

THE CENTRAL BANK AND THE MONEY SUPPLY PROCESS



THREE PLAYERS IN THE MONEY SUPPLY PROCESS

- 1. The Central bank:** Federal Reserve System
- 2. Banks & NBFIs:** depository institutions; financial intermediaries
- 3. Depositors:** individuals and institutions

ESTABLISHMENT OF BANGLADESH BANK

- The most important player in the financial sector- Bangladesh Bank is the Government authorities in charge of monetary policy
- Established: 16 December, 1971
- Currency: Taka
- 9 Branches

OBJECTIVES OF BANGLADESH BANK

The broad objectives of the Bangladesh Bank are:

- To regulate the issue of currency and the keeping of reserves
- To manage the monetary and credit system of Bangladesh
- To preserve the par value (The official exchange rate between two countries' currencies) of Bangladesh Taka.
- To promote and maintain a high level of production, employment and real income in Bangladesh

FUNCTIONS OF BANGLADESH BANK

- Regulations and supervision of banks and non-bank financial institutions, promotions and development of domestic financial markets. It is the *“Lender of the Last Resort”*.
- Management of country's international reserves
- Issuance of currency and banknotes
- Regulation and supervision of payment system
- Acting as banker to the Government
- Money laundering prevention

THE FED'S BALANCE SHEET

Federal Reserve System	
Assets	Liabilities
Securities	Currency in circulation
Loans to Financial Institutions	Reserves

THE FED'S BALANCE SHEET

- **Liabilities**

- Currency in circulation: in the hands of the public
- Reserves: bank deposits at the Fed and vault cash

- **Assets**

- Government securities: holdings by the Fed that affect money supply and earn interest
- Discount loans: provide reserves to banks and earn the discount rate

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

RESERVE REQUIREMENTS

- A monetary policy instrument that is only used when very large adjustments are in order
- When a bank takes a deposit into an account on which a check can be written, it must place a percentage of that deposit on reserve at a central bank. That percentage is called a reserve ratio.
- RR Raised – banks reduce lending
- RR Lowered - Banks increase lending

MONETARY POLICY

If the Central Bank wants to expand the economy, it can:

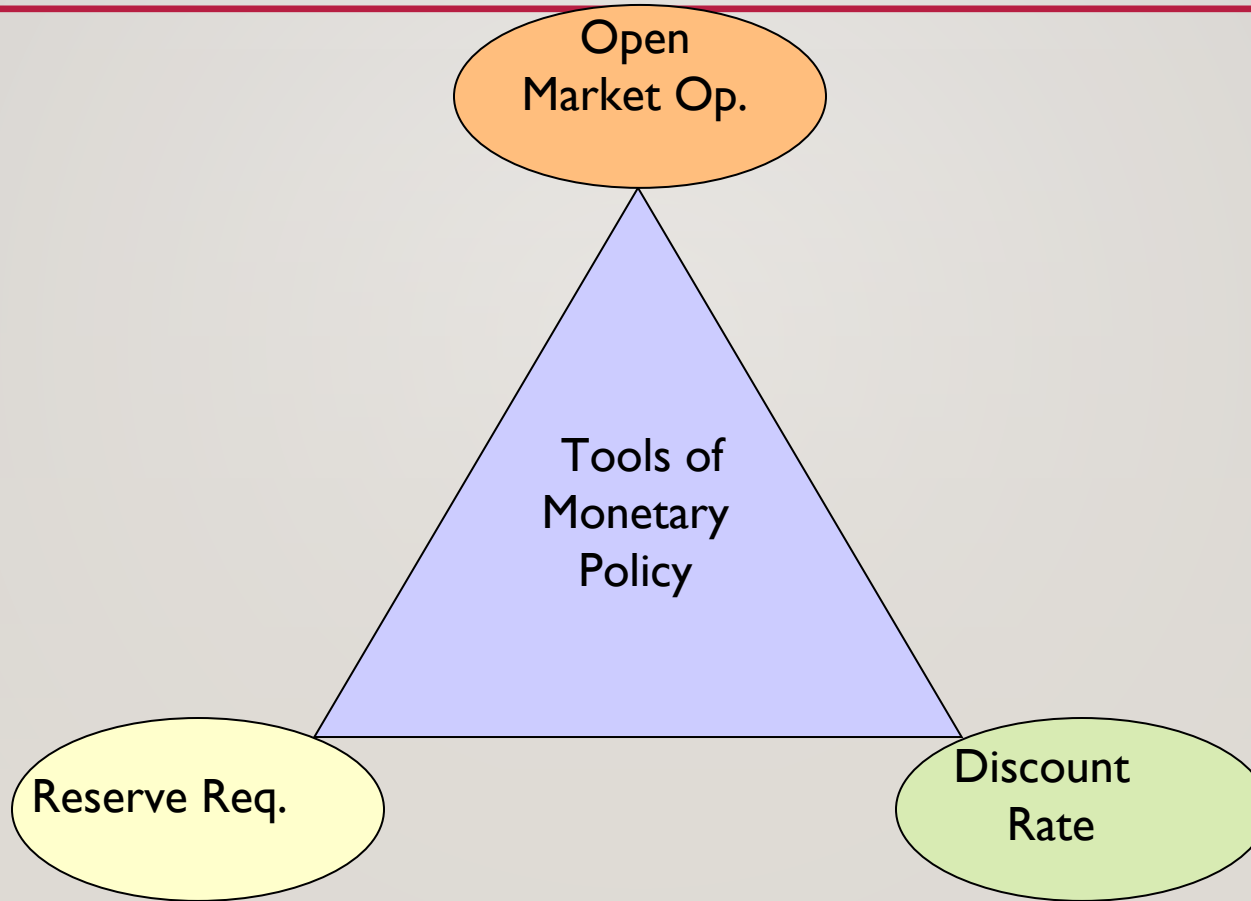
- Buy Bonds
- Decrease the discount rates
- Lower the reserve ratio
- This increases the supply of loanable funds and lowers the interest rates which increases aggregate demand

MONETARY POLICY

If the Central Bank wants to contract the economy, it can:

- Sell Bonds
- Increase the discount rates
- Raise the reserve ratio
- This decreases the supply of loanable funds and raises the interest rates which decreases aggregate demand

TOOLS OF MONETARY POLICY



WHY DOES FED CONTROL MONEY SUPPLY?

The Fed controls the money supply in order to affect interest rates and thereby affect economic conditions.

- Interest rates affect both households and businesses and hence the overall economic condition of the country.
- It impacts the consumption, buying, borrowing, investing, and many other decisions.
- By changing interest rate, central bank can influence economic growth and employment

HOW FED CONTROLS MONEY SUPPLY

- Banks must maintain reserves as percent of deposits
- Reserves kept as deposits in Fed (plus vault cash)
- Fed influences bank deposit portion of money supply

MONETARY POLICY TOOLS:

I. OPEN MARKET OPERATIONS

Open market operations involve the purchase or sale of government securities by the central bank.

Open market purchase of government securities:

- When the Fed purchases securities through government securities dealers, the bank account balances of the dealers increase and so the total deposits in the banking system increase.
- Increases the money supply
- Opposite effects are observed when **sale of government securities takes place**. As the dealers pay for the securities, their bank account balances are reduced. Thus the total amount of funds in the banking system is reduced

MONETARY POLICY TOOLS:

2. ADJUSTING THE DISCOUNT RATE

- Adjusting the discount rate
 - Depository institutions borrow from Fed for three reasons:
 - Adjustment credit for short-term reserve deficiencies
 - Seasonal credit to agricultural banks
 - Extended credit for longer-term liquidity problems of problem banks
 - Lower discount rate
 - More bank borrowing from Fed, bank reserves expand, money supply increases

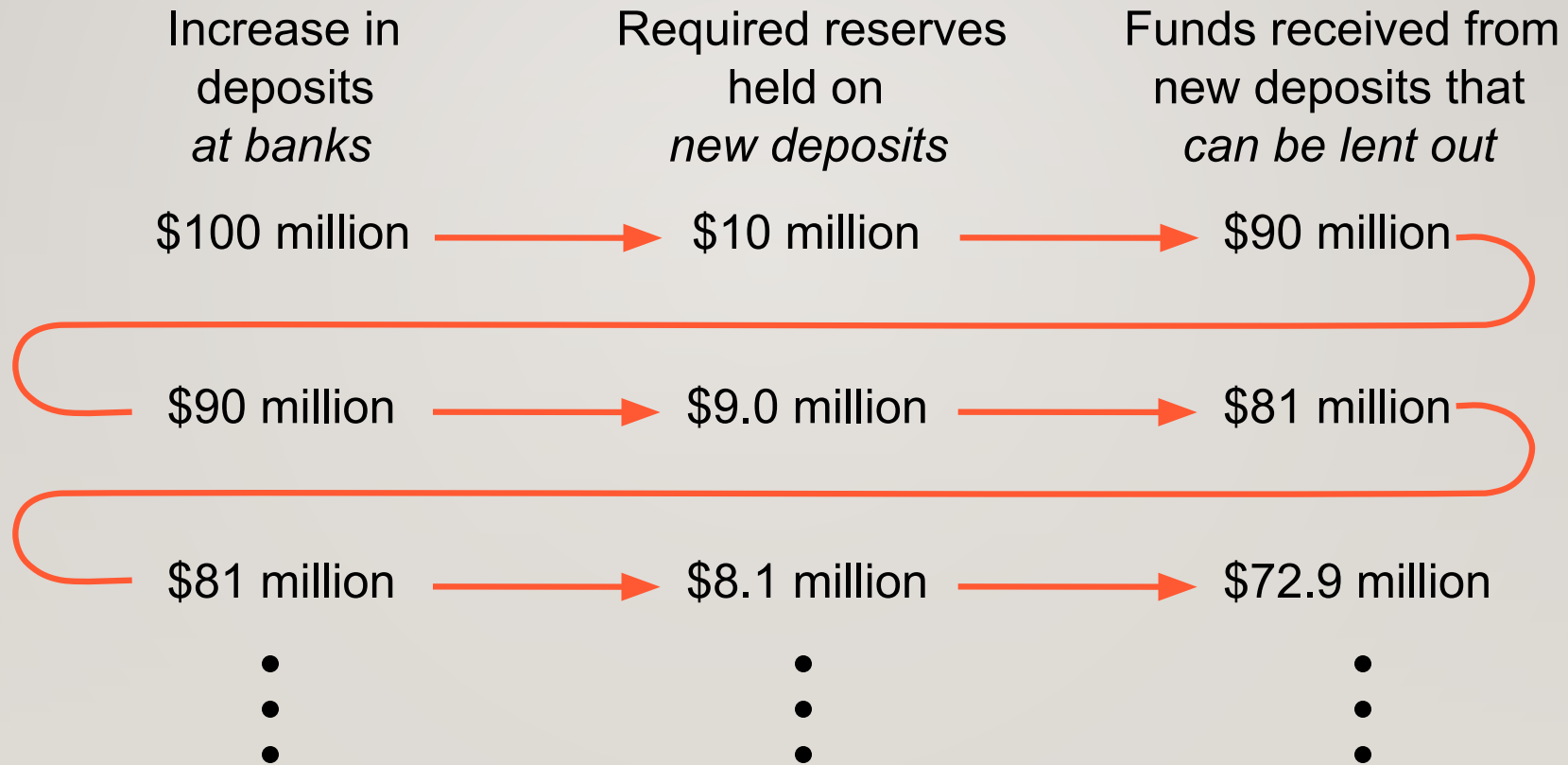
MONETARY POLICY TOOLS:

3. ADJUSTING THE RESERVE REQUIREMENT RATIO

- Adjusting the reserve requirement ratio
 - Proportion of deposits at depository institutions set aside to meet their reserve requirements
 - Increase in lending or expansion limited by (\$) reserves bank must hold to meet reserve requirements (%)
 - Total dollar expansion effect as follows:

$$\begin{array}{l} \text{Dollar amount of open} \\ \text{market} \\ \text{Fed purchase or discount} \\ \text{loan} \end{array} \times \frac{1}{RR}$$

EXHIBIT 4.4



LIMITING FACTORS TO DEPOSIT EXPANSION

- Banks may not lend excess reserves
- Public may not re-deposit payments In expansion process (cash drains)

COMPARISON OF POLICY TOOLS

- Increasing the money supply
 - Open market operation purchase of securities via the Trading Desk in the secondary market
 - Discount rate lowered to encourage borrowing at the discount window
 - Reserve requirements lowered

COMPARISON OF POLICY TOOLS

- Decreasing the money supply
 - Open market operation sale of securities via the Trading Desk in the secondary market
 - Discount rate raised to encourage borrowing at the discount window
 - Reserve requirements raised

HOW CENTRAL BANK'S OPERATIONS AFFECT INTEREST RATE

Even though most interest rates are market determined, the Fed can have a strong influence on these rates by controlling the supply of loanable funds.

Purchase of treasury bill or other expansionary monetary policy effect:

- First, the federal funds rate may decline because a larger supply of excess funds to lend out in the federal funds market. Lowers federal fund rate.
- Second, banks with excess funds may offer new loans at a lower interest rate in order to make use of these funds.
- Third, these banks may also lower interest rates offered on deposits because they have more than adequate funds to conduct existing operations.

HOW CENTRAL BANK'S OPERATIONS AFFECT INTEREST RATE-CONTINUED

Think on your own how contractionary monetary policy drives the interest rate up?



Regulatory functions of Central Bank in Bangladesh



Importance of Regulation in the financial system

- Poorly regulated financial institutions have the potential to undermine the stability of the financial system, harm consumers and can damage the prospects for the economy. That's why strong financial regulation is important - to put rules in place to stop things from going wrong, and to safeguard the wider financial system and protect consumers if they do go wrong.

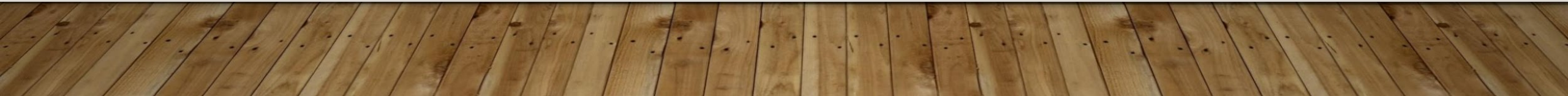
Major regulations

Bangladesh Bank act as a regulator of financial system. As such, it has established several regulations through several regulatory bodies:

- **Monetary policy:** The main objectives of monetary policy of Bangladesh Bank are:
 1. Price stability both internal & external
 2. Sustainable growth & development
 3. High employment
 4. Economic and efficient use of resources
 5. Stability of financial & payment system
- **Reserve Management Strategy** Bangladesh Bank maintains the foreign exchange reserve of the country in different currencies to minimize the risk emerging from widespread fluctuation in exchange rate of major currencies and very irregular movement in interest rates in the global money market.

Major regulations

- **Interest Rate Policy**
- Under the Financial sector reform program, a flexible interest policy was formulated. According to that, banks are free to charge/fix their deposit (Bank/Financial Institutes) and Lending (Bank/Financial Institutes) rates other than Export Credit. At present, except Pre-shipment export credit and agricultural lending, there is no interest rate cap on lending for banks. Yet, banks can differentiate interest rate up to 3% considering comparative risk elements involved among borrowers in same lending category.
- **Capital Adequacy for Banks and FIs**
- Basel-III has been introduced with a view to strengthening the capital base of banks with the goal of promoting a more resilient banking sector. Now, scheduled banks in Bangladesh are required to maintain minimum capital of Taka 4 billion or Capital to Risk Weighted Assets Ratio (CRAR) 10%, whichever is higher.



Major regulations

- **Deposit Insurance**
- The deposit insurance scheme (DIS) was introduced in Bangladesh in August 1984 to act as a safety net for the depositors. The purpose of DIS is to help to increase market discipline, reduce moral hazard in the financial sector and provide safety nets at the minimum cost to the public in the event of bank failure. A Deposit Insurance Trust Fund (DITF) has also been created for providing limited protection (not exceeding Taka 0.01 million) to a small depositor in case of winding up of any bank. According to new instruction regarding premium rates, problem banks are required to pay 0.09 percent and private banks other than the problem banks and state owned commercial banks are required to pay 0.07 percent where the percent coverage of the deposits is taka one hundred thousand per depositor per bank.

Major regulations

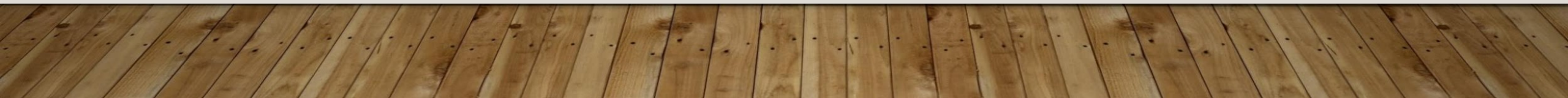
- **Insurance Authority**
- Insurance Development and Regulatory Authority (IDRA) has been established to make the insurance industry as the premier financial service provider in the country by structuring on an efficient corporate environment. The mission of IDRA is to protect the interest of the policy holders and other stakeholders under insurance policy, supervise and regulate the insurance industry effectively, ensure orderly and systematic growth of the insurance industry and for matters connected therewith or incidental thereto.

Major regulations

- **Regulator of Micro Finance Institutions**

To bring Non-government Microfinance Institutions (NGO-MFIs) under a regulatory framework, the Government of Bangladesh enacted "Microcredit Regulatory Authority Act, 2006" (Act no. 32 of 2006) which came into effect from August 27, 2006. Under this Act, the Government established Microcredit Regulatory Authority (MRA) with a view to ensuring transparency and accountability of microcredit activities of the NGO-MFIs in the country.

- MRA's mission is to ensure transparency and accountability of microfinance operations of NGO-MFIs as well as foster sustainable growth of this sector.



Supervision of Financial Institutions

Fls

Non Bank Financial Institutions (Fls) are those types of financial institutions which are regulated under Financial Institution Act, 1993 and controlled by Bangladesh Bank.

Regulator of Financial System

- Securities and Exchange Commission (SEC) performs the functions to regulate the capital market intermediaries and issuance of capital and financial instruments by public limited companies. It was established on June 8, 1993 under the Securities and Exchange Commission Act, 1993. A 5 member commission headed by a Chairman has the overall responsibility to administer securities legislation and the Commission is attached to the Ministry of Finance.

Supervision of Financial Institutions

The main functions of SEC are:

- ~~Regulating the business of the Stock Exchanges or any other securities market.~~
- Registering and regulating the business of stock-brokers, sub-brokers, share transfer agents, merchant bankers and managers of issues, trustee of trust deeds, registrar of an issue, underwriters, portfolio managers, investment advisers and other intermediaries in the securities market.
- Registering, monitoring and regulating of collective investment scheme including all forms of mutual funds.
- Monitoring and regulating all authorized self regulatory organizations in the securities market.
- Prohibiting fraudulent and unfair trade practices in any securities market.



Supervision of Financial Institutions

The main functions of SEC are (contd) :

- Promoting investors' education and providing training for intermediaries of the securities market.
- Prohibiting insider trading in securities.
- Regulating the substantial acquisition of shares and take-over of companies.
- Undertaking investigation and inspection, inquiries and audit of any issuer or dealer of securities, the Stock Exchanges and intermediaries and any self regulatory organization in the securities market.

Exchange rate policy in Bangladesh

- While Bangladesh adopted a floating exchange regime in 2003, it follows a managed floating exchange rate regime. As a result, multiple exchange rates prevail now in the country, such as one for imports, another for exports and another for remittances.
- Under such circumstances, the exchange rate is not allowed to adjust. Also, jacking up interest rates by Bangladesh Bank to fight inflation has become less effective, as reflected in resurging inflation in the country, nor has it helped stabilise the BDT. This is simply because exchange rates impact domestic inflation through their effect on tradable prices.

Money laundering

Money laundering can be defined in a number of ways. The definition of money laundering as per the UN Convention is as follows:

- The conversion or transfer of property, knowing that such property is derived from any offense, e.g. drug trafficking, or offenses or from an act of participation in such offense or offenses, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such an offense or offenses to evade the legal consequences of his actions;
- The acquisition, possession or use of property, knowing at the time of receipt that such property was derived from an offense or offenses or from an act of participation in such offense or offenses.

Money Laundering Prevention Act, 2012

- Offence of money laundering and punishment.— (1) For the purposes of this Act, money laundering shall be deemed to be an offence.
- (2) Any person who commits or abets or conspires to commit the offence of money laundering, shall be punished with imprisonment for a term of at least 4(four) years but not exceeding 12(twelve) years and, in addition to that, a fine equivalent to the twice of the value of the property involved in the offence or taka 10(ten) lacks, whichever is greater.

Money Laundering Prevention Act, 2012

- (3) In addition to any fine or punishment, the court may pass an order to forfeit the property of the convicted person in favour of the State which directly or indirectly involved in or related with money laundering or any predicate offence.
- (4) Any entity which commits an offence under this section shall be punished with a fine of not less than twice of the value of the property or taka 20(twenty) lacks, whichever is greater and in addition to this the registration of the said entity shall be liable to be cancelled.
- (5) It shall not be a prerequisite to charge or punish for money laundering to be convicted or sentenced for any predicate offence.

- References:

- <https://www.bb.org.bd/>

Thank you