

Bangladesh

Asian Development Outlook 2006 (ADO 2006) in April this year forecast that GDP growth in FY2006 (ended June 2006) would accelerate; that inflationary pressures would heighten; and that the current account would show a modest deficit. Whereas GDP growth and inflation turned out close to projections, the current account posted a small surplus, primarily because export growth was faster, and import expansion slower, than expected. This *Update* maintains the earlier FY2007 projection for GDP growth, sees less progress in reducing inflation, and forecasts a small surplus (rather than deficit) on the current account due to continued robust export performance and contained import growth. Despite the generally positive outlook though, substantial underpricing of energy products is continuing to build large financial imbalances, which are posing a growing threat to both fiscal and monetary stability. Other risks include political uncertainty that could disrupt the economy in the lead-up to general elections in January 2007.

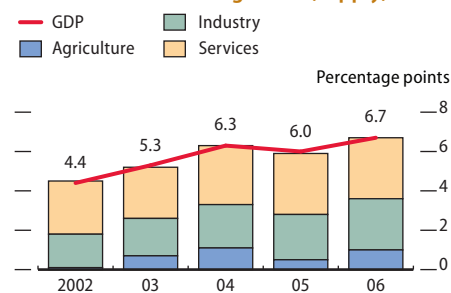
Updated assessment

Recently released data estimate GDP growth in FY2006 at 6.7%, up from 6.0% in the previous year (Figure 2.1.1). Following a flood-induced setback in FY2005, agriculture rebounded sharply with growth estimated at 4.5%. (Foodgrain production steadily increased to 27.3 million tons—largely on account of favorable weather.) Lifted by a robust performance in export-oriented manufacturing, expansion in industry is estimated at 9.6%, even though the manufacturing subsector performed somewhat below full potential because of frequent power disruptions. Performance in services also remained robust, with a 6.5% gain in output.

On the expenditure side, private consumption was the main driver of growth (Figure 2.1.2), bolstered by a near 25% surge in workers' remittances from abroad. Investment maintained a positive contribution to growth, while that of net exports of goods and services was slightly negative—though less so than in FY2005, as import growth has subsided. At 25.0% of GDP, investment spending showed a moderate 8.0% advance, mainly reflecting a rise in private investment.

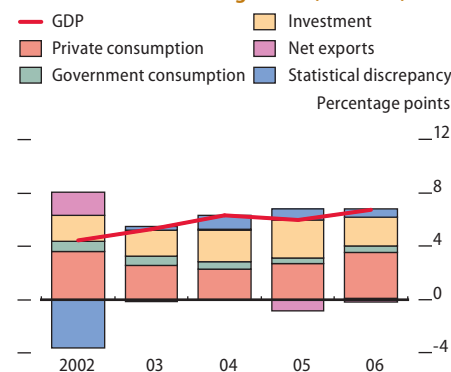
Inflation climbed to 7.2% in FY2006, from 6.5% in FY2005. Rapid growth in the money supply and rising import prices—amplified by a marked depreciation of the taka against the US dollar (of 8.5% in FY2006)—heightened price pressures. Moreover, growing exports of some items, such as fish and vegetables, appear to be nudging up their domestic prices toward international levels. As indicated in Figure 2.1.3, food price inflation has continued to pull up the overall index despite the agricultural recovery, possibly reflecting the uptick in international food prices in the April–June quarter of 2006.

2.1.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, May 2006.

2.1.2 Contributions to growth (demand)



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, May 2006.

Bangladesh Bank adopted a tighter monetary policy stance for FY2006. The broad money growth target under the monetary program was set at 14.3%, and policy interest rates, the cash-reserve requirement, and the statutory liquidity ratio were all revised upward during the year. The yield on 28-day treasury bills moved up moderately from 6.6% in June 2005 to 7.1% in June 2006, while the reverse repo rate rose from 4.5% to 6.0% over the period. Nevertheless, in the fiscal year ended June 2006, expansion in broad money (19.5%) and domestic credit (20.2%) remained high (Figure 2.1.4), and well above both Bangladesh Bank's program targets for FY2006 and actual growth rates in FY2005. The growth of credit was much faster to the public sector than to the private sector.

The FY2006 fiscal deficit, estimated at 3.9% of GDP, was lower than the budget target of 4.5%, and stemmed from underperformance in development spending. In line with key fiscal objectives, domestic financing was limited to 2.0% of GDP and total government revenue rose by 0.5 percentage points to 10.8% of GDP. Total expenditure increased by 1 percentage point to 14.7% of GDP. The development spending component edged up marginally to 5.2% of GDP, mirroring delays in project starts and continued slow implementation of projects already under way.

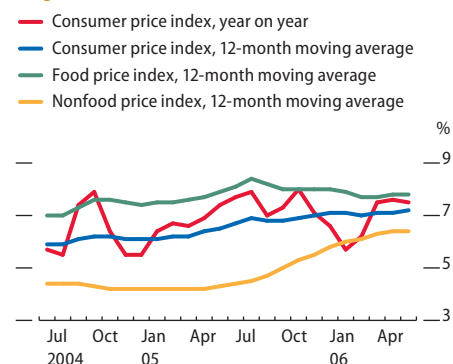
In FY2006, marked increases in export earnings and in workers' remittances (Figure 2.1.5), as well as lower growth in imports (at 12.1%), strengthened the current account position. Concerns about the impact on the economy of the elimination of textile and clothing quotas at end-2004 have not been borne out. Outperforming many competing countries, the industry's exports (about 75% of total exports) continued to expand rapidly. A steep depreciation in the nominal exchange rate (Figure 2.1.6) worked to maintain export competitiveness. Other exports also did well.

Despite a 25% steady increase in oil imports, reflecting primarily higher prices, overall import growth slowed, mainly because of credit restrictions for non-oil imports. Accordingly, the FY2006 current account is estimated to have recorded a surplus of 0.9% of GDP, moving from a 0.9% deficit in FY2005. The improvement in the current account brought gross international reserves to \$3.5 billion at end-FY2006, up by \$0.6 billion for the year (Figure 2.1.7).

The Government's policy of limiting domestic price increases for petroleum products (Figure 2.1.8) has substantially weakened the financial position of state-owned Bangladesh Petroleum Corporation (BPC) as well as the nationalized commercial banks (NCBs). This is because the resulting subsidies have been financed entirely by bank credit rather than paid for by budget allocations. Effective 9 June 2006, domestic prices for diesel and kerosene, which account for three quarters of domestic consumption of fuel, were increased by 10% to Tk33 per liter (or about two thirds of prevailing international prices). At the same time, prices were raised by about 30% for high octane and regular gasoline (to Tk58 and Tk56 per liter, respectively), but these items account for only about one tenth of petroleum consumption. Even though these first price increases since September 2005 were expected to generate additional revenue of around \$210 million annually, they were seen as reducing the likely implicit subsidy for FY2007 by no more than one fifth.

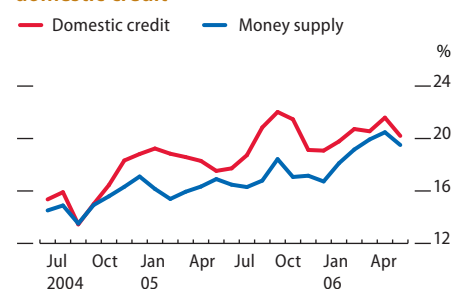
Because of its straitened financial situation, BPC experienced

2.1.3 Inflation



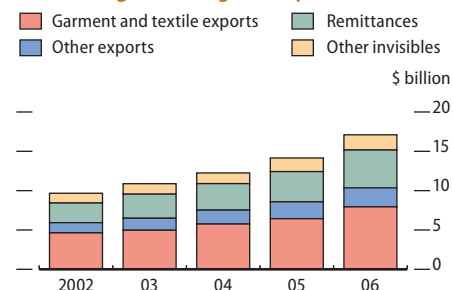
Sources: Bangladesh Bureau of Statistics; Bangladesh Bank, *Economic Trends and Major Economic Indicators: Monthly Update*, July 2006, available: <http://www.bangladesh-bank.org>, both downloaded 31 July 2006.

2.1.4 Growth in money supply and domestic credit



Sources: Bangladesh Bank; CEIC Data Company Ltd., downloaded 1 August 2006.

2.1.5 Foreign exchange receipts



Sources: Bangladesh Bank, *Annual Report 2004/2005 and Major Economic Indicators: Monthly Update*, July 2006, available: <http://www.bangladesh-bank.org>, both downloaded 31 July 2006.

problems in financing and importing petroleum products in FY2006, though the Government assisted it by providing sovereign guarantees against its borrowing from NCBs. In late FY2006, the authorities settled Tk10 billion of BPC credit at the Sonali Bank (the largest NCB) with a 3-year bond to ease that bank's liquidity crunch. BPC's liability to the four NCBs at end-FY2006 was estimated at Tk105 billion (about \$1.5 billion), or 2.4% of GDP.

Heavily subsidized petroleum prices pose considerable risks to fiscal sustainability. BPC's accumulated losses constitute a quasi-fiscal obligation, with which the Government will eventually have to deal. On the basis of BPC's mid-June cost and selling prices, the implicit subsidy per liter of fuel was \$0.24 for diesel and \$0.23 for kerosene. This translates into an annual implicit subsidy for these two fuels of \$810 million in FY2007 (about 1.3% of GDP), which will apparently be added to BPC's large existing obligations to NCBs.

While the Government has indicated that a further round of fuel price increases in FY2007 is possible, it clearly needs to adopt a new pricing system that will regularly set retail prices closer to international levels. A new system (which could include a budget-supported safety net for the very poor) is evidently needed to avoid the further accumulation of unsustainable debt that has resulted from nonmarket pricing. Then, as a next step, the Government could relieve the present stress in the financial system by cleaning up the BPC and NCB balance sheets through budgetary allocations to help these institutions return to normal commercial operations.

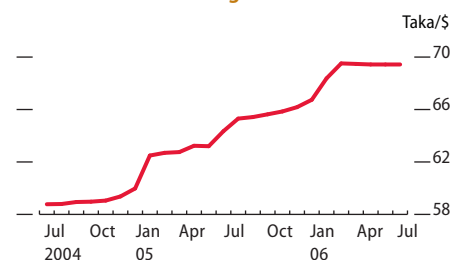
Good progress was made in financial sector reform, particularly in the banking sector, in terms of improving regulatory oversight and in tightening provisioning standards. The banking system's gross nonperforming loan ratio declined from 17.5% in the first quarter of 2005 to 15.4% a year later. However, the ratio for NCBs increased by about 1 percentage point to 27.1%, mainly due to the inability of BPC to fully service its large debts. Privatization of the Rupali Bank continued, and the process is likely to be completed in the next few months.

Prospects

The key baseline assumption for the FY2007 growth forecast is that any political instability before the general elections in January 2007 will not significantly affect economic activity. GDP growth is forecast to moderate to 6.0% in FY2007 (as in the *ADO 2006* projection), mainly due to a reversion to more normal growth in agriculture following the post-flood high-growth recovery of FY2006. Conditions for expansion in industry (aided by new capacity in garments and textiles, chemicals, and engineering) as well as in services are expected to be favorable, though the frequent power disruptions need to be addressed. The two main challenges facing the thriving garment industry are social compliance issues (as epitomized in recent labor unrest over wages) that are a concern to many international buyers, and progress in relieving infrastructure constraints.

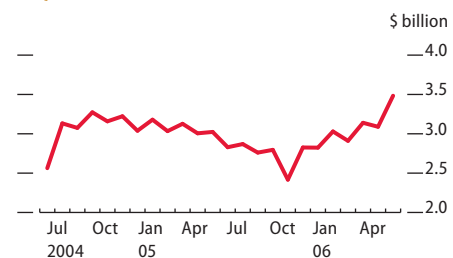
For FY2007, this *Update* raises the average inflation forecast from 6.0% to 7.0%. This rate is the target ceiling in Bangladesh Bank's monetary program for the year. While the Bank has indicated that it

2.1.6 Nominal exchange rate



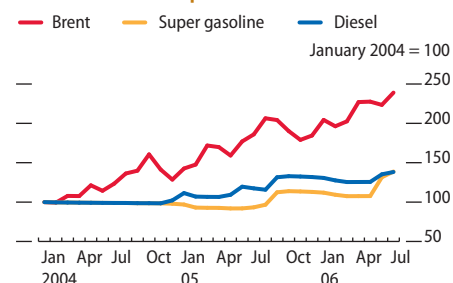
Source: Datastream, downloaded 3 August 2006.

2.1.7 Gross international reserves



Source: CEIC Data Company Ltd., downloaded 1 August 2006.

2.1.8 Oil and fuel price indexes



Note: Super gasoline and diesel prices have been converted to US dollars prior to indexing.

Sources: Bangladesh Petroleum Corporation; Datastream, downloaded 7 August 2006.

will maintain its tightening bias, the elections suggest that a broadly accommodative stance will continue and, with the legacy of large rises in monetary aggregates in FY2006, only a slight moderation in inflation is expected during the year. Apart from international price rises, inflationary pressures include likely further upward adjustments to domestic oil prices, though these may well come only after the January elections and expected further depreciation of the taka.

Growth in imports in FY2007 is projected at about 12%, the same as in the preceding year. The restrictive monetary policy may well contain growth in non-oil imports, though the oil import bill is likely to rise, reflecting further increases in international oil prices. Exports in FY2007 are set to remain buoyant with 18% growth, aided by continued robust performance in garments. The projected decline in the trade deficit, reinforced by strong growth in workers' remittances, is expected to generate a small surplus on the current account, equivalent to 0.3% of GDP.

As discussed in *ADO 2006*, Bangladesh faces several downside risks to its medium-term prospects. These include infrastructure constraints, underpricing of energy products, and the longer-term competitiveness of the garment and textile industry. Possible political disruption affecting the economy prior to the general elections in early 2007 is also a concern, given the country's record of confrontational politics.

2.1.1 Selected economic indicators, %

| | 2006 | | 2007 | |
|--------------------------------------|--------------------|---------------|--------------------|---------------|
| | <i>ADO</i> 2006 | <i>Update</i> | <i>ADO</i> 2006 | <i>Update</i> |
| GDP growth | 6.5 | 6.7 | 6.0 | 6.0 |
| Inflation | 7.5 | 7.2 | 6.0 | 7.0 |
| Current acct. bal. (share of GDP) | -0.8 | 0.9 | -1.0 | 0.3 |

Sources: Bangladesh Bureau of Statistics; staff estimates.