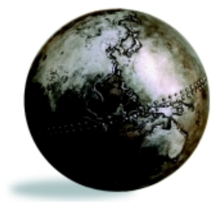

Bangladesh

Macroeconomic stability has been put under severe pressure by the disruptions from flooding in the third quarter of 1998. Signs of vulnerability have emerged both in the domestic and external sectors. Further structural reforms are needed if Bangladesh is to achieve greater economic efficiency, growth, and international competitiveness while reducing poverty.

RECENT TRENDS AND PROSPECTS

In the early 1990s, the government launched a comprehensive set of structural reforms aimed at strengthening fiscal and monetary management, fostering private sector development, and liberalizing the external trade and foreign exchange rate regimes. Such reforms resulted in a relatively stable macroeconomic environment, with improvements in economic growth, savings, and investment. Decreased poverty and improved social indicators accompanied the acceleration in economic growth. Between 1995 and 1999, the GDP growth rate averaged 5 percent compared with 4.7 percent in the preceding five years. The agriculture sector maintained an average growth rate of 3 percent, and the country achieved near self-sufficiency in rice production in those years without flooding. During the same period, growth in the industry sector averaged 6 percent, mainly because of robust manufacturing performance, while the service sector grew at an average of 6 percent. The export sector showed an average annual growth rate of about 16 percent in dollar terms because of strong trade in garments and knitwear products. Bangladesh succeeded in attracting significant foreign direct investment (FDI), which increased from about $80 million in 1995 to about $400 million per year for 1996 through 1999.

This strong growth trend in GDP was slowed when severe floods hit in the third quarter of 1998, disrupting industrial growth in particular. Nevertheless, with the help of a bumper winter harvest, GDP grew 4.4 percent in 1999. This was better than the immediate postflood estimates of 3.3 percent, though lower than the 5.2 percent growth of 1998. Agriculture and services performed well, overcoming the adverse impact of the flooding. Agriculture grew 3.9 percent, up from 3.2 percent in 1998, because of new higher-yielding varieties, particularly of rice. Moreover, the government helped in postflood rehabilitation by providing seeds, fertilizer, and credits. The service sector maintained steady growth of 5 percent, while growth in the industry sector slipped to 4 per-

1999 refers to fiscal year 1998/99, ending 30 June.

cent from 8.3 percent in 1998. The floods seriously disrupted production of major medium- and large-scale manufacturing enterprises, including ready-made garments for export.

Gross domestic investment increased to 22.5 percent of GDP in 1999, from 21.6 percent the previous year, because of an investment surge in flood-induced reconstruction and rehabilitation. Gross national savings increased to 21.1 percent of GDP compared with 20.4 percent in 1998, mainly because of a surge in remittances from overseas workers.

After double-digit growth for several years, export growth dwindled to 2.8 percent in 1999 from 17.1 percent in 1998. The major setback was in the woven ready-made garments sector, which registered only 4.8 percent growth. While floods adversely affected export shipments and production, the devaluation of Southeast Asian currencies also weakened export competitiveness. This demonstrates how vulnerable the export sector is because of excessive dependence on a single subsector.

Imports grew 6.6 percent in 1999, higher than the preceding two years, because of imports of food grains triggered by the fear of flood losses. As a result, the current account deficit increased to 1.4 percent of GDP from 1.2 percent the preceding year. Increasing pressure on the balance of payments was reflected by the low level of foreign exchange reserves of $1.5 billion (2.2 months of import equivalent) at the end of 1999. Lower export growth resulted in a slight increase in the debt-service ratio to 12 percent from 11.7 percent the previous year. Currency depreciated slightly, as the annual average exchange rate increased to Tk48.5 per dollar compared with Tk46.3 in 1998. Because of additional spending brought on by the flood —including imports of extra food grains and postflood rehabilitation costs—and a shortfall in current revenue collection resulting from production disruption, a higher budget deficit resulted. Current revenue declined to 9 percent of GDP from 9.7 percent in 1998, while the fiscal deficit increased to 5.3 percent of GDP from 4.2 percent. However, the fiscal losses of Tk15 billion associated with operating state-owned enterprises exposed a serious fiscal management problem. If the fiscal liabilities arising from these losses were considered, the government's fiscal position would be even weaker.

The government pursued an expansionary monetary policy to finance the flood recovery program. Money supply (M2) increased 12.8 percent in 1999

Table 2.14 Major Economic Indicators, Bangladesh, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth	5.4	5.2	4.4	5.0	5.5
Gross domestic investment/GDP	20.8	21.6	22.5	22.8	23.5
Gross national savings/GDP	18.6	20.4	21.1	21.8	22.3
Inflation rate (consumer price index)	2.6	7.0	9.0	6.0	8.0
Money supply (M2) growth	10.8	10.4	12.8	14.0	12.0
Fiscal balance/GDP	-4.5	-4.2	-5.3	-4.2	-5.0
Merchandise exports growth	13.3	17.1	2.8	7.0	12.0
Merchandise imports growth	3.2	5.1	6.6	7.0	7.0
Current account balance/GDP	-2.2	-1.2	-1.4	-1.0	-1.2
Debt service/exports	11.4	11.7	12.0	12.1	12.1

Note: National accounts data are based on 1995/96 base year, are under government review, and not yet officially released.

Sources: Bangladesh Bank; Bangladesh Bureau of Statistics; World Bank; staff estimates.

compared with 10.4 percent the preceding year. The average inflation rate increased to 9 percent from 7 percent in 1998. However, after the new harvest, inflation started falling, reflecting the decline in food prices. In the banking sector some steps were taken to reduce the number of nonperforming loans (NPLs), particularly by removing major defaulters from the directorships of commercial banks. However, NPLs increased to 43 percent of total loans at the end of June 1999, compared with 41 percent six months earlier.

The macroeconomic outlook for 2000 remains positive, with reasonably high GDP growth of 5 percent and inflation limited to 6 percent. The economic growth will continue to be largely dependent on the agriculture sector as in the past few years. Domestic investment and national savings (22.8 percent and 21.8 percent of GDP, respectively) are expected to improve moderately. Two successive bumper harvests should ease the strain on the rural sector, with only moderate price increases expected. The industry sector is expected to recover partly from the setback suffered during the floods. The 2000 budget aims at reversing a flood-related upward trend in the budget deficit by raising revenue 1 percent of GDP to 10 percent, and lowering the budget deficit to 4.2 percent of GDP.

Nevertheless, the historical shortfall in government revenue and increased government borrowing from the banking system reflect the vulnerability of the government's fiscal position. Moreover, growing political turbulence could hurt the investment climate, which in turn could slow industrial growth, including growth in export-oriented establishments. Coupled with a high concentration of export and FDI in certain sectors, the balance of payments is likely to be threatened. Because the taka is overvalued compared with its competitors, any further devaluation in competing Southeast Asian countries, coupled with higher import payments, will pressure Bangladesh to devalue its currency in 2000.

ISSUES IN ECONOMIC MANAGEMENT

Low fiscal effort is a continuing issue. The tax base is narrow and tax compliance low. The share of government revenue is small compared with other countries in the region, and tax elasticity needs to be improved. The 2000 budget introduced improvements in the tax structure and tax administration. These include automating customs administration, simplifying tax assessment and collection procedures, expanding the value-added tax base to cover 31 new items, and introducing mandatory preshipment inspection. Nevertheless, the fiscal position is likely to deteriorate more unless action is taken to reverse the government's low revenue-generating capacity and poor tax collection record. Government revenue as a percentage of GDP is not likely to exceed 12 percent in the near future. The problem lies primarily in poor tax collection and, in general, poor governance. Unless there is a significant improvement in governance, strict monitoring of the firms assigned to carry out mandatory preshipment inspections—which have yet to be fully implemented—may not be feasible.

On the expenditure side, the budget has faced increasing claims for wages, salaries, and defense expenditure, as well as growing pressure of debt obligations. Increasing government borrowing from the banking system to finance the large budget deficits has contributed to monetary expansion and inflation. The size of the government deficits and the corresponding borrowing requirements, together with the high interest rate on lending, have curtailed or reduced demand for bank credit by the private sector. Coupled with the high proportion of NPLs in the banking system, banks are reluctant to renew credit lines. Unless policies change, growth in the private sector will suffer, including growth in export-oriented industries. The government therefore must reach a political consensus on a national fiscal policy that will ensure increased revenue collection, reduce expenditure on unproductive sectors, and contain the fiscal deficit. Simultaneously, further financial sector and capital market reforms are needed to mobilize domestic resources for enhancing private sector investment.

In the external sector, the balance of payments is likely to deteriorate if export industries and the inflow of FDI are not diversified. Both remain highly dependent on a few products and sectors. Garments compose about 70 percent of total exports, creating vulnerability to unfavorable changes in global demand and supply. In addition, the world demand for garments is growing slowly and markets are extremely competitive. Export diversification is needed, particularly into higher value-added products such as electronics, computers, and higher-quality clothing, where world demand is growing faster. Similarly, the high concentration of FDI in the natural gas and power sectors, about 60 percent, not only has failed to increase foreign exchange reserves, but has also jeopardized the balance of payments. The government is obliged to pay foreign investors under the production-sharing contracts of natural gas and power purchase agreements. The situation will be further aggravated when significant profit repatriation begins. Unless the government considers exporting natural gas to neighboring countries such as India, or diversifying FDI to export-oriented industries, the balance of payments may deteriorate further.

POLICY AND DEVELOPMENT ISSUES

Poverty alleviation will continue to be the central agenda for both the government and external donors. Reducing poverty through accelerated economic and agricultural productivity is the main thrust of the government's Fifth Five-Year Plan (1997-2002). Poverty incidence is targeted to decline from 47.5 percent to 30 percent by 2002, while the annual average GDP growth rate is set at 7 percent, a level necessary to significantly decrease poverty. Halfway through the plan, growth had averaged only 5 percent.

The plan emphasizes the role of the private sector, especially in export-oriented industries, as the main engine for sustainable economic growth and employment opportunities. This will be facilitated by reforms in the financial and capital markets. Because 80 percent of the population still lives in rural areas, self-sufficiency in food grains is emphasized as a route to sustainable poverty reduction. Other measures to tackle poverty are human resource development; promotion of small-scale enterprises through microfinance; participation of local-level institutions in rural development; and good governance.

Prospects for poverty reduction in Bangladesh were set back in 1998 by heavy floods. Progress has been slow despite substantial government effort and resources that included allocating about a fourth of the annual development budget to social infrastructure. Thus, the use of the development budget allocated to the social sectors and social infrastructure needs to be extensively analyzed, and a strategy developed for increasing budget efficiency to reduce poverty in a cost-effective manner.

Microfinance has been extended to a large segment of the rural population. It is time to establish stronger ties between these small-scale enterprises and the formal sector by developing more effective marketing and distribution links with medium- and large-scale industries. Nongovernment institutions organized to assist small-scale industry can play a key role. These links will also enhance the role of the private sector in poverty reduction through generating employment and income for rural small-scale industries, many of which are run by women.

While the government has been actively promoting the private sector's role in the country's development effort, progress in privatizing state-owned enterprises has been slow. The current privatization board, which was established in 1993, lacks full legislative power. The bureaucracy, labor unions, and politicians with vested interest still exert strong resistance to privatization. However, substantial state-owned enterprise losses continue to drain the budget, consuming funds that could otherwise be used for poverty reduction.

The country's annual economic growth target of 7 percent envisaged in the Fifth Five-Year Plan remains unattainable, not because the country lacks economic potential, but because the growth prospects of the economy have been seriously clouded by internecine political conflicts, continuous general strikes (*hartals*) disrupting work, endemic corruption, and the general lack of good governance. Unless the country's political leadership becomes more enlightened and seriously sets itself to the task of addressing these issues, the economy may remain mired in poverty and underdevelopment for years to come.