

Bangladesh

Summary

In April, the *Asian Development Outlook 2005* (ADO 2005) predicted that gross domestic product (GDP) growth in FY2005 (ended June 2005) would slow—mainly reflecting the adverse impact of devastating flooding in July–September 2004—before picking up in FY2006. Inflationary pressures were expected to accelerate in FY2005, due to higher domestic food prices and an increase in international commodity prices, while the fiscal deficit would worsen, due to a sharp rise in government spending in the face of weak revenue performance. Despite an expected improvement in workers' remittances, a widening trade deficit was projected to turn the balance-of-payments current account surplus into a deficit.

Provisional government estimates show GDP growth in FY2005 to be marginally higher than forecast in ADO 2005. This *Update* lowers the earlier growth projection for FY2006 on the basis of pressures that will be exerted by higher oil prices, while the current account deficit for FY2006 is now expected to widen. Sustained high oil prices present a considerable risk to domestic fiscal and external balances.

Updated assessment

The agriculture sector, particularly foodgrain production, slipped during FY2005 as a result of the serious flooding that affected the country in July–September 2004. Total foodgrain produced in the year is estimated at 26.3 million tons, 4% lower than in FY2004. Offsetting this weak performance, industry and services recorded a steady expansion. During July–May FY2005, the output of large- and medium-scale manufacturing

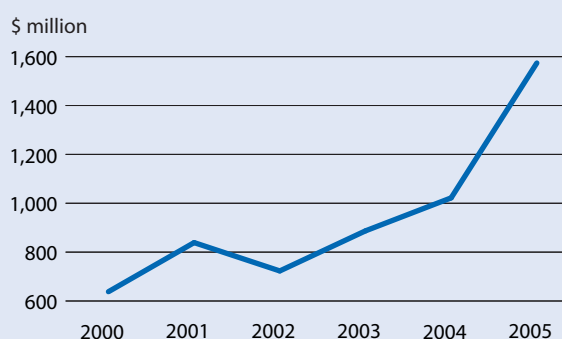
rose by 8.2% compared with the same period of the previous year, while output of small-scale manufacturing in July–March strengthened by 7.9% on the equivalent prior-year period. The services sector registered improvement, due particularly to strong growth in foreign trade and manufacturing. Based on recently released data, GDP growth in FY2005 is estimated at 5.4%, down from 6.3% in FY2004.

On the expenditure side, relatively rapid expansion was sustained by increased consumption, since the contribution of net exports turned negative and investment strengthened only marginally from FY2004, to 24.4% of GDP. An increase in private investment was largely offset by a decline in public investment.

Inflation picked up to 6.5% in FY2005 from 5.8% a year earlier, due mainly to flood-induced rises in domestic food prices and, amplified by a 4% depreciation of the taka, an upturn in international commodity prices. The surge in global oil prices was not a major factor in inflation due to a limited pass-through to administered retail oil-product prices.

Despite earlier uncertainties surrounding the impact of the ending of quotas under the Multifibre Arrangement, exports in fact grew by a solid 14% during FY2005. Even though growth of woven garments slowed, that of knitwear registered an impressive 31% expansion, with the garment sector essentially matching the previous year's strong performance. Imports during FY2005 grew substantially faster than exports at 20.6%, reflecting a 54% jump in the oil import bill (Figure 2.1), and strong rises in foodgrains and food products, industrial raw materials, and capital goods. Although workers' remittances rose by 14.2% over this period, the sharp increase in the trade deficit swung the current

Figure 2.1 Trends in oil imports, Bangladesh, FY2000–FY2005



Sources: Bangladesh Bank, available: <http://www.bangladesh-bank.org/econdata/imprrpay.html>, downloaded 29 July 2005; staff estimates.

account (excluding official grants) to a deficit of \$555 million, or 0.9% of GDP, from a surplus of \$115 million, or 0.2%, in FY2004. However, a steep rise in the financial account surplus, propelled mainly by net aid flows, outweighed the current account deficit, leading to a substantial surplus on the overall balance of payments and to a rise in official reserves of about \$300 million over the period, to \$3.0 billion at end-June 2005.

Largely as a reflection of the faster growth in imports (boosted by a surge in private sector credit) than in exports, the exchange rate exhibited greater volatility in FY2005. However, pressures on the balance of payments appear more evident in the first weeks of FY2006, with foreign exchange reserves declining by about \$200 million to \$2.8 billion on 20 August 2005.

Monetary policy remained generally accommodative in FY2005, with annual broad money growth accelerating to 16.8% in June 2005 from 13.8% a year earlier, driven by private sector credit. Although net credit to the Government declined during July–May FY2005, in June 2005 the Government had to borrow heavily because of delays in the disbursement of budget support from development partners. Bangladesh Bank tightened monetary policy after February 2005, both by raising the cash-reserve requirement of banks from 4.0% to 4.5%, and by raising treasury bill rates and repo and reverse repo rates in line with market conditions. In response, commercial banks raised their deposit and lending rates.

Despite efforts to improve tax adminis-

tration, the revenue gain expected in the budget for FY2005 did not materialize, contributing to a widening of the fiscal deficit to 4.5% of GDP, or slightly more than had been planned. Despite sharply higher current spending (mainly required to finance flood-related outlays), the deficit was kept in check by lower than budgeted development expenditure.

Although it is too early to make more than a cursory assessment, earlier concerns over the termination of quotas have not yet been realized. In the first few months after quotas ended, exports of knitwear and woven garments to the US continued to grow rapidly. In a somewhat different pattern, in other markets, particularly the European Union, knitwear exports showed robust growth while exports of woven garments slowed. Prices of some products dropped markedly as suppliers came under immediate pressure to be more competitive, but in the longer term, various challenges must be addressed to improve the position of the garment industry. For example, low wages are accompanied by low productivity—eroding some of the benefits of the country's low-cost labor, mainly because much of the industry's capital stock is outmoded and does not match standards of most global competitors. Limited availability of local fabrics (in comparison with, for example, the People's Republic of China and India, which can operate along the whole supply chain) and poor domestic infrastructure also constrain expansion. Finally, following several incidents at factories, the garment sector has now come under mounting pressure from international buyers and other agencies to ensure compliance with social standards.

Prospects

GDP growth is now expected to level off at 5.5% in FY2006, slightly lower than the *ADO 2005* projection of 6.0% and the Government's target in its poverty reduction strategy paper. While aggregate growth in FY2006 will be aided by recovery in agriculture, expansion in industry and services is expected to moderate from its strong performance in FY2005. This slowing in part reflects a more moderate gain expected in overall export growth as the garment and textile industry comes under more intense competitive

Table 2.1 Selected economic indicators, Bangladesh, 2005–2006, %

Item	2005		2006	
	ADO 2005	Update	ADO 2005	Update
GDP growth	5.3	5.4	6.0	5.5
Inflation (CPI)	7.0	6.5	6.0	6.0
Current account/GDP	-1.0	-0.9	-1.0	-1.7

Source: Staff estimates.

pressure. More generally, the outlook points to the need to tighten monetary policy, both to keep a lid on pressures on the exchange rate as the current account deficit moves sharply worse and to contain inflation. Tightened interest and credit policies in turn may slow consumer and investment spending. Foreign direct investment is expected to be maintained at recent levels in the next couple of years but could pick up significantly after that if ongoing negotiations over several large investment projects prove successful.

Inflation is expected to moderate to 6.0% in FY2006, helped to a great extent by the recovery in crop production, the continuation of the Government's policy of gradual adjustment to international oil prices, tightened credit conditions, and the maintenance of strong fiscal policies. Fiscal deficits in these 2 years are put at about 4.5% of GDP, in line with the targets in the poverty reduction strategy paper. Revenue collection is targeted to improve by 0.5% of GDP annually, but this will require strengthened efforts at implementation of reforms in the tax system and more effective tax administration.

Growth in exports is expected to moderate somewhat in response to stiff global competition in garments and textiles but generally to remain healthy in the forecast period (e.g., 12.0% in FY2006). Although slower than in FY2005, growth in imports will still be large (15.0% in FY2006), mainly reflecting a continued steep rise in the oil import bill and in inputs to the heavily import-reliant garment sector. The current account deficit is now expected to escalate to 1.7% of GDP in FY2006, or 0.7 percentage point larger than the *ADO 2005* projection. This outcome is despite a steady strong projected expansion in

workers' remittances and leaves less room for maneuver should downside risks emerge.

Sustained high oil prices are a heightened risk to the macroeconomic outlook. In FY2005, the oil import bill jumped by \$540 million to \$1,540 million. While the state-owned Bangladesh Petroleum Corporation has experienced losses for many years, very high import prices, together with administered retail prices, further undermine its financial viability. Over FY2005, domestic prices of some oil products were increased but the limited adjustment meant that losses for the year escalated to an estimated \$445 million (equivalent to 0.7% of GDP). The corporation is funding its operating losses with financing from the nationalized commercial banks and a credit line from the Islamic Development Bank. Budgets have not provided for subsidies.

To reduce the corporation's losses, the FY2006 budget substantially reduced oil taxation; cut the duty rate on crude oil to 7.5% from 25%; lowered rates on petroleum products to 15% from 25%; and cut to zero the supplementary duty on products from 15%. Even so, without a substantial pass-through of international prices to consumers, losses will remain large. The accumulated losses—in effect, a quasi-fiscal obligation—will eventually need to be dealt with by the Government. Moreover, since oil taxes have accounted for about 11% of tax revenue in recent years, the issue of forgone taxes (the effective tax rate appears now to be just less than 15%) will have an immediate impact on the budget, in spite of the fact that higher average oil prices over FY2006 work to raise the tax base.

High oil prices mean the Government will also need to mobilize external financing adequate to ensure that foreign exchange is available in the market both for oil and other essential imports, such that excessive pressures are not placed on the exchange rate or on the country's foreign reserves.

Over the medium term, Bangladesh faces downside risks to its economic prospects. These include the longer-term consequences of the loss of quotas for the garment industry; the implications of high oil prices on macroeconomic management; and political uncertainty, especially in the lead-up to the January 2007 elections. Natural disasters affecting the performance of agriculture, of course, are a perennial risk.