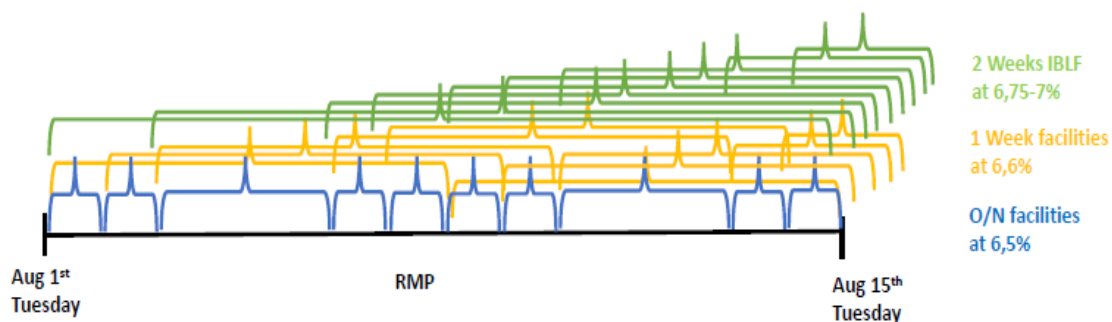


Source: Bangladesh Bank and mission elaborations.

14. **BB relies on a broad range of OMOs during a CRR reserve RPM (Figure 2).**

- *The Overnight (O/N) OMO serves as the main policy instrument.* It serves to provide liquidity on a daily basis at the policy rate, using full allotment auctions. BB conducts O/N operations using 2 facilities: Repurchase Agreement (REPO) to Non-Primary Dealers (NPD), and Liquidity Support Facility (LSF) to Primary Dealers (PD). However, both facilities having similar features, this multiplicity of instruments complicates the communication of BB's operational framework.
- *BB relies on other types of liquidity providing OMOs.* They include a one-week REPO facility to PDs and non-PDs, at a fixed rate set 10 basis points above the policy rate, using full allotment auctions. They also include an Islamic banking liquidity facility designed to address liquidity needs of Islamic Banks (IB)s and conducted at rates between 6.75-7 percent.

**Figure 2. OMOs During a RMP
(Aug 1st-Aug 15th, 2023)**



Source: Bangladesh Bank and mission elaborations.

15. **BB's heavy presence in the market might currently be warranted due to the low level of CRR averaging (see below).** Although commercial banks appear to be comfortable with the ability given to them by BB to obtain a daily liquidity support, the mission is of the view that BB should

reduce its presence in the market, and transition to more market-based interest rate framework in the future. This transition should also be supported by actions to stimulate interbank market activity, with the goal of facilitate a redistributing among the banks the overall liquidity available in the system.

16. **BB uses two distinct legal arrangements for its liquidity-providing operations.** The Repo facility involves the buying and selling of government securities with ownership title transfer, while the lending facility, backed by collateral, maintains collateral ownership with the owner. Generally, Repo facility with title transfer offers better protection for the central bank balance sheet in case of a credit event.

17. **BB also uses varying collateral valuation metrics based on the type of borrower.** For collateral provided by PDs, haircuts of 5 percent for government bonds and 15 percent for T-bills to the face value of the securities are applied. NPDs, on the other hand, have their collateral valued using market-based estimations. Good practices would imply a distinction depending on the types of collateral rather than the type of borrowers. Furthermore, BB doesn't use additional risk mitigating measures such as margining requirements.

Cash Reserve Requirement

18. **The CRR is regulated by BB's Department of Off-site supervision (DOS) and is used as an instrument for prudential objective for banking and financial institutions.** Yet, DOS has in place other tools, such as the Liquidity Coverage Ratio and the Statutory Liquidity Ratio, which makes CRR as less useful instrument for prudential objectives.

19. **The CRR is calculated as percentage of banks' liabilities and is differentiated in terms of currency denomination.** Banking institutions are required to maintain an average CRR of 4 percent for Bangladesh Taka (BDT) liabilities and 2 percent for Foreign Currency (FCY) liabilities, applicable to both CBs and IBs. Additionally, BB also requires regulated non-banking financial institutions to maintain CRR of 1,5 percent. Liabilities in BDT must be fulfilled using the same currency, whereas the CRR on FCY can be fulfilled either in BDT or in FCY on accounts maintained with BB. The flexibility for banks to meet their FCY CRR in either currency can complicate liquidity forecasting.

20. **The following comments can be presented with regard to the current CRR design:**

- *Lower CRR on FCY deposits to BDT deposits could encourage dollarization.* Financial dollarization may appear relatively low (FCY deposits accounting for about 10 percent of total banks' liabilities). However, such metrics can sometimes be misleading, as they may not reflect accurately the degree of usage of FCY as means of payment and unit of account in the economy. These factors can result in high pass-through of exchange rate volatility to inflation. Central banks should therefore promote the usage of local currency as part of a broader de-dollarisation strategy including imposing CRR that does not disadvantage the local currency compared to FCY.

- *CRR averaging is low.* Banks must maintain daily balances of a minimum of 3,5 percent of their BDT liabilities or about 88 percent of CRR during the RMP. Such a low averaging, coupled with a structural liquidity deficit, necessitates a regular presence of BB in the market, as already discussed, to offer liquidity-providing instruments. However, it hampers interbank market arbitrage activity during the RMP.

Interbank Market

21. Several factors lead to interbank market segmentation and inefficiencies:

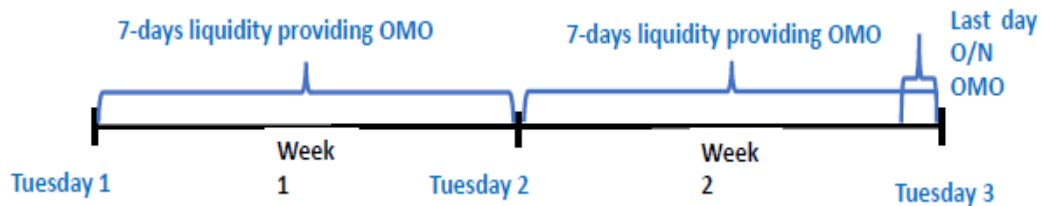
- *Market liquidity is segmented between Islamic banks (IBs) and CBs.* Liquidity cannot move freely between IBs and CBs since at present there is no instrument consistent with Islamic principles available to transfer liquidity between IBs and CBs: while CBs can provide liquidity to IBs through an Islamic compliant instrument, reverse transactions are not yet possible. Given the significant size of IBs (about 23 percent of total deposits as of end 2022) such market segmentation might complicate BB's liquidity management.
- *Foreign-owned banks (FOB) have substantial liquidity surplus, but due to risk aversion they are not able to redistribute all their excess liquidity in the interbank market.* Instead, FOBs are forced to keep involuntary excess reserves at their accounts with BB since, as already mentioned, BB is placing limitations to their ability to deposit funds at the SDF, and BB does not offer liquidity absorbing OMOs to the banks.
- *BB does not actively encourage MM development.* Regulatory constraints, such as Wholesale Borrowing limit (encompassing any form of interbank borrowing below 1 year), hinder interbank trading. The limit stands at 100 percent of capital for PMs and 80 percent of capital for NPDs.

B. Recommendations

22. The mission recommended following a phased approach, starting with an initial stage focused on streamlining and simplifying the operational framework. The presence of BB in the market needs to be considerably downsized. Instead of the current reliance on a number of daily OMO auctions with different maturities, the mission recommends reliance on a one-week main OMO instrument, conducted weekly at the policy rate and with full allotment (Figure 3). The mission also proposes to establish similar one-week facility for IBs based on Islamic principles. As an interim step, BB may consider conducting 3-4 days main OMO so as to be in a position to provide liquidity support more frequently as the banks adjust to the new environment of a lesser presence of BB in the market. To avoid interest rate volatility, BB should substantially increase the CRR averaging, occasionally conduct fine-tuning operations, and engage actions to improve its liquidity forecasting capacity. These measures should also help banks adjust to the new environment of a lesser presence of BB in the market.

23. **The main OMO instrument must be aligned with the 2 weeks RMP.** It is recommended to replace half-month calendar based RMP with a 2 weeks RMP that starts/ends in the middle of the week. Consequently, within each RMP, there would be 2 main one-week operations: the first OMO commencing on the first day of the RMP, and second OMO maturing on the first day of the subsequent RMP. On the last day of the RMP, BB may conduct O/N fine tuning OMO. This design aims to minimize interest rate volatility resulting from OMO instruments maturing at the end of month or week when demand for liquidity is higher.

Figure 3. Proposed New Operational Framework



Source: Mission's elaborations.

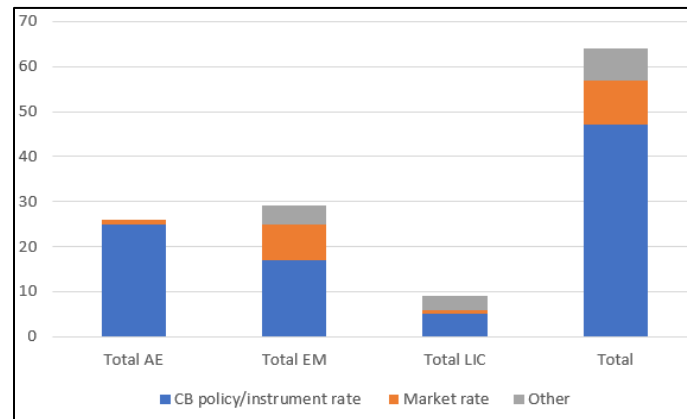
24. **Access to the SFs must be automatic with a "no questions asked policy". However, BB should investigate cases of frequent recourse to SFs to better understand reasons and address shortcomings that may exist.** The main criterion for accessing the SLF must be the availability of sufficient collateral to be provided by the banks. In general SFs are designed to fulfill the role of buffer suppressing interest rate volatility. As interest rates at SFs are effectively penalty rates, banks should not have frequent recourse to such facilities. Instances where banks frequently access SFs might arise due to imperfections in the design of liquidity management instruments, such as early deadlines for OMO auctions, low CRR averaging, large, unexpected changes in the autonomous factors of liquidity, and market segmentation stemming from financial stability concerns etc. It is advisable for the central bank to address weaknesses by improving instruments design, liquidity forecasting and maintaining financial stability, rather than discouraging or denying access to the SFs.

25. **BB must clearly define the role of CRR for monetary policy objective.** In the context of an interest rate targeting monetary regime, CRR with averaging provisions serve as a buffer against unpredictable autonomous factors fluctuation. Since CRR are not used for prudential objectives, CRR regulation monitoring could be transferred from DOS to the MPD.

26. **The mission proposes to increase the level of CRR on FCY at least to the level of the CRR on BDT** as part of comprehensive framework aimed at de-dollarization and promoting the usage of the local currency. This requirement should be met in FCY. However, due to the current shortage of FCY liquidity this measure could be implemented in the later stages of monetary policy modernization.

27. **The mission proposes linking CRR non-compliance penalty to the policy rate or to other instruments tied to the policy rate used by BB.** This practice is the most common among central banks (Figure 4). However, there are no specific rules regarding the margin applied to these reference rates. The mission recommends setting the penalty level above SLF to incentivize compliance but cautions against setting it too high to avoid liquidity hoarding.

Figure 4. Reference rate used for setting penalty rates for CRR non-compliance (Number of Central Banks).



Source: IMF staff, MOID 2018.

28. **BB should analyze legal arrangements for various of liquidity-providing collateralized instruments and select the most suitable one for all BB's monetary instruments.** Preference should be given to the arrangement that offers better protection for BB's balance sheet. The mission also recommends upgrading collateral framework implementation. Collateral valuation and risk mitigating measures should be universal regardless of type of borrower. The collateral framework should also include haircuts and margin requirements.

29. **BB should actively participate in MM development initiatives, in particular the development of Islamic finance instruments to facilitate the free flow of liquidity between CBs and IBs.** The availability of such financial instruments will facilitate BB's liquidity forecasting and management, in particular the calibration of OMOs on the basis of an aggregate level of liquidity.

30. **At the later stages, when BB improves its liquidity forecasting capacity, the mission recommends reliance on fixed quantity variable-rate OMOs.** It is also critical to address impediments for interbank market trading, particularly market segmentation especially between conventional and Islamic banks, in order to enable liquidity to migrate freely within the banking system. Improvement of financial stability would also contribute to promoting interbank market activity. This approach would facilitate the effectiveness of a calibration of OMOs based on an aggregate liquidity forecast.

IV. LIQUIDITY MONITORING AND FORECASTING

A. Current Situation and Assessment

31. **There are several data gaps in the liquidity monitoring and forecasting framework is insufficient.** Currently, the MoF doesn't provide BB with a forecasting of government expenditures and revenues. It only provides BB with a monthly calendar detailing planned government BDT debt placements. High-level debt committee meetings, involving representatives from MoF and BB, occur four times annually, while junior committee meetings take place six times a year, focusing mainly on debt management issues.

32. **BB's liquidity forecasting framework has other deficiencies and it relies mainly on the calendar of OMOs and G-secs redemptions.** BB also produces a 1-week forecast on changes in Net Foreign Assets and Currency in Circulation (CiC). Several obstacles exist for liquidity forecasting, as mentioned earlier: banking segmentation, CRR non-compliance by IBs, relatively light penalties for CRR non-compliance and bank's flexibility in meeting their FCY CRR in either BDT or FCY.

B. Recommendations

33. **Modernizing the liquidity monitoring and forecasting framework is critical for transitioning to fixed quantity variable-rate OMOs.** A clear distinction between liquidity monitoring and forecasting is essential. The liquidity monitoring framework should differentiate between autonomous factors (FX transactions, GOB operations and changes in CiC) and BB's liquidity operations. MoF must develop capability to generate government cash flow projections, which have to be incorporated into the liquidity forecasts.

V. SUPPORTING MEASURERS

A. Bangladesh Bank Communications

34. **BB communications will become even more critical with the transition to the new monetary regime.** BB's July-December 2023 MPS does a good job in announcing the key measures that have been taken to transition from a monetary targeting to an interest rate targeting framework, namely the introduction of the IRC and of the SMART reference rate. However, banks' representatives met by the mission appeared to have a limited understanding of the central role that would play BB's policy rate as the tool to signal the stance of monetary policy, and their attention was more on the SMART. One option to avoid perceived inconsistencies in BB's communications regarding the stance of monetary policy would be to eliminate the backwards looking features of the SMART. Adopting BB's policy rate as the base for setting the SMART could serve that purpose, as it would reinforce the signaling role of BB's policy rate.

35. **Furthermore, the rationale for the mission's operational recommendations (greater room for CRR averaging, less frequent presence of BB in the market...) will need to be explained in detail to banks' treasurers** in particular, so that BB actions in the MM are well understood, and banks can distinguish actions that reflect in change in the monetary policy stance

(i.e., a change in BB policy rate) from actions of a purely technical nature (i.e., response to changes in the autonomous factors of liquidity). Important will also be to explain the critical role that will play the interbank market for the smooth redistribution among banks of liquidity left available to the market by BB. Therefore, rather than exercising some level of control on banks' intermediation of funds, BB should encourage banks to trade in the market so that available liquidity flows freely and swiftly among banks. Of particular important will also be the development of Islamic finance instruments that would allow the free flow of liquidity between CBs and IBs.

36. **Therefore, the mission recommends active BB communications to enhance banks' treasurers understanding of the new market environment that is needed to allow a smooth transmission of BB's actions on the MM.** The golden rule to be followed in that regard is the following: *"Do what you say, and say what you do"*, as reflected in the Principe VII that characterize effective policy frameworks in countries with scope for independent monetary policy.³ The focus of communication should be on explaining past outcomes and actions necessary to align expected outcomes with the policy objective (i.e., BB's liquidity management operations and their ability to ensure the alignment of short-term interbank market rate with BB's policy rate). Effective communication will help reduce uncertainty, improves monetary policy transmission, and facilitates accountability, thereby building credibility. Clear communication can also help anchor BB's credibility, "words" are confirmed by actions and outcomes. The mission also recommends requesting TA to help BB to elaborate a medium-term monetary policy communication strategy.

B. Normalizing the Foreign Exchange Market

37. **The current FX market arrangements do not allow for proper coordination of monetary and FX policies under an interest rate-based monetary regime.** These arrangements, whereby the Bangladesh Foreign Exchange Dealers' Association (BAFEDA) set periodically *"by consensus"* the exchange rates to be applied for categories of FX transactions lacks transparency, most notably with regard to the informal guidance played by BB, or the underlying exchange rate regime that may guide BB. There is also anecdotal evidence that certain actors do not see the current exchange rate as reflecting market forces, and they find ways to transact at rates which differ from those set by the BAFEDA. As soon as possible, it is therefore critical to rescind the current arrangements and for BB to assume fully and in a transparent manner its role in the FX market, as outlined in Article 7A of the BBO.

38. **The mission recommends normalizing the FX market so that proper coordination of monetary and FX policies can be set in motion, and the exchange rate can respond to market forces.** That would involve clarifying the exchange rate regime that the Bangladesh authorities want to follow and designing appropriate FX interventions instruments aimed at either accumulating

³ See IMF Policy Paper: *"Evolving Monetary Policy Frameworks in Low-Income and Other Developing Countries"* (October 2015). <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Evolving-Monetary-Policy-Frameworks-in-Low-Income-and-Other-Developing-Countries-PP5000>

international reserves in order to maintain an adequate level or reducing disorderly or erratic developments in the FX market (to reduce volatility).

C. Developing the Local Currency Bond Market (LCBM)

39. **The Ministry of Finance of Bangladesh has recently embarked in a reform agenda aimed at developing Bangladesh LCBM.** A number of policy recommendations have been presented in the Aide-memoire of the recent joint IMF/World Bank mission that visited Bangladesh from July 5 to 17, 2023, to assist the authorities in assessing the functioning of the LCBM, and preparing a roadmap for further action and technical assistance in this area.⁴ The development of Bangladesh LCBM will be particularly relevant as it will enhance monetary policy transmission: it will facilitate the emergence of a robust and reliable yield curve, and enhance the transmission of BB's policy rate to financial markets and ultimately the economy.

40. **The mission encourages BB to take an active part in this endeavor, in those areas where it has a distinctive role and responsibility.**

⁴ See *Bangladesh: Local Currency Bond Market Development Diagnostic*, aide-memoire of the joint IMF/World Bank mission prepared by Arindam Roy (IMF), Zsolt Bango (World Bank), Rose Nyongesa (IMF), Jose Franco Medeiros de Morais (World Bank), Elias Kazarian (IMF expert), Guido Della Valle (IMF expert), July 2023.