



Bangladesh

Economic Assessment

In FY2004, which ended in June 2004, GDP is estimated to have risen by 5.5%, a rate virtually unchanged from 5.3% in the previous year. It was driven by steady growth in industrial production and services, which accounted for 2.1 and 2.8 percentage points, respectively, of growth. Agriculture accounted for the balance, with a slight expansion of 2.7% in FY2004, down from 3.1% in the previous year, largely due to weaker growth in food grain production.

Industrial output is estimated at 7.7% stronger, up from 7.3% in FY2003, due to further gains in export-led manufacturing and domestic construction activity. Manufacturing expanded by 7.4%, from 6.8%. Construction growth also edged up, to 8.3% from 8.1% in FY2003, while services showed an improvement of 5.7%, again, just a tad higher than the previous year's 5.4%.

On an expenditure basis, the GDP expansion in FY2004 was fueled by stronger private consumption, rising to 6.0% from 4.1% a year earlier. In contrast, private investment decelerated moderately to 7.4% growth from 8.8% in the previous year, while public investment climbed to 8.4% growth, against 5.4%.

In spite of a shortfall in targeted revenues, the fiscal deficit in FY2004 narrowed to 4.2% of GDP from the 4.8% projected in *ADO 2004*. This stemmed from the restraint imposed on current expenditures to keep inflation under control and from underperformance in development spending. As a share of GDP, revenues remained at 10.6%, a low rate even by South Asian standards. Domestic resources funded 43% of the deficit, and foreign financing the rest.

Supported by the PRGF arrangement with IMF, the Government, in line with its ongoing economic reform program, pursued a prudent monetary policy to keep inflation low while promoting growth through assuring conditions

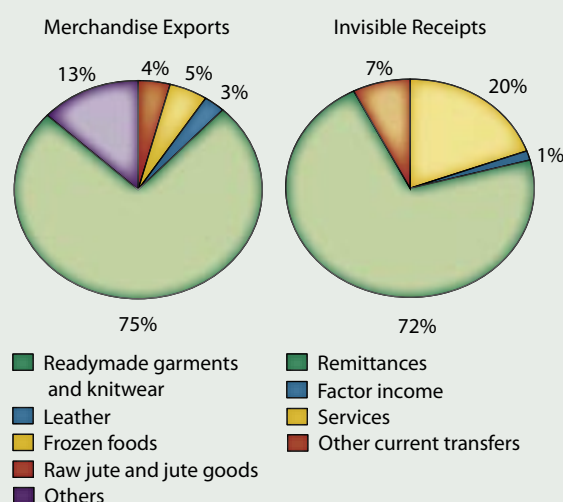
for a steady flow of credit to the private sector. Broad money (M2) growth, which declined from 15.6% in FY2003 to 13.8%, remained broadly in line with the Government's program target of 14.1%. Reserve money growth (7.6%) was also lower than the target of 10.0%. Credit to the private sector increased by 16.2% from 14.9% in FY2003, reflecting the continued strengthening in manufacturing and services.

Year-on-year inflation stepped up from 5.0% in June 2003 to a peak of 6.7% in November that year, but declined subsequently, with some fluctuations. It fell to 5.6% in June 2004, due mainly to the tightening of the money supply, controls on current expenditures, and reductions in import taxes. On an annual average basis, inflation rose to 5.8% in FY2004 from 4.4% a year earlier. Higher import prices of food and nonfood products were the main factors. The exchange rate remained largely stable against the US dollar, requiring minimal intervention from the central bank.

Propelled by a rise in external demand for the country's major products, exports gathered further pace in FY2004, strengthening by 15.9% compared with 9.5% in the previous year. This performance was underpinned by garments, knitwear, textiles, and frozen food (Figure 2.13). Import growth slowed slightly to 12.6% from 13.1% a year earlier. As the rise in imports offset that in exports, the trade deficit widened slightly to \$2.3 billion in FY2004 from \$2.2 billion. The surplus on the current account also widened, to \$184 million from \$176 million in the preceding year, mainly due to an increase in current transfers, including worker remittances.

The overall balance-of-payments surplus fell sharply to \$184 million from \$815 million in FY2003, reflecting reductions in the capital and financial account surpluses, in turn rooted in the steep fall in aid disbursements caused by low development spending. Foreign exchange reserves

Figure 2.13 Total Merchandise Exports and Invisible Receipts by Category, Bangladesh, FY2004



Sources: Bangladesh Bank; Export Promotion Bureau.

stood at \$2.7 billion, equivalent to about 3 months of imports, at end-FY2004.

Policy Developments

The budget for FY2005 (effective July 2004) sets an ambitious revenue target of a 16.7% increase in revenue collection from the FY2004 level, with measures to expand income tax and VAT coverage, and to rationalize customs duty, supplementary duty, and income tax rates. Attaining the revenue target will require an effective revenue mobilization drive and enforcement of greater discipline in tax management, including increased monitoring and supervision of tax officials. The budget gives priority to projects with growth and poverty reduction potential, and seeks to raise public investment in infrastructure and the social sector with a 15.6% increase in total spending from FY2004's figure. Achieving this will require improved public expenditure management and stronger institutional capacity for the selection, preparation, and implementation of development projects.

In the area of monetary policy, the authorities made greater use of market-based instruments to manage liquidity. As a part of the PRGF-supported program, the interest rates on National Savings Certificates (NSCs) are expected to be

adjusted semiannually to stimulate greater flexibility in the interest rate structure and to bring down the costs of financing the fiscal deficit. The NSC rates were reduced in January 2004, and, largely due to this move, average bank and nonbank lending rates subsequently declined. The NSC rates were lowered again in July 2004.

The FY2005 budget moderates tariff protection by reducing the top tariff rate to 25% and compressing tariff rates, and should promote the efficiency of domestic industries by generating greater competition. Gas prices were adjusted upward by 3.5% effective July 2004 and the price of kerosene was raised to the level of diesel to discourage adulteration, although prices of other oil products were left unchanged in spite of the sharp rise in the international oil price.

Outlook for FY2005

In FY2005, GDP is now expected to rise by 4.8% against the *ADO 2004* projection of 6.0%, a downgrade resulting from the devastating flooding of July and August. Its damage to infrastructure and other assets will slow economic growth and present a serious challenge to macroeconomic management. Industrial growth is expected to be lower than in FY2004 due to the severe flood damage to SMEs, including the export-oriented knitwear industry. Similarly, the destruction of standing crops and the severe impact on output of poultry, livestock, fisheries, and forestry will lower agricultural growth from the year-earlier level. Expansion in services is also likely to suffer, reflecting deceleration in industry and agriculture.

Annual average inflation is likely to edge up to 6.0% in FY2005, mainly due to higher domestic food prices and, in part, to the pass-through of high international oil prices. Given the unsustainability of leaving administered prices of oil products unadjusted for long, the Government will likely allow a partial pass-through of the increased oil prices to consumers.

The combined effects of the termination of the MFA quotas at end-2004, affecting the second half of FY2005, and the flood-related damage will cut by nearly half, to 8.5%, growth in exports of textiles and clothing to \$6.2 billion in FY2005. Since textile and clothing exports normally

Table 2.13 Selected Economic Indicators, Bangladesh, 2004–2005, %

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.7	5.5	6.0	4.8
Inflation (CPI)	4.7	5.8	4.2	6.0
Current account/GDP	0.0	0.3	-1.5	-1.5

Source: Staff estimates.

account for about 75% of total exports, overall export growth will also likely fall steeply, probably by more than half, to 7.0% from 15.9% in FY2004.

Import growth will remain high at 14.0%. Reduced imports of raw materials for the textile and clothing industry will be more than offset by the rise in postflood imports of food grains, medicines, and machinery, and by a higher import bill for oil. Although an expected increase in remittances from overseas workers to their flood-devastated families and in flood-related grants will cushion the trade deficit, the current account will switch to a deficit of 1.5% of GDP from an estimated surplus of 0.3% in FY2004. IMF's augmentation of the PRGF by SDR53 million under the first tranche of its Trade Integration Mechanism will help the country cope with balance-of-payments pressures. Due to the restraint imposed on current spending, particularly in the wake of the floods and the planned financing of postflood reconstruction through diversion of resources from low-priority projects, the fiscal deficit is expected to remain around the FY2005 budget projected level of 4.3% of GDP, unless there is a major shortfall in revenue collection.

Bangladesh relies on MFA quota-restrained markets (primarily the EU and US) for around 94% of its textile and clothing exports. Although wages are low, poor labor productivity along with inadequate infrastructure and policy constraints could cause the country to lose much of its market share after MFA quota abolition. A recent WTO study¹ using the Global Trade Analysis Project (GTAP) model indicates that Bangladesh's market share for textiles in the EU will fall from 5% in 2002 to 3%, once quotas are eliminated in 2005, although its market share for clothing there will increase from 3% to 4% over the same

period. The study also shows that the country's market share for clothing in the US will decline from 4% to 2% between 2002 and 2005. An IMF study² notes that a simple extrapolation of Bangladesh's performance under stage 3 integration, effective 1 January 2002, of the WTO Agreement on Textiles and Clothing suggests a net loss of \$750 million on the merchandise trade account after the end of the quota system.

In addition to putting pressure on the balance of payments, the abolition of MFA quotas is likely to pose serious problems in terms of reduced output and employment. According to the same IMF study, GTAP simulations (assuming standard GTAP elasticities and fixed nominal wages) indicate contractions in GDP of 2.3% and in employment of 4.5% from baseline levels that assumed the maintenance of quotas through 2007. Apart from affecting jobs in the textile and clothing industry, which employs around 1.8 million people (mostly poor women), representing 40% of manufacturing employment, the MFA phaseout will also likely displace workers in activities linked to the sector. Although some temporary employment will be generated by the postflood reconstruction activities and under the Government's food for works program, enlarged because of the flooding, this may not benefit the displaced workers. However, greater availability of donor-supported financing and business development assistance to SMEs may create jobs in this sector in the coming years.

In FY2005, macroeconomic management will be a challenge, given the likely deterioration in the current account and the increase in public expenditures for flood rehabilitation. Sound operation of monetary and fiscal policies will be constrained if domestic food and nonfood production takes time to pick up. In addition, sustaining competitiveness of the textile and clothing industry in the post-MFA era, and so protecting jobs in the industry, will require that governance issues and key infrastructure constraints be urgently addressed.

1 WTO. 2004. *The Global Textile and Clothing Industry post the Agreement on Textiles and Clothing*. Geneva.

2 IMF. 2004. *The End of Textiles Quotas: A Case Study of the Impact on Bangladesh*. Working Paper. June.