For a central bank to be successful in regulating the financial sector, it must have relevant and pragmatic policies. It should ensure that all financial institutions, including banks, comply with prudential and management norms. Both internal and external factors are making it difficult for Bangladesh Bank to monitor and regulate the financial sector, especially banks. Bangladesh Bank has to move away from its present conventional stance towards a heterogeneous, unconventional and implementable approach. It must strike a balance showing an appropriate professional stance while avoiding the negativity of politically motivated reforms in a highly technical domain.

*Keywords*: prudential regulation, reform, financial sector, central bank independence

*JEL classification*: E42, E44, E58
Introduction

Monetary policy is an important tool to help accelerate economic development, especially in developing countries. Through monetary policy statements (MPSs), central banks set the policy dealing with monetary targets, instruments and implementation. The central bank of Bangladesh, Bangladesh Bank, is solely responsible for monetary policy functions.

Starting from January 2006, MPSs are usually given for six months: January to June and July to December. Exceptions have been made in only few cases when a one-year MPS was issued. The most recent one-year MPS was unveiled in July 2020 for the 12-month period of fiscal year 2020/21.

The tasks of Bangladesh Bank are enormous and its functions are stated in the vision and mission statements. The vision statement is as follows:

“to develop continually as a forward-looking central bank with competent and committed professionals of high ethical standards, conducting monetary management and financial sector supervision to maintain price stability and financial system robustness, supporting rapid, broad based inclusive economic growth, employment generation and poverty eradication in Bangladesh.”

Bangladesh Bank is carrying out its functions as the country’s central bank as per the following mission statements:

- “Formulating monetary and credit policies;
- “Managing currency issue and regulating payment system;
- “Managing foreign exchange reserves and regulating the foreign exchange market;
- “Regulating and supervising banks and financial institutions, and advising the Government on interactions and impacts of fiscal, monetary and other economic policies.”

The main purposes of Bangladesh Bank are monetary policy functions, bankers’ bank, the banker of the Government and regulators as well as the supervisor of commercial banks. Most central banks have dual functions like those of Bangladesh Bank. Therefore, the performance of the economy as a whole and that of the different sectors are closely linked with the performance of Bangladesh Bank.

The vision and mission of Bangladesh Bank are quite appropriate but putting them into action has faced serious challenges and limitations. In the context of Bangladesh
Bank, the debates on macroeconomic issues centred around how Bangladesh Bank can set up monetary targets without political pressure and how far monetary policy can be implemented without any political and structural limitations.

The authority of Bangladesh Bank regarding the constituent banks and financial institutions has recently shown some limitations in controlling corruption and increasing non-performing loans, lack of good governance, weak management and finally erosion of public faith on banks. It seems Bangladesh Bank, due to both internal (within the bank itself) and external (outside the purview of the bank) hurdles, is finding itself difficult to exert effective control.

The pressure groups of stakeholders, namely Bangladesh Association of Bankers—an association of bank owners and the Association of Bankers, Bangladesh—an association of chief executive officers and managing directors of banks, play vital roles in the regulatory aspects of the banking sector. Even the chamber bodies representing business enterprises, such as the Federation of Bangladesh Chambers of Commerce and Industry and the Bangladesh Garment Manufacturers and Exporters Association also work as pressure groups on policies and procedures.

In Bangladesh, there is a dual system of control of the banking sector. The state-owned commercial banks, such as Sonali, Rupali, Janata and Agrani, and specialized banks, such as Bangladesh Small Industries and Commerce (BASIC) Bank Limited, Bangladesh Krishi Bank, Bangladesh Development Bank Limited, and some statutory banks, such as Ansar VDP Unnyan Bank and Karmasangsthan Bank, are controlled by the Bank and Financial Institution Division of the Ministry of Finance.

Nevertheless, all private commercial banks, foreign banks, non-bank financial institutions are regulated by Bangladesh Bank. The dual system of control has often resulted in uncoordinated weak policy measures for banks regulated by the Government. Bangladesh Bank has serious limitations to enforce prudential and management norms in these banks, which have made the whole banking sector weak and vulnerable through the “domino effect”.

The time has come to reform and revitalize the financial sector (comprising banks, financial institutions and capital market), to make the role of banks in financial intermediation more proactive to financially excluded enterprises and to introduce more innovative financial products, such as hedging, factoring and securitization. The time has also come to look into the foreign exchange management of Bangladesh.

In this policy note, I shall briefly review some key reforms in the regulatory environment and outline what further reforms are needed to make Bangladesh Bank more efficient and effective in discharging its tasks; I shall highlight some structural issues that need to be addressed. Finally, I shall reflect on the issue of central bank
independence and the need for prudential regulation in the context of complex
development challenges.

Regulatory reforms so far

Banks and financial institutions in Bangladesh have been working under diversified
regulatory development over the past few years. These developments were a result
of felt needs on the part of the regulators, mainly Bangladesh Bank, to bring about
efficiency and discipline in the financial sector. The main regulatory developments
are partly discussed below:

• Regarding reform of monetary policy tools, the first step was to make the
  monetary policy more effective and relevant to the economy. Instruments
  like “repo”, “reverse repo”, “open market operations” to auction government
  securities and foreign exchange management tools were built in MPS
  of Bangladesh Bank. The first MPS was formally announced to the
  public by Bangladesh Bank in January 2006. The policy statement was
  independently prepared by Bangladesh Bank, without any intervention of
  the Government. After that, an MPS was issued in January and July of
  every year, demonstrating the autonomy of the central bank.

• In January 2015, Basel-III was phased in and complete capital ratios were
  implemented from the beginning of 2019.

• Risk management guidelines on environmental and climate change, for
  banks, were distributed. A green banking policy was released as well.

• Stress-testing guidelines were published for banks and financial institutions
  to evaluate the resilience of banks and financial institutions under various
  negative conditions.

• Banks had to introduce a distinct risk management unit to manage risk
  thoroughly and intensively.

• Banks were ordered to form a distinct capital market subsidiary. They are
  now being carefully controlled in terms of capital market activities.

• Guidelines have been issued to increase bank involvement in corporate
  social responsibility.

• Guidelines for moneychangers, insurance companies and postal transfers
  have already been circulated to meet the international standard on anti-
  money-laundering and combating the financing of terrorism.
Needed reforms

Allow me to name some aspects which Bangladesh Bank should take into account for its future stance and policies for the financial sector:

- Monetary policy should be for six months, not one year, mainly because rapid changes are taking place on domestic and external fronts.

- Setting inflation as a policy target should not be overemphasized. Inflation and growth can be achieved through the coordination of monetary and fiscal policies and other sectoral policies, such as export policy, industrial policy and investment policy.

- The policy rates should be revisited and excess liquidity in the banks should be taken care of. In the absence of investment demand and lack of opportunities in expanding businesses, Bangladesh Bank should take steps in liquidity management policies of the banks.

- The rate of exchange of Bangladesh taka and the operation of foreign exchange market should be analysed and quick action to be taken by Bangladesh Bank. I am not advocating to align the nominal effective exchange rate fully with real effective exchange rate, but the relationship between the two and the fundamental factors to be taken into account to monitor movements of the nominal effective exchange rate. The global situation with the United States dollar and other hard currencies and the recent move by China to delink its currency from the dollar have created an atmosphere which Bangladesh cannot ignore.

- Finally, Bangladesh Bank should look into the impact of COVID-19 on the economy and future challenges, remove injustice and inequality created because of misplaced priorities focused on growth only, facilitate employment generation and increase access to finance by small businesses, farmers and marginal people.

Structural issues to be considered

Having said all the things above, I would like to point out some basic issues, which Bangladesh Bank must consider for formulating its policies and guidelines, including the next MPS and subsequent ones, because the following issues cannot be resolved within a short period.

The first is the transmission mechanism of monetary policy, which is the effect of macropolicy on the micro level, such as households and business enterprises. There is one middle level through which any macropolicy passes, that is the meso
level, which consists of markets and institutions, such as banks, financial institutions, merchant bankers and brokers for the capital market; regulatory agencies, such as Bangladesh Bank, Bangladesh Energy Regulatory Commission and Bangladesh Securities and Exchange Commission; and promoting agencies, such as Bangladesh Investment Development Authority and Export Promotion Bureau.

Unless these institutions function effectively, no monetary or fiscal policy measures will be properly implemented for effective impact on the desired entities. Therefore, what we need are structural reforms. There are four major weaknesses in this regard. First, as pointed out above, Bangladesh has problems with institutions, however they are defined.

Second, our goods and services markets are exposed to international influences, which have become more acute due to globalization and then due to the COVID-19 pandemic. The recent crisis between the Russian Federation and Ukraine has given rise to unsettling situations both in international political and economic orders. Until now the policy stance of Bangladesh Bank has been “growth supportive needs while attaining the targeted inflation” (Bangladesh Bank, 2020).

Against this background, our monetary policy has to be formulated and implemented in earnest. Bangladesh, like many other developing countries, is faced with a fluid situation and the consequent uncertainties. Therefore, a country’s monetary policy, moving away from conventional accommodating or contractionary policies towards a heterogeneous, unconventional and implementable policy should be taken.

Third, volatility has risen out of domestic macroeconomic and political imperatives, greater incidence of default risk, corruption and lack of accountability in the banks and financial institutions. Fourth, there is poor protection of small and marginal borrowers, lending and deposit operations made under administrative guidance and pressure groups working to create undue influence on the banks and even the central bank.

Central bank independence and prudential regulatory functions

Central bank autonomy is a debatable but crucial issue. However, for Bangladesh Bank to achieve its objectives, such as controlling inflation, increasing employment, ensuring economic stability and better financial management, it must be free from all external influences. Thus, Bangladesh Bank should be fully autonomous in all its functional and decisional activities.

Some attributes of interdependence are whether the central bank can refuse credit to the Government; whether it can meet its expenses without depending on the Government; whether its Governor or Board of Directors can function independently; whether its Governor is independent in following monetary policy; whether it is free
to choose its monetary instruments; and finally, whether it is free to regulate the banking policy and banks.

To have an independent and effective Bangladesh Bank, three major steps are necessary: (a) a strong and independent central bank with more focus on core banking issues, (b) a well thought out set of prudential and managerial norms of the central bank that are not subject to frequent changes due to external political or administrative pressure, and (c) a system of prompt corrective actions for management of crises and legal or administrative actions against persons responsible for crises in a particular bank or the banking system as a whole.

It must be pointed out that a balance must be made between the regulation and independence of a bank. This means that banks should neither be overregulated nor should they be left alone to enjoy complete freedom, which often results in banking disasters. This point has been very aptly articulated in a book co-authored by Jean Tirole, the Nobel Prize winner of Economics in 2014 (Dewatripont, Rochet and Tirole, 2010).

It is important to keep in mind what financial regulation is meant to achieve. The most important objective is to protect depositors, investors, the general public and the real economy (real goods and services) as a whole. The second rationale for regulation is to minimize the domino effect of the systematic risks of the financial institutions which destroys the foundation of economic activities resulting in the loss of real output, lower growth, higher unemployment and reduction of human welfare. Good governance in the banking sector is an important agenda of our country, especially in the present context of the crisis in the banking sector. Transparency and accountability have recently become an issue of greater concern in the context of the public and private responsibility of managing banks.

A perfect example of lack of both transparency and accountability are Sonali and BASIC Bank Limited scams where both borrowers and officials colluded in a non-transparent manner and siphoned off huge amounts of public money. Those responsible for such fraud have not yet been subjected to strong administrative and legal actions. In fact, they benefited from perverse incentives, and honest and dedicated people working in the same bank and elsewhere were marginalized and pushed back into oblivion.

For Bangladesh Bank to be successful in regulating the financial sector, it has to have relevant and pragmatic policies, prudential and managerial norms and ensure that these are fully followed by all banks and financial intuitions. Discretionary powers or ad hoc measures should be avoided to safeguard the independence and autonomy of Bangladesh Bank. The typical case of policy versus discretion has to be resolved with the strong stance of Bangladesh Bank where policies and rules
will be supreme, and not the discretionary powers of any individual and agency. The
time has come for Bangladesh Bank to strike a balance, showing an appropriate
professional stance while avoiding the danger of politically motivated actions in a
highly technical domain.

Concluding remarks

The policy stances towards the financial sector of Bangladesh resulted from action
on two fronts. On the one hand, the stakeholders, mainly business people, clients of
banks and other users (internal and external), articulated the need for and the kind of
changes required in the sector. On the other hand, in response to the stakeholders' 
demands, the policymakers (politicians and advisors to the Government), initiated
the process of reform and change on their own (Muqtada, 2018). Therefore, changes
to take the country forward took place in different phases. However, the challenge
of backing the tasks to be undertaken by political will remains, and the actions to
be taken should be based on facts, data and knowledge of the decision maker and
implementers.

The policies and activities of the financial sector directly impact productive activities,
covering both income and employment, and income and asset distribution. The
indirect impacts of the financial sector operate through its effects on the fiscal and
monetary policy stances. In this context, the macropolicy stances and the financial
sector are critical to the accelerated and sustainable development of Bangladesh.

Some features of the economy of Bangladesh also impede in deriving optimum
results of monetary policy. These are related mainly to the transmission mechanism
mentioned earlier. First, the rate of financial inclusion is low at approximately 55 per
cent of the population compared to more than 90 per cent in developed countries.
Low monetization limits the efficacy of monetary policy. Second, low market
sensitivity to the rate of interest of financial institutions is a reason for the low impact
of monetary policy. Third, the policy rates, such as the repo rate and reserve money
ratio, are not very effective as pointed out by a recent study (ADB, 2021) because
of the predominance of national savings certificates and government borrowing
from the banks. Fourth, other savings and investment instruments, such as national
savings certificates and credit by microfinance institutions, are not affected much
by the monetary policy. Unless the amount of money and rate of interest used in
such financial instruments are used in formulating monetary policy, its efficacy will
remain limited.

In a real-world situation, extraordinary independence and full autonomy of the
central bank may not be easily achieved. Therefore, a central bank like Bangladesh
Bank can minimize political and other external pressure by constantly engaging with
politicians and policymakers and gaining public support for actions which may make
it autonomous and effective. Whether in good or bad times, supervisors always face pressure from lobbyists and politicians that can undermine the stability of the financial system.

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