

COUNTRY ECONOMIC REVIEW

BANGLADESH

December 2000

CURRENCY EQUIVALENTS

(11 December 2000)

Currency Unit	–	Taka (Tk)
\$1.00	=	Tk54.00
Tk1.00	=	\$0.0185

ABBREVIATIONS

ADB	–	Asian Development Bank
ADP	–	Annual Development Program
BPDB	–	Bangladesh Power Development Board
DESA	–	Dhaka Electric Supply Authority
GDP	–	gross domestic product
MW	–	megawatt
NCB	–	nationalized commercial bank
NPL	–	non performing loan
REB	–	Rural Electrification Board
RPC	–	Rural Power Company
SOE	–	state owned enterprises

NOTES

- (i) The fiscal year (FY) of the Government ends on 30 June.
- (ii) In this report, "\$" refers to US dollars.

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EXECUTIVE SUMMARY

Bangladesh achieved good economic progress during the 1990s by adopting a series of structural and economic reform measures. Economic performance improved with gross domestic product (GDP) growth averaging 5 percent in the 1990s compared with 4 percent in the preceding decade. The acceleration in economic growth was accompanied by decreased incidence of poverty and a distinct improvement of some key social indicators. Rapid growth in foodgrain production has been a remarkable feature of the country's economic performance in recent years. The last four years have witnessed consecutive record production of foodgrains. And in FY2000, Bangladesh reached self-sufficiency in foodgrain production. A combination of factors accounts for the robust growth of the agriculture sector, and in particular of foodgrains. Apart from favorable weather conditions, the output of foodgrains was boosted by an adequate supply of key agricultural inputs—fertilizer, diesel, and seeds—at stable prices. Increased investment in agriculture research and extension was also instrumental in raising foodgrain production by stimulating more extensive use of high-yielding varieties, modern technologies, and better inputs. In addition, the Government removed the restriction on the import of irrigation pumps, and trade in agriculture inputs was liberalized with the elimination of import duties on irrigation equipment, power tillers, and other agricultural equipment. During the five years preceding FY1999, the industry sector¹ grew by about 8 percent per annum. Partly due to the impact of the floods, the industrial growth rate decelerated to 4.9 percent in FY1999 but improved somewhat to 5.6 percent in FY2000. The recent slowdown in the performance of the sector is mainly attributed to the sluggishness of manufacturing due to growing infrastructure constraints (power, transportation, and telecommunications), high cost of doing business (high real interest rates and transaction costs), political uncertainty, scarcity of long-term credit, and loss of competitiveness.

Since the mid-1990s, saving and investment rates have improved noticeably. National saving increased from 16.7 percent of GDP in FY1995 to 20.8 percent in FY1999 and to 21.4 percent in FY2000. Remittances of out-of-country workers, which have averaged around 3-4 percent per annum of GDP, have been an important contributory factor in raising the level of national saving. Gross investment rose from 19.1 percent of GDP in FY1995 to 22.2 percent in FY1999, and then marginally to 22.4 percent in FY2000. Over this period, investment surged mainly due to increased private investment; public investment as a proportion of GDP has remained around 6-7 percent. The saving and investment rates are low in comparison with countries with a comparable per capita income. With concessional assistance becoming increasingly scarce, and the limited capacity of the country to tap commercial sources of external finance, Bangladesh has little option but to step up the rate of domestic savings. To raise the level of domestic saving and allocate it to the most productive uses, the country needs to implement comprehensive financial sector reforms.

Prudent fiscal management recently emerged as a major challenge for the country. The Government's revenue mobilization efforts improved notably in the early 1990s following the launch of some key fiscal reforms, particularly introduction of the value-added tax in 1991. The new tax regime provided greater coverage and increased rates compared with the taxes that it replaced (mainly excise duty). The tax revenue-GDP ratio increased from 5.9 percent in FY1991 to 7.3 percent in FY1993, but since then, the ratio has remained constant in the range of 7 percent. Despite disappointing revenue collection efforts, for much of the 1990s, the Government was able to maintain the fiscal deficit within 45 percent of GDP by keeping expenditure under control. Over the last three years, Government expenditure, both current and

¹ The industry sector comprises mining and quarrying, manufacturing, power, gas, water, and construction.

capital, has been increasing rapidly. As a consequence, the fiscal deficit has risen to unsustainable levels. With declining recourse to foreign financing of the deficit, the Government has been forced to finance the deficit from domestic sources—banking and domestic borrowings. The resulting monetary accommodation has seriously strained macroeconomic stability.

Despite initiating some significant policy reforms over recent years, Bangladesh's financial sector continues to be shallow and underdeveloped. While banking has expanded at a reasonable rate during recent years, a robust and efficient banking system has yet to be established. Inadequate legal framework, poor governance, and limited capacity of the central bank to effectively undertake its regulatory and supervisory role are some of the major underlying factors. The capital market is also at a nascent stage, although good progress has been made to improve the efficiency of the market. A well-developed, long-term savings market has yet to emerge. In the 1990s, Bangladesh made significant progress in liberalizing foreign trade. Quantitative restrictions were gradually removed and the maximum and average tariff rate were reduced. However, the pace of trade liberalization has slowed over recent years. No significant trade policy reforms were announced in the FY2001 budget. Export diversification remains a major challenge for the Government. The situation is serious because the Multifibre Agreement, which shields Bangladesh's export of garments and apparel from external competition in the quota markets, is due to end in early 2005.

The current account deficit of the balance of payments in FY2000 declined to \$442 million (1 percent of GDP) from \$653 million (1.4 percent of GDP) in the preceding year. Despite an improvement in the current account, the overall balance of payments position remained fragile, and the level of foreign exchange reserves was a mere \$1.6 billion (2.3 months equivalent of imports) at the end of FY2000. The main reason for the weakness in the balance of payments is the large negative entry under the category—errors and omissions: negative \$632 million in FY1998, negative \$594 million in FY1999, and negative \$719 million in FY2000. These negative entries in the balance of payments partly reflect lags between shipment of exports and receipt of foreign exchange. A part of it could also be due to inaccurate recording of some categories in the balance of payments. There is also a possibility that a sizable amount of foreign exchange earnings is being retained out of the country. This is tantamount to capital flight, and is probably happening because of emerging uncertainty about domestic economic management.

Bangladesh's short-term economic prospects remain somewhat uncertain because of the forthcoming general elections. Much depends on if the Government adopts a prudent policy stance and addresses the emerging strains on macroeconomic stability. Assuming that the Government is able to address the macroeconomic problems, and to the extent feasible in an election year, attempts to tackle some of the key sector policy constraints, the economy could grow at about 5.5-6.0 percent in FY2001. Over the medium term, i.e., in FY2002 and FY2003, growth prospects for the economy should improve after the general elections. The Government is expected to adopt a more prudent fiscal stance, and make considerable progress in pushing ahead with sectoral reforms. The Government is likely to favorably resolve the issue of gas export, which will have a positive impact on the balance of payments in subsequent years. With renewed emphasis on policy reforms, economic growth is likely to increase, and could average 6 to 6.5 percent over the medium term.

I. RECENT ECONOMIC DEVELOPMENTS

A. Growth, Employment, Savings, and Investment

1. Aggregate Growth

1. Bangladesh achieved good economic progress during the 1990s by adopting a series of structural and economic reform measures. As a result of these initial reforms, the economy's performance improved with gross domestic product (GDP) growth averaging 5 percent in the 1990s compared with 4 percent in the preceding decade. Acceleration of economic growth was accompanied by decreased incidence of poverty and a distinct improvement in some key social indicators. The agriculture sector grew rapidly in the latter half of the 1990s, and the country attained near self-sufficiency in food production. Manufacturing also showed considerable dynamism for much of the 1990s, and the saving and investment rates of the economy have recorded considerable improvement. Simultaneously, with the opening up of the energy and infrastructure to the private sector, the inflow of foreign direct investment has increased. The Government also made progress in reforming fiscal, monetary, and exchange rate management, and reforms were initiated for trade and sector-specific policies. For much of the 1990s, fiscal and current account deficits were contained within prudent limits, with single-digit inflation rates. However, in recent years macroeconomic management has deteriorated due to growing fiscal deficits accommodated by an expansionary monetary policy. The statistical appendix provides detailed macroeconomic indices.

2. In FY1999, Bangladesh suffered devastating floods, which slowed economic growth. Although the summer crops suffered a major setback, agriculture production recovered later in the year with an unusually large winter crop, assisted by the Government-supported rehabilitation program. However, growth of manufacturing slowed considerably due to flood-induced damage and dislocation, and loss of competitiveness. GDP growth during FY1999 was 4.9 percent, slightly lower compared with 5.2 percent in FY1998, but substantially higher than the postflood estimate of 3.3 percent. The economy experienced higher inflation, deterioration in the current account of the balance of payments, and an increase in the fiscal deficit. The economy recovered in FY2000 with a GDP growth rate of 5.5 percent, improved external balance, and reduced inflation rate due mainly to successive record crop harvests. However, manufacturing has not regained the dynamism of the early 1990s. The pattern of agriculture-led growth observed in recent years points to a potential source of vulnerability due to the dependence of the sector on weather.

Table 1: Economic Growth by Sector

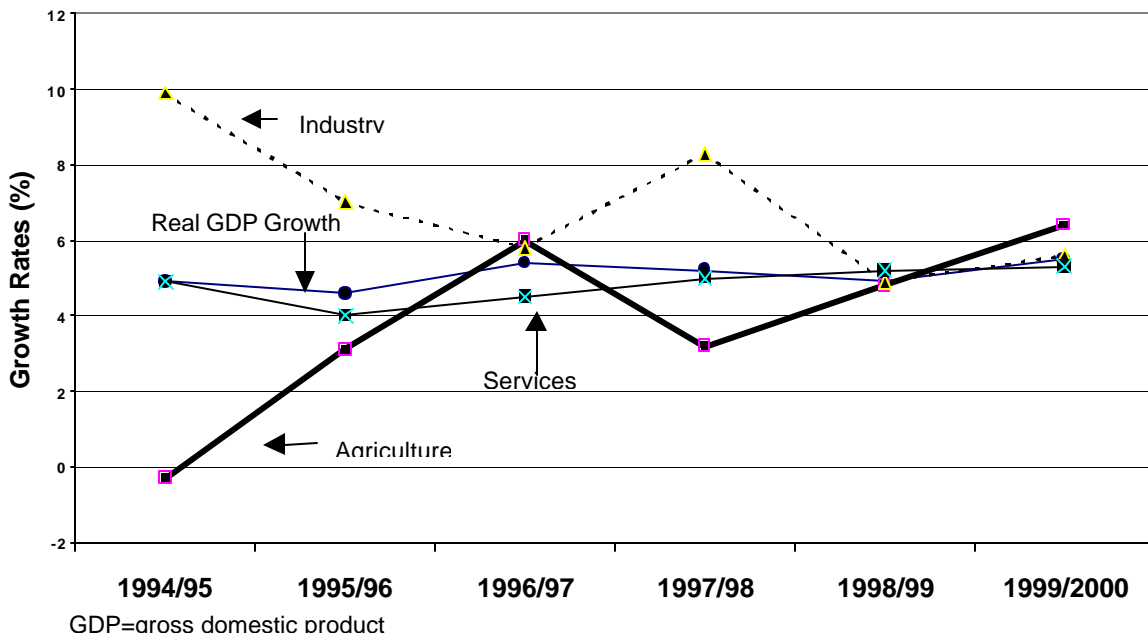
Growth Rates (%)	1994/95	1995/96	1996/97	1997/98	1998/99	1999/2000 ^P
Real GDP Growth	4.9	4.6	5.4	5.2	4.9	5.5
Agriculture	(0.3)	3.1	6.0	3.2	4.8	6.4
Industry	9.9	7.0	5.8	8.3	4.9	5.6
Services	4.9	4.0	4.5	5.0	5.2	5.3

GDP = gross domestic product.

^PProvisional

Source: Bangladesh Bureau of Statistics.

Figure 1: Sectoral Growth



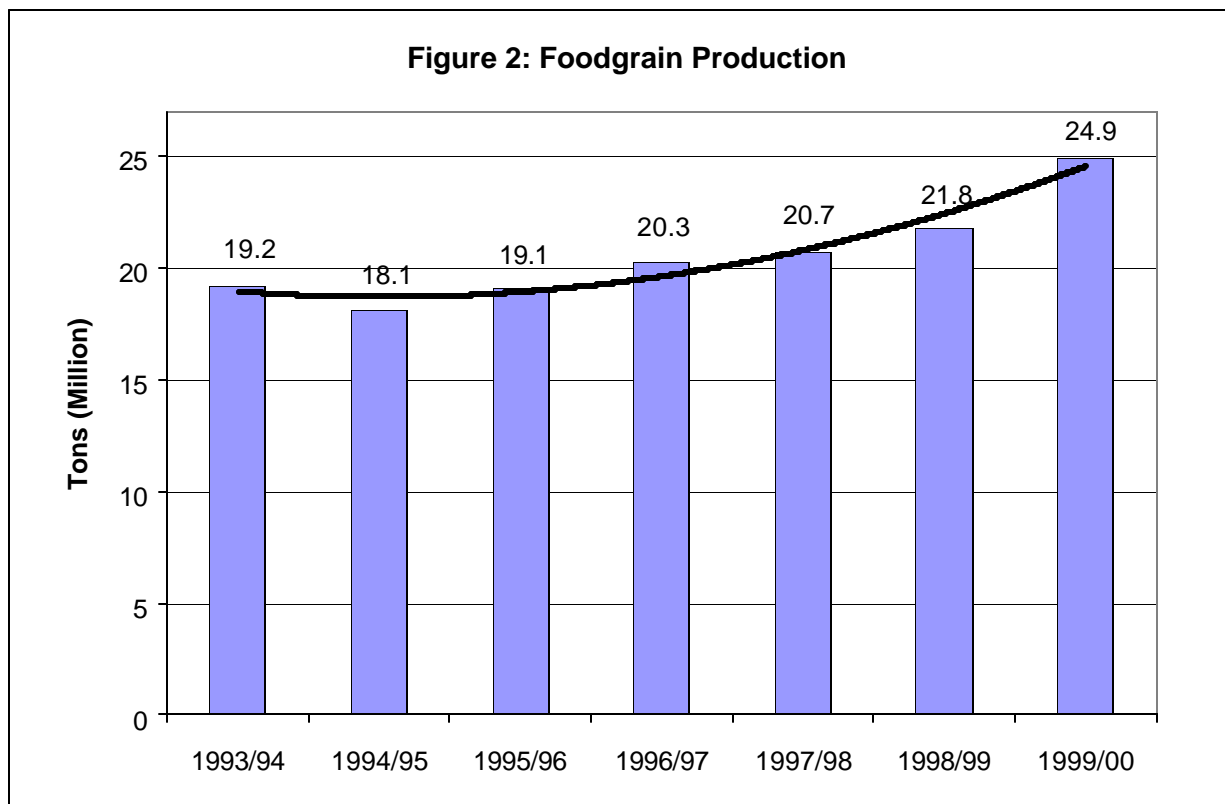
2. Sectoral Growth

3. Rapid growth in foodgrain production has been a remarkable feature of the country's economic performance in recent years. The last four years have witnessed consecutive record production of foodgrains. During FY2000, foodgrain production was estimated at 24.9 million tons compared with 21.8 million tons in FY1999, representing a growth of 14.2 percent. Both the summer and winter crops were unusually large; aman and boro crops increased respectively by 33 percent to 10.31 million tons and 4.5 percent to 11.03 million tons over the preceding year. During FY2000, Bangladesh reached self-sufficiency in foodgrain production; in fact, foodgrain production was estimated to be about 1 million tons in excess of requirements¹. As a consequence of consecutive higher than average harvests, the price of coarse rice declined by 14 percent in the open market. Declining food prices particularly benefited the poor, as 70 percent of rural households in the country are net purchasers of rice. For the agriculture sector as a whole, value added increased by 6.4 percent in FY2000 compared with 4.8 percent in the previous year. Sector growth was due mainly to the crop subsector (accounting for about 60 percent of agriculture output), which grew by over 6 percent. Fisheries also experienced robust growth of 9.5 percent. Growth in animal farming and forestry remained modest, although liberalization of policies for import of feeds, feed ingredients, medicines, cattle, and chicks has created better opportunities for the private sector to develop the livestock subsector. Over recent years, the private sector and nongovernment organizations have contributed to the development of minidairies and poultry farms.

¹ During FY2000, net foodgrain production was 22.41 million tons (after deducting 10 percent for seeds and losses from the gross production of 24.9 million tons). The foodgrain requirement was 21.42 million tons (on the basis of average daily per capita foodgrain requirement of 455 gram). These estimates indicate excess production of about 1 million tons over requirement. (Sources Bangladesh Bureau of Statistics and World Food Program).

4. A combination of factors accounted for the robust growth of the agriculture sector, and in particular of foodgrains. Apart from favorable weather conditions, foodgrain output was boosted by the adequate supply of key agricultural inputs—fertilizer, diesel, fuel and seeds—at stable prices. Good procurement support from the Government and improved delivery of agriculture credit were also contributory factors. Over the last five years, agricultural credit is estimated to have grown at an annual rate of 15 percent, and the Government has progressively raised the procurement prices for major crops. Increased investments in agriculture research and extension were also instrumental in raising foodgrain production by increasing the use of high-yielding varieties, modern technology, and better inputs. In addition, the Government removed the restriction on the import of irrigation pumps, and trade in agriculture inputs was liberalized with the elimination of import duties on irrigation equipment, power tillers, and other agricultural equipment.

5. In 1999, the Government approved the National Agriculture Policy, the main thrust of which is to make the nation self-sufficient in foodgrain production and provide a dependable food security system. In addition, a legal basis was created for an efficient and effective agriculture research system. In other subsectors, the National Fisheries Policy was adopted, and to encourage private investment, fisheries, fish, and shrimp cultures were declared as industry. The Government has undertaken programs for sustainable development and management of forest resources in the country with assistance of the Asian Development Bank (ADB).



BOX 1: Power Subsector Reforms

With annual per capita electricity consumption of 71 kilowatt-hour, Bangladesh is one of the lowest electricity-consuming countries in the developing world. Despite intensive efforts to increase coverage, only about 18 percent of the population has access to electricity. The Bangladesh Power Development Board (BPDB) and the Dhaka Electric Supply Authority (DESA) are unable to maintain smooth functioning of power generating plants, and efficient transmission and distribution systems. Of the current installed capacity of 3,500 megawatts (MW), only about 2,500 MW, or 71 percent, is available because of capacity constraints and low efficiency of the existing plants. This is considerably lower than the peak demand of around 2,900 MW. During 1999, the country suffered widespread energy rationing ranging from 16 to 774 MW on a daily basis for 335 days of the year. The total duration of rationing in the year was estimated at 1,690 hours, which seriously affected the growth potential of the economy.

Weak institutional capability of public sector entities, namely, BPDB and DESA, result in high system losses and accounts receivable. Although the situation has improved, the distribution losses of BPDB and DESA are still unacceptably high, at around 30 percent. On the other hand, the Pally Biddut Samities (PBSs), under the Rural Electrification Board (REB), which have a collection performance of over 95 percent and distribution loss contained within 16 percent, can be considered as the only efficiently performing entities in the sector. With demand anticipated to grow by about 8 percent per annum, the Government estimated additional investment requirements of \$6 billion for power, including \$4 billion for new power generation plants, over 1997-2005. Investments of this magnitude are clearly beyond the Government's capacity. The only viable option is to attract domestic and foreign private investment. For this to materialize, a comprehensive reform package must be implemented—which the Government has been slow to adopt.

Despite the slower than expected pace of reforms, some positive signs of improvement have been observed in recent years. The development partners, who in 1991 suspended assistance to power because of poor performance, resumed assistance in support of the Government's reform initiatives through technical assistance for planning and institutional strengthening, as well as capital for system expansion, in line with the principle of reform-linked assistance. The Government outlined the reform process to gradually remove constraints by improving corporate governance, introducing competition, and facilitating public-private partnerships. The reform agenda focuses on (i) a separation of power regulation and operation; (ii) autonomy and commercial orientation of the power entities; (iii) unbundling of generation, transmission, and distribution; and (iv) increased private sector participation. While the transmission segment is expected to remain in the public sector, generation and distribution assets would have both public and private ownership.

Following the Government's agreement to allow private sector participation in generation in 1994, the Asian Development Bank (ADB) provided technical assistance to prepare and finance the 450 MW Meghnaghat power project. Further, ADB extended a loan for a 70 MW power plant to be constructed by the Rural Power Company (RPC), a corporate entity created by REB. RPC successfully constructed a 70 MW power plant, and is now constructing an additional 70 MW plant on the same site by mobilizing domestic resources. The World Bank has helped the Government solicit another 360 MW power plant at Haripur. So far, the Government has signed six independent power producer (IPP) contracts inclusive of RPC and is negotiating two more projects. The United States Agency for International Development helped REB solicit small-scale (10 MW) power plants for the internal use of the Pally Biddut Samities. REB has signed contracts for three 10 MW plants and solicited for another eight plants, which are now being negotiated. The Government, on its own, has implemented three barge-mounted power plants (340 MW) on a fast track basis through IPPs. At present, IPPs account for about 10 percent of total generation, but are expected to reach 40-50 percent by 2003—a remarkably rapid shift of power production from the Government to the private sector.

The Government has implemented several ADB-assisted reforms for power. As a step towards vertical disintegration of BPDB, the Government incorporated the Power Grid Company of Bangladesh (PGCB) in 1996, which has since commenced operation with the construction of transmission lines and associated facilities that are required for transmitting the power generated from the Meghnaghat Power Station. For distribution, the Government incorporated the Dhaka Electric Supply Company Limited in 1997. Although the new company is owned by DESA, it will gradually take over the entire operations of DESA. The Government has also redefined the boundary of DESA by amending the DESA Act 1990; DESA has already handed over all areas outside its redefined boundary to REB. BPDB, meanwhile, has handed over the transmission lines and substations, linked with PGCB's construction activities, for operation and maintenance by PGCB. Remaining transmission assets will be handed over by December 2002.

The Government established the Power Cell to facilitate the implementation of reforms. At present, the Power Cell acts as a quasiregulator, and is now framing rules and regulations for the proposed regulatory body with assistance from consultants. The Cabinet approved the Electricity Reform Bill in 1999, which defines the restructured power subsector and provides for the creation of a regulatory body. The Government introduced a semiannual tariff adjustment formula to compensate the power entities for increase in the gas price and devaluation of taka as an interim arrangement, until a rationalized tariff structure is introduced. The arrangement is working satisfactorily.

6. During the five years preceding FY1999, industry sector growth² averaged about 8 percent per annum. Partly due to the impact of the floods, the industrial growth rate decelerated to 4.9 percent in FY1999, but improved somewhat to 5.6 percent in FY2000. The recent slowdown in the performance of the sector is mainly attributed to the sluggishness of the manufacturing sub-sector. Manufacturing seems to have lost the dynamism that was witnessed in the first eight years of the 1990s, when it grew at an average annual rate of 7.6 percent. Manufacturing growth declined sharply to 3.2 percent in FY1999, and then improved marginally to 4.3 percent in FY2000. While the deceleration in the growth rate in FY1999 can be attributed to dislocation caused by the floods, the prolonged sluggishness in manufacturing is a cause for concern, especially since it is dominantly export oriented and labor intensive. The continuing sluggishness is attributed to growing infrastructure constraints (power, transportation, and telecommunications), high cost of doing business (high real interest rates and transaction costs), political uncertainty, scarcity of long-term credit, and loss of competitiveness. Slow decision making, and half-hearted implementation of well-intentioned policy pronouncements have deterred both local and foreign investors.

7. On the policy front, the Government has liberalized the investment regime for the private sector. A new industrial policy was announced in 1999 reaffirming the Government's commitment to creating an enabling environment for industrial expansion based on private sector participation, including foreign investors. The new policy places considerable importance on stimulating competitiveness, both in internal and external markets. The diversification of the manufacturing base, which is overwhelmingly dominated by textiles, chemicals, and food processing, remains a major challenge. The Government has created the Equity Development Fund for the development of three potential sectors: software, agroprocessing, and food processing. Although the information and communications technology sector has promising potential, the country is as yet ill-equipped to face intense global competition. Long-term development of the industry sector is critically dependent on being able to address the infrastructure constraints, create a stable macroeconomic environment, develop efficient markets for alternative sources of capital for investment (both debt and equity), hasten the pace of sectoral reforms, and instill transparency in the decision-making process.

8. The outputs of electricity and gas increased rapidly during FY2000, recording growth rates of 6.4 percent and 4.0 percent over the previous year. However, the increase in electricity production was inadequate, and scarcity of power adversely affected the performance of other sectors. From 1996 to 2000, the country installed an additional 1256 megawatts (MW) of generating capacity, including 372 MW in the private sector. Despite the installed generation capacity exceeding peak demand, the economy still suffers because of substantial load-shedding³. Some of the older plants need to be replaced, while some existing plants have not had routine maintenance. Hence, the effective availability of supply is considerably below installed capacity. On the generation side, the Government has adopted a private power generation policy. Five contracts for 1,100 MW power generation have been signed with the private sector. The Government has also permitted the Rural Electrification Board to incorporate the Rural Power Company to install a 70 MW power plant for selling power to the national grid. The plant was commissioned in February 2000, and the company is installing another 70 MW plant at the same site, financed by mobilizing domestic resources from the shareholders and borrowing from The Rural Electrification Board. Natural gas accounts for over 70 percent of commercial energy in the country. Prospecting and development through production sharing contracts and external assistance has rapidly increased production capacity. However, the size of the domestic market is limited, resulting in temporary excess supply, combined with substantial foreign exchange payment commitments. Agreements have already been signed with four international oil companies for gas exploration in eight blocks. So far, \$600 million has been

² The industry sector comprises mining and quarrying, manufacturing, power, gas, water, and construction.

³ Load-shedding refers to the rationing of electricity (power).

invested in these blocks. In addition, production sharing contracts are being negotiated with large oil companies for exploration of nine blocks.

9. The construction subsector recorded an impressive growth rate of 8 percent in FY2000 due mainly to the surge in private activity. However, growth was slightly lower than the preceding year when flood-induced rehabilitation works spurred the construction sector's growth to 8.9 percent. The services sector, comprising trade, transport, catering, financial intermediation, public administration, professional services, etc., maintained a growth of 5.3 percent, slightly higher than the previous year. The growth rates of catering and transport services improved notably. The financial sector, as a whole, grew by 5.4 percent, maintaining the same growth rate as the previous year. Banking subsector's growth has leveled off at 3.9 percent during the last two years, while the insurance subsector expanded steadily with double-digit growth due mainly to licensing of several new private companies. The growth in telecommunications improved following its opening up to private investment. The Government is considering legislating a new Telecommunications Act to develop sound telecommunications infrastructure, enhance competition, and improve the quality of services.

3. Employment and Wages

10. Poverty is pervasive in Bangladesh afflicting about 45 percent of the population. Progress in reducing income poverty has been slow—about 1 percent per annum over the last two decades. The country has achieved notable progress over recent years in reducing human poverty with (i) marked improvements in life expectancy, adult literacy, and gross primary school enrollment rates; and (ii) decreases in infant mortality rates, total fertility rates, and dropout rates in primary schools.

11. With about 2 million people entering the labor force annually on top of the large number of existing underemployed, the country faces a formidable task to absorb labor into gainful employment. Relatively low growth of the economy, limited labor absorptive capacity in the agriculture sector, and sluggish performance of the labor-intensive manufacturing sector has accentuated the problem. The only avenue of employment for the growing labor force, which is currently expanding at almost twice the population growth rate, is self employment in the low productive segments of the nonformal sector. Declining population growth has been more than offset by the increased participation rates of women. According to the 1995/96 labor force survey, the unemployment rate in Bangladesh was estimated at only 2.5 percent; this grossly underestimates the unemployment rate and overlooks the large number of underemployed. According to some estimates, the unemployment rate in the country is over 25 percent. Agriculture accounts for 58 percent of employment, industry 16 percent, and services 26 percent. Over 80 percent of the labor force is employed in the nonformal sector. The garments industry, which has absorbed a large proportion of the population entering the labor market, especially females, seems to have become over-saturated. Lack of dynamism in other industries and services poses a major problem in generating productive employment opportunities. A key challenge in the coming years will be to create remunerative employment opportunities for the growing labor force, especially in the informal sector.

12. In terms of labor rights, Bangladesh generally has sound labor laws for protecting workers, providing right of association and collective bargaining. However, due to weak enforcement machinery, the labor laws are not always effectively enforced. As a result, workers in the informal sector face poor working and living conditions. Industrial relations in Bangladesh are confrontational and are a cause of friction and disruption. Politicization of trade unions at the national level compounds the problem. In the absence of collective bargaining in public enterprises, the unions try to influence the Government's wage policy, directly or indirectly. With no link between wages and productivity, centrally fixed wages in the public sector tend to influence private sector wages, eroding the competitiveness of these enterprises. Child labor is prevalent in some industries due to lack of

birth records, widespread unemployment, and a large and unregulated informal sector. A major breakthrough is the resolution of the problem of child labor in the garments subsector. Around 10,000 child workers (below 14 years old) have been withdrawn from the garment industries. Recently, pressures have been mounted to allow trade unions in the country's export processing zones.

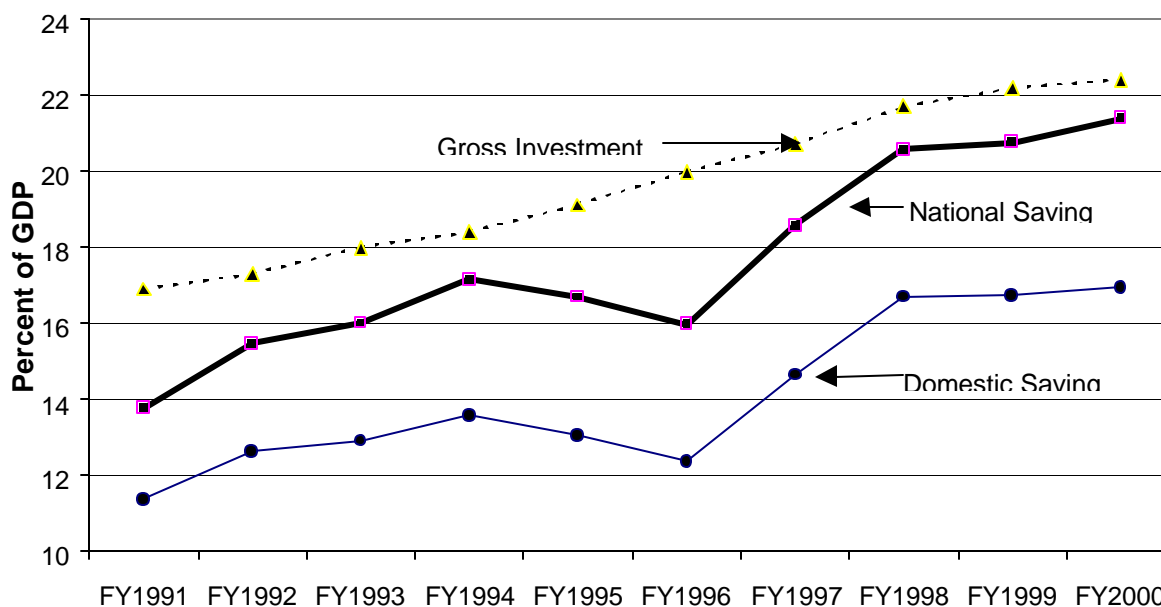
4. Saving and Investment

13. Since the mid-1990s, saving and investment rates have shown notable improvement. National saving increased from 16.7 percent of GDP in FY1995 to 20.8 percent in FY1999, and to 21.4 percent in FY2000. Remittances of out-of-country workers, which have averaged around 3-4 percent per annum of GDP, have been an important contributory factor in raising the level of national saving. Gross investment rose from 19.1 percent of GDP in FY1995 to 22.2 percent in FY1999, and then marginally to 22.4 percent in FY2000. Over this period, investment surged mainly because of increased private investments; public investment as a proportion of GDP has remained around 6-7 percent of GDP. Private investment increased from 12.4 percent of GDP in FY1995, to 15.5 percent in FY1999, and 15.7 percent in FY2000. The saving and investment rates in Bangladesh are low in comparison with countries at a comparable per capita income. With concessional assistance becoming increasingly scarce, and the limited capacity of the country to tap commercial sources of external finance, Bangladesh has little option but to step up the rates of domestic savings. For raising the level of domestic savings and allocating them to the most productive uses, the country needs to implement comprehensive financial sector reforms.

14. The investment to GDP ratio has been sluggish at about 22 percent over the last three years. The worrying feature is that the private investment to GDP ratio has not shown any dynamism. This reflects low investor confidence due to the increasing cost of doing business, infrastructure constraints, deteriorating law and order, and growing political confrontation. The pace of structural reforms, which are critical to stimulate private investment, has also slowed. The problem is accentuated by a serious shortage of term credit because of underdeveloped debt markets. The private sector has also been crowded-out by the Government's attempts to mobilize savings to finance the growing budget deficit by offering high interest rates on different savings instruments; rates range from 15 to 18 percent (on maturity). The banking system has been apprehensive of undertaking additional term credit exposure, given the large portfolio of nonperforming loans (NPLs).

15. Foreign direct investment⁴ has declined over the last three years, from \$249 million in FY1998, to \$198 million in FY1999, and \$194 million in FY2000. Foreign director investment continuities to be largely concentrated on energy; manufacturing and infrastructure, in particular, have not attracted significant inflows. Even though Bangladesh offers attractive incentives to potential investors, and has a relatively liberal policy regime, the overall environment is not particularly conducive for foreign direct investment. The gap between stated policies and their implementation is often considerable. Foreign investors are also deterred by slow decision making, legal complexities, and the cumbersome and centralized bureaucracy. Bangladesh also suffers from lack of information and an image problem. The Board of Investment, and Bangladesh Export Processing Zones Authority, the two leading organizations mandated to provide assistance and necessary facilities to foreign investors, have not been adequately successful in attracting potential foreign investors. Deep-rooted organizational, procedural, and operational problems have severely hampered the promotional activities of these organizations.

⁴ Based on balance of payments data.

Figure 3: Savings and Investment

B. Fiscal Developments

16. Prudent fiscal management recently emerged as a major challenge facing the country. The Government's revenue mobilization efforts improved notably in the early 1990s following the launch of some key fiscal reforms, particularly introduction of the value-added tax (VAT) in 1991. The VAT provided greater coverage and increased rates than the taxes that it replaced (mainly excise duty). The tax revenue to GDP ratio increased from 5.9 percent in FY1991 to 7.3 percent in FY1993, but since then, the ratio has remained constant at about 7 percent. A stagnant tax to GDP ratio reflects lack of progress in widening the tax net and in improving the tax administration system; in short, the efficiency of tax collection remains weak and ineffective. In particular, the Government has failed to broaden the coverage of direct taxes, extend VAT coverage to high-revenue-yielding trades and services, improve the compliance of import taxes, and strengthen tax administration. On the other hand, nontax revenues are comparatively small (a little less than 2 percent of GDP), and they too have stagnated over much of the 1990s. As consequence, since FY1993, the total revenue to GDP ratio has fluctuated around 9 percent, making Bangladesh's revenue collection effort one of the weakest in the world.⁵

17. Despite disappointing revenue collection efforts for much of the 1990s, the Government was able to maintain the fiscal deficit within 4-5 percent of GDP by keeping expenditure under control. Over the last three years, Government expenditure, both current and capital, has increased rapidly. As a consequence, the fiscal deficit has risen to unsustainable levels. With declining recourse to foreign financing of the deficit, the Government has been forced to finance the deficit from domestic sources—from banking sector and domestic borrowing. The resulting monetary accommodation has seriously strained macroeconomic stability.

⁵ In 1999, the revenue to GDP ratio of some comparable countries was: India (15.5 percent), Pakistan (18.9 percent), and Sri Lanka (17.6 percent). Source: ADB 2000 *Asian Development Outlook*. Hongkong: Oxford University Press.

Table 2: Selected Fiscal Indicators
(percent of gross domestic product)

	FY1991	FY1992	FY1993	FY1994	FY1995	FY1996	FY1997	FY1998	FY1999	FY2000 ^a	FY2001 ^b
Total Revenue	7.2	8.3	9.1	9.3	9.3	9.0	9.2	9.3	9.0	8.9	9.2
Tax Revenue	5.9	6.7	7.3	7.1	7.3	7.2	7.4	7.3	7.2	7.1	7.3
Nontax Revenue	1.3	1.6	1.8	2.1	2.0	1.8	1.8	1.9	1.8	1.8	1.9
Total Expenditure	12.7	12.7	13.3	13.8	14.6	13.4	13.5	13.3	13.8	15.0	15.3
Current Expenditure	6.5	6.3	6.7	6.7	6.8	6.8	6.8	7.2	7.6	7.6	7.4
Annual Development Program	4.7	4.8	5.4	6.4	6.6	5.8	6.0	5.6	5.6	6.7	6.5
Overall Budget Deficit	5.4	4.5	4.4	4.5	5.2	4.5	4.3	4.1	4.8	6.1	6.1
Net Foreign Financing	4.7	3.7	4.2	3.7	3.8	2.8	2.8	2.4	2.4	2.8	2.6
Net Domestic Financing	0.7	0.8	0.2	0.8	1.5	1.7	1.5	1.6	2.4	3.3	3.5
Banking System	0.2	(0.2)	(0.8)	(0.4)	0.3	0.9	0.9	0.6	0.9	1.6	1.3
Other Domestic	0.3	0.8	1.0	1.2	1.1	0.8	0.5	0.9	1.5	1.6	2.2

^a Revised estimate.

^b Budget.

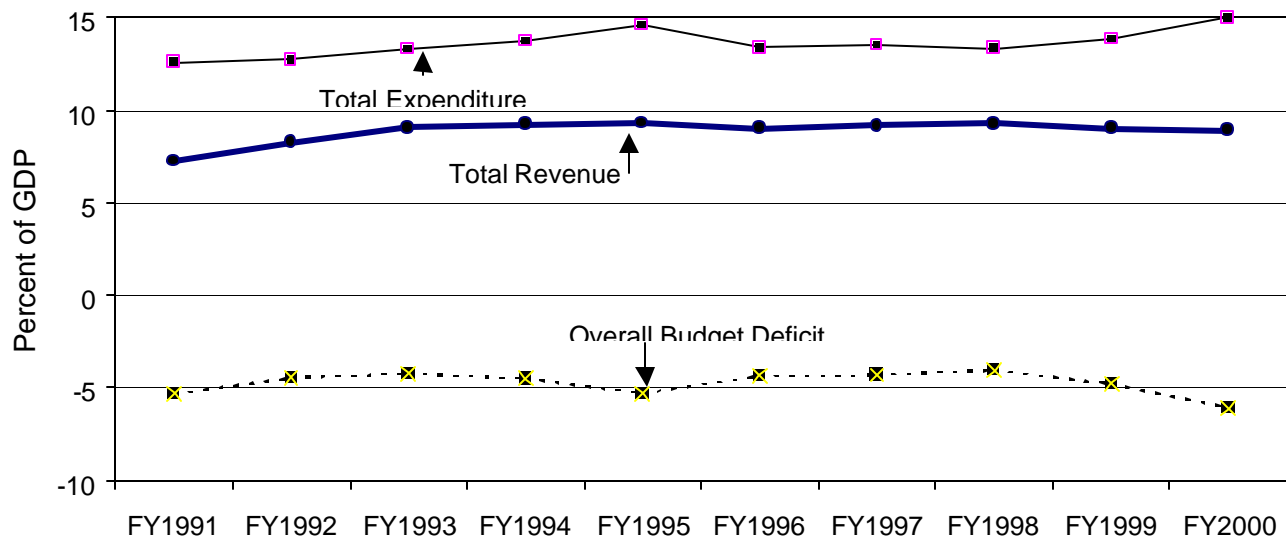
Sources: Ministry of Finance, World Bank, and Bangladesh Bureau of Statistics.

18. Due to the drop of the revenue to GDP ratio to 9 percent in FY1999 from 9.3 percent in FY1998, caused by flood-induced disruptions, the Government attempted to reverse the declining trend and projected a revenue to GDP ratio of 10 percent in the FY2000 budget. Despite setting an ambitious revenue mobilization target, no serious efforts were made to implement key fiscal reforms, rationalize the tax structure, strengthen tax administration, and widen the tax base. Besides, the delay in introducing the preshipment inspection scheme, and sluggish growth in imports also contributed to revenue shortfall. Customs duties collection declined by 10 percent in FY2000 compared with FY1999, and the share of customs duties in National Board of Revenue portion of taxes declined to 28 percent from 32 percent. Nontax revenue collection was also less than projected due mainly to reduced profit and dividend income of state-owned enterprises (SOEs). In FY2000, losses of nonfinancial SOEs were estimated at Tk31 billion, or 1.3 percent of GDP. As a result, actual revenue mobilization in FY2000 turned out to be considerably below budget projections, at 8.9 percent of GDP.

19. Government expenditure increased to 13.8 percent of GDP in FY1999 from 13.3 percent in FY1998, because of a surge in current expenditure resulting from flood-induced spending, especially the need for additional imports of foodgrains and postflood rehabilitation costs. The trend continued in FY2000 with total expenditure increasing to 15 percent of GDP. Although the Government was able to contain current expenditure at 7.6 percent of GDP (the same proportion as in the previous year), expenditure under the annual development program (ADP) rose to 6.7 percent of GDP from 5.6 percent in FY1999. In the FY2001 budget, the Government is aiming to reduce current expenditure to 7.4 percent of GDP. This is an ambitious target in view of the forthcoming general election (scheduled for October 2001) when the pressures on the Government to accommodate increased expenditure is bound to be considerable. In FY2001 current expenditure budget, defense gets the second highest sectoral allocation (16.7 percent), after education (17.0 percent). The allocation for the ADP in the FY2001 budget is 6.5 percent of GDP, 50 percent of which is expected to be financed from domestic resources, and 40 percent of the domestic funding of the ADP will be

from bank borrowing. The decision to finance a higher development budget with substantial borrowing from banks has risks for sustaining macroeconomic stability. While 34 percent of the ADP funds have been allocated to sectors that address poverty directly, about 33 percent have been allocated to infrastructure development comprising energy, transport, and communication. Not all ADP projects can be justified on grounds of accelerating the pace of development; several projects have questionable merit. What is more worrying is that some low-priority projects are being financed by high-cost foreign suppliers' credits. The Government should undertake an objective assessment of ADP projects and identify those with limited development impact. This is particularly important when fiscal austerity is essential for maintaining macroeconomic stability.

Figure 4: Fiscal Situation



20. The FY2001 budget projects current revenue of 9.2 percent of GDP, implying a 0.3 percentage point increase over the achievement of FY2000. This may be difficult to accomplish as the budget has extended substantial income tax and custom duties reduction, including extension of tax holidays for investments. The Government anticipates that the resulting decline in revenue from these sources will be offset by an expansion of the VAT, and selected increases in supplementary duties. The major improvement in revenue collection is expected from tax reforms, strengthened tax administration, increased profits and dividends of state-owned enterprises, growth of imports, and an anticipated increase in the growth of the economy. Some measures such as mandatory pre-shipment inspection, extension of the VAT, and tax administration reforms could give a mild boost to revenue collection, but are likely to be substantially offset by the new exemptions and restructuring of duties. The projected increase in nontax revenue is also ambitious because of continuing weak

21. As a consequence of weak revenue mobilization efforts in conjunction with a surge in expenditure, the budget deficit increased sharply to 6.1 percent of GDP in FY2000 compared with 4.8 percent in FY1999. Including the quasifiscal burden⁶ resulting from SOE losses and nonperforming loans of nationalized commercial banks (NCBs), the consolidated fiscal deficit of the Government is estimated at 7.5 percent of GDP. With constraints on the availability of external

⁶ Represents the fiscal burden not financed directly through the Government budget.

BOX 2: Important Budgetary Measures For FY2001

Income Taxes

A number of changes were introduced by the FY2001 budget for income tax rates to reduce the burden on low-income groups, widen the tax base, check tax evasion, and streamline tax administration. The floor limit for taxable income for individuals has been raised to Tk100,000 from Tk75,000, with minimum and maximum tax rates remaining at 10 percent and 25 percent respectively. The tax holiday facilities for new industrial undertakings, physical infrastructure, and tourist industries have been extended up to 30 June 2002. To induce individuals to declare undisclosed income, the budget has introduced a scheme, whereby up to 30 June 2001, the Government will accept, without question, declaration of previously undisclosed income, subject to payment of 10 percent tax on the amount disclosed. Some other positive measures have been introduced to improve tax administration and enhance efficiency of tax collection.

Incentives for Capital Market Development

A tax rebate of 10 percent of the tax payable will be provided to listed companies that declare dividends of 25 percent or more. The exemption limit on dividend income will be raised from Tk30,000 to Tk40,000. Investments in secondary markets are now eligible for tax credit. An investment allowance is now permitted up to Tk225,000 to replace the limit of Tk200,000 if investment is made in initial public offerings.

Indirect Taxes

The broad structure of import duties has not been changed, with the rates ranging between 5 and 37.5 percent. However, to increase protection to domestic industries, lower rates of customs duty are now applicable for basic raw materials and intermediate inputs, compared with finished goods. This policy has been strengthened with a further reduction of import duties on basic raw materials and intermediate goods, and an increase in the import duties on some finished goods. The budget has also introduced certain environment-friendly measures such as withdrawal of all duties and taxes on double-decker buses using compressed natural gas; exemption of all taxes, except 5 percent custom duties, on buses with 40 or more seats using compressed natural gas; and banning import of three-wheelers with two-stroke engines. Value-added tax (VAT) coverage was extended and some measures introduced to streamline the system and make VAT collection more transparent.

Other Important Proposals

The Government will issue interest-bearing bonds worth Tk18 billion to cover the debt of nationalized commercial banks owed by state-owned enterprises that have been closed down. While this measure will increase the Government's debt burden, it is a significant step to banking reforms. Another noteworthy measure is the establishment of the Tk1 billion Equity Development Fund in Bangladesh Bank to support financially viable software, food processing, and agroprocessing industries.

finance, the Government has been forced to predominantly finance the deficit from domestic sources. Net domestic financing of the deficit increased to 3.3 percent of GDP in FY2000, from 2.4 percent in FY1999, and 1.6 percent in FY1998. What is more significant is that the Government has been increasingly borrowing from the banking system to finance the deficit. This increased sharply to 1.6 percent of GDP in FY2000 from 0.9 percent in FY1999. The FY2001 budget continues the trend of increasing reliance on domestic financing, particularly bank borrowing, to finance the projected budget deficit of 6.1 percent of GDP. The growing domestic debt of the Government has increased the budgetary interest liabilities; the latter accounted for about 15 percent of the Government's revenue expenditure in FY2000. performance of the SOEs.

22. Fiscal management of recent years is unsustainable and needs to be urgently addressed to restore macroeconomic stability. Serious efforts should be made to strengthen revenue mobilization efforts, contain unproductive expenditure, utilize scarce external assistance in the most efficient manner, address the mounting problems of the banking system, and take bold measures to deal with the inefficiencies and losses of the SOEs. In mid-August 2000, the Government made upward adjustments to the administered prices of natural gas (15 percent) and different fuel oils (9 to 20

percent) to reflect changes in international prices. While these measures will, to some extent, help strengthen the Government's fiscal position, the Government needs to do much more to reduce the fiscal deficit to sustainable levels.

C. Monetary Developments and Prices

23. During FY2000 the monetary policy was expansionary, fueled by the rapid growth of Government borrowing from the banking system to finance the budget deficit. Broad money (M2) growth accelerated sharply to 19 percent at the end of FY2000, compared with 13 percent in the corresponding period of FY1999. Government borrowing from the banking system increased by 31 percent, with the Bangladesh Bank accounting for about 50 percent of the credit expansion. The growth of bank credit to the private sector declined to 11 percent from 14 percent in the previous year, due mainly to depressed economic activity and the high cost of borrowing (i.e., high real interest rates). Moreover, the banks have become more cautious when lending to the private sector because of recent strengthening of prudential norms. However, the Government took a number of measures in FY2000 to ease the monetary and credit conditions. These included withdrawing the interest rate band applicable for lending to small and cottage industries and the agriculture sector, lowering the bank rate from 8 percent to 7 percent, and reducing the cash reserve requirement by 1 percentage point to 4 percent.

24. The inflation rate (based on the consumer price index) declined to 3.8 percent in FY2000 from 9 percent in the preceding year. Better availability of food items due to above-average harvests, weak business activity, excess capacity in the manufacturing sector, and delays in adjusting administered prices contributed to the low inflation rate. Inflation of food items declined sharply from 11.8 percent in FY1999 to 4.1 percent in FY2000, and inflation of nonfood items fell from 4.1 percent to 3.3 percent. While inflation was low in FY2000, the lagged impact of the expansionary monetary policy is likely to be felt in the current year. The situation could deteriorate considerably if the main harvests fail because of adverse weather conditions. The country's ability to mitigate the inflationary impact by increasing imports is limited due to low foreign exchange reserves.

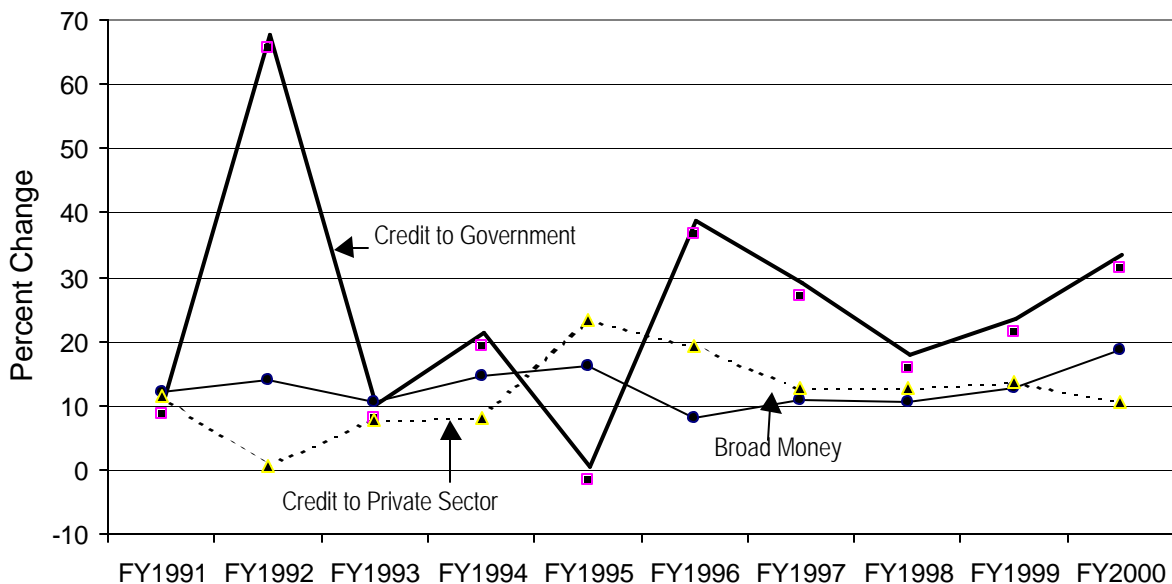
25. Despite initiating some significant policy reforms over recent years, Bangladesh's financial sector continues to be shallow and underdeveloped. While banking has expanded at a reasonable rate during recent years, a robust and efficient banking system has yet to be established. Inadequate legal framework, poor governance, and limited capacity of the central bank to effectively undertake its regulatory and supervisory role are some of the major underlying factors. The capital market is also at a nascent stage, although good progress has been made in improving market efficiency (Box 3). A well-developed long-term savings market has yet to emerge.

26. The financial system, which is dominated by banking, is under distress mainly because of the large NPL portfolio, low recovery rates, high spreads to cover provisioning and management costs, weak institutional capacity of the banking system, and a deficient legal framework. A large number of banks, especially the NCBs, are unable to meet the capital adequacy requirements. As of 30 June 2000, the NPLs of the banks increased to 40 percent compared with 32 percent at the end of 1995. NPLs, as a proportion of the total portfolio, were 44.6 percent for NCBs, 25.8 percent for private commercial banks, 3.7 percent for foreign commercial banks, and 69 percent for public development finance institutions. More importantly, a staggering 88 percent of NPLs were classified as bad/loss loans. Only the private and foreign commercial banks have been able to reduce their NPLs during recent years. The NCBs remain institutionally fragile and are subject to government and political influence. Lending to the loss-making public enterprises through these banks continues. In addition, insider lending has affected the portfolios of several private banks. The central bank is also

institutionally weak and the Government has not accorded adequate independence for it to effectively conduct its regulatory and supervisory functions. Lack of expeditious court settlement is another major impediments to recovering overdue bank loans. At present, a backlog of approximately 500,000 cases exists. On an average, up to 15-20 years are required for a case to be resolved. The judiciary is very understaffed.

27. During recent years, the Government has taken steps to address some of the financial sector problems, although progress has been slow. An attempt has been made to strengthen prudential regulations and supervision. The Bankruptcy Law, 1997, was enacted to facilitate the recovery of bad loans. Simultaneously, the Banking Companies Act, 1991 was amended to disqualify defaulting directors from remaining on the boards of the banks. In January 1999, changes were introduced for loan classification and provisioning standards, bringing them closer to international norms. To expedite disposal of default cases, exclusive loan courts and bankruptcy courts have been set up in Dhaka and Chittagong. In the FY2001 budget, the Government decided to issue Tk18 billion of interest-bearing bonds to NCBs for payment of debts of closed, state-owned enterprises. Recently, steps have been taken to regulate insider lending, restricting the size of such loans and making the process more transparent. Some progress has been made in removing the major defaulters from the directorship of the commercial banks. The central bank has so far served notices for the removal of 139 defaulting directors. Of these, 47 have lost their directorships, while 19 have obtained a stay order from the court. The Government is considering amending key banking legislation and policies to improve governance, the legal framework, and institutional capacity of the banking system.

Figure 5: Money and Credit



BOX 3: Capital Market Development

The Asian Development Bank (ADB) has assisted the Bangladesh Government to strengthen and regulate the capital market through a reform package under the policy-based Capital Market Development Program (CMDP) loan approved at the end of 1997. The reform measures were implemented in five main areas to strengthen market regulation and supervision, develop capital market infrastructure, modernize capital market support facilities, increase the supply of securities in the capital market, and develop institutional sources of medium to long-term funds for capital market investment.

The Government has taken major initiatives to address the fundamental weaknesses of the stock market. The Securities and Exchange Commission was strengthened and now enjoys considerable autonomy and can frame its own regulations, without requiring Government approval. The professionalism of market practitioners has been upgraded and the CMDP has infused greater transparency in market transactions. Regulations have been introduced that require higher disclosure and reporting standards of issuers. The antiquated system of trading in the stock exchanges has been replaced by an automated trading system. The Central Depository Company was established to facilitate scriptless trading in corporate stocks. The Government has implemented specific reforms to encourage an increase in supply of securities to the capital market. These include using tax incentives to encourage listing, divesting government equity in 11 companies, and encouraging the development of financial intermediaries to originate and package the securities for eventual resale in the market. Legislation was enacted to open up the possibility of investing a portion of the insurance and private provident and pension funds into the capital market. The CMDP has also encouraged greater private sector participation in merchant banking and mutual fund operations. The Government enacted the Privatization Act 2000, which provides greater flexibility to the Privatization Commission for divestment. Legislation was enacted to unbundle the Investment Corporation of Bangladesh into three separate corporate entities to carry out merchant banking, mutual fund operations, and stock brokerage activities.

The share price indices, which suffered a major crash in 1996, have been rising since the beginning of 2000. Investor confidence seems to be gradually restored. The incentives announced in the FY2001 budget will also provide a boost to the stock market (Box 2). After the automation of the stock exchanges, trading volume rose dramatically in FY1999 to Tk1900 million (\$39.5 million) and, thereafter, adjusted to more normal level of Tk935 million (\$18.6 million) in FY2000. Reflecting the subdued environment of the stock market, the number of listed companies in the Dhaka and the Chittagong stock markets increased from 204 and 131 in FY1998, to 210 and 140 in FY1999, and to 219 and 149 in FY2000. In accordance with the requirements of the CMDP, the number of broker dealers increased in the stock exchanges from 135 to 175 in the Dhaka Stock Exchange, and from 27 to 110 in the Chittagong Stock Exchange over FY1998–FY2000. Despite the depressed stock market, the number of licensed merchant banks increased from 13 to 25.

D. External Trade and Balance of Payments

28. In the 1990s, Bangladesh made significant progress in liberalizing foreign trade. Quantitative restrictions were gradually removed along with reductions of the maximum and average tariff rates. As a consequence, the anti-export bias of the trade regime was significantly reduced. Exports responded strongly and their value increased almost four times over the decade—from \$1.5 billion in FY1990 to \$5.8 billion in FY2000. With trade liberalization, imports also increased (220 percent during the 1990s), and foreign trade as a proportion of GDP almost doubled, over the decade reaching 30 percent in FY2000. The maximum tariff rate dropped from 350 percent to 37.5 percent and the (unweighted) average tariff rate was reduced to 17 percent. While the FY2000 budget reduced the maximum customs duty rate from 40 percent to 37.5 percent, and the number of tax slabs were brought down 6 to 4, the pace of trade liberalization has slowed over recent years. No significant trade policy reforms were announced in the FY2001 budget. One of the factors underlying the slowdown in the pace of reforms is concern over the possible adverse impact of trade liberalization on domestic industries. However, recent studies have shown that trade liberalization has had no significant adverse effects on the economy, and that the gains from export expansion and employment creation far outweigh any negative effects.

29. Exports grew at a healthy average annual rate of about 17 percent from FY1991 to FY1998. Export growth decelerated sharply to 2.9 percent during FY1999, partly due to floods. However, in FY2000, export growth recovered to 8.2 percent. A noteworthy feature is that during the 1990s,

export growth concentrated largely on two products: ready-made garments and hosiery products. The share of these two categories in total exports has increased from about 50 percent in FY1991 to 76 percent in FY2000. Over the last five years, these two commodity groups accounted for virtually all growth in exports. This concentration is a matter of considerable concern, as with the exception of frozen foods, chemical products, and leather, no other commodity groups experienced any growth over the 1990s; if anything, exports of other commodities have declined. Frozen foods, chemical products, and leather (i.e., the commodities that experienced growth in the 1990s) accounted for a mere 11 percent of total exports in FY2000.

30. Export diversification remains a major challenge before the Government. The situation is serious because the Multifibre Agreement, which shields Bangladesh's export of garments and apparel from external competition in the quota markets is due to end in early 2005. Experience of other countries shows that to diversify exports, several complementary policy interventions have to be simultaneously pursued over a sustained period to achieve the desired result. Macroeconomic stability is a necessary prerequisite for sustained export growth. Along with it, a liberal trade regime that gradually eliminates the anti-export bias, and competitive exchange rate management are also critical. Bangladesh should address the anti-export bias soon, as it is currently estimated at about 20 percent. Exchange rate management should be more flexible, as delayed adjustments often cause considerable uncertainty for exporters. Along with appropriate policy, sound institutional development should be simultaneously pursued. To attract domestic and foreign investors to the export markets, the overall decision-making process in the Government needs to be more transparent and predictable. The Government needs to think hard about different options for resolving the severe infrastructure constraints; there are no easy or quick solutions. Prolonged labor problems in the country's major ports severely hamper export growth.

31. In FY2000, import growth was relatively low at 4.8 percent, due mainly to reduced food imports because of the excellent harvest. However, the import of nonfood items increased by 13 percent because of higher imports of petroleum and oil products, chemicals, textiles, and capital goods. Imports by the export processing zones recorded a growth of 34 percent.

32. With the trade deficit remaining virtually the same as FY1999, and strong growth (14 percent) in workers remittances, the current account deficit in FY2000 declined to \$442 million (1 percent of GDP) from \$653 million (1.4 percent of GDP) in FY1999. Despite the improvement in the current account, the overall balance of payments position remained fragile, and the level of foreign exchange reserves was only \$1.6 billion (2.3 months equivalent of imports) at the end of FY2000. The main reason for the weakness in the balance of payments is the large negative entry under the category—errors and omissions: negative \$632 million in FY1998, negative \$594 million in FY1999, and negative \$719 million in FY2000. These negative entries in the balance of payments partly reflect lags between shipment of exports and receipt of foreign exchange. A part could also be due to inaccurate recording of some categories of the balance of payments. But a sizable amount of foreign exchange earnings could be retained out of the country. This is tantamount to capital flight abroad and is probably happening due to emerging uncertainty about domestic economic management. The Government needs to closely examine the underlying reasons and take remedial policy measures.

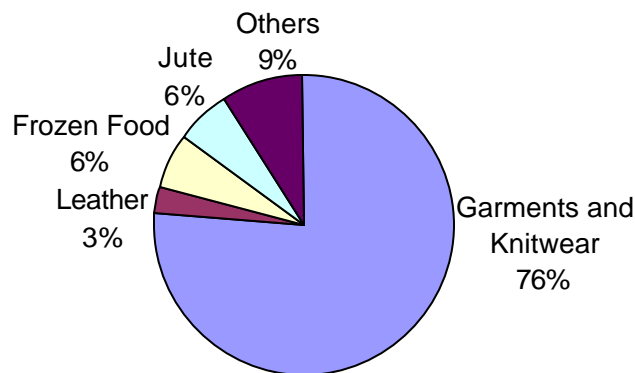
33. The strain on the balance of payments in FY2000 was reflected in a significant premium on foreign exchange traded in the curb market⁷. Based on the International Monetary Fund index, by May 2000, the real effective exchange rate had appreciated by about 10 percent compared with the mid-1997 level, and its impact was beginning to be felt on export performance. The Government devalued the taka by about 6 percent in mid-August 2000. While the devaluation was a step in the

⁷ Unregulated or unofficial market, usually involving exchange of foreign currency.

right direction, it fell short of fully restoring export competitiveness. Despite the devaluation, the premium on foreign exchange in the curb market remains significantly above the official rate. Foreign exchange reserves have fallen further in the first quarter of FY2001, and are currently around \$1.4 billion.

34. Although Bangladesh has received substantial amounts of external assistance, the external debt portfolio has been managed prudently with external debt estimated at 33 percent of GDP, and external debt service ratio of only 7 percent in FY 2000. The external debt of Bangladesh is predominantly public or publicly guaranteed, most of it carrying long term maturities and concessional interest rates. However, over the medium to long-term, debt sustainability could be under pressure due to exposure to nonconcessional financing, especially suppliers' credit and publicly guaranteed foreign direct investment with significant foreign exchange payment liabilities.

Figure 6: Export Composition (FY2000)



II. SHORT- AND MEDIUM -TERM ECONOMIC PROSPECTS AND POLICY ISSUES

35. Bangladesh's short-term economic prospects remain somewhat uncertain because of the forthcoming general elections. Much would depend upon whether the Government adopts a prudent policy stance and addresses the emerging strains on macroeconomic stability. Assuming that the Government is able to address the macroeconomic problems, and to the extent feasible in an election year, attempts to tackle some of the key sector policy constraints, the economy could grow at about 5.5-6.0 percent in FY2001. This projection assumes that the current tempo of agricultural growth will continue and industry sector performance will improve, due mainly to an increase in the growth rate of exports. According to available data, export growth in the first quarter of FY2001 is estimated to be 25.4 percent higher than in the corresponding period of FY1999, and if this momentum is not disrupted by some unforeseen events, manufacturing could regain its earlier momentum and grow at about 8 percent. To sustain GDP growth of about 6 percent, import growth will increase to 8-9 percent, mainly due to higher imports of raw materials and intermediate inputs for manufacturing. And assuming that the workers' remittances grow at about 10 percent, in this scenario, the current account of the balance of payments will deteriorate somewhat to 1.5 percent of GDP. The increased deficit can be easily financed by utilizing external assistance already in the pipeline. The pressure on foreign exchange reserves will depend on whether the Government is able to arrest the large negative outflow of foreign exchange recorded in the errors and omissions category, and improve investor confidence. If this can be achieved, then the level of foreign exchange reserves, while still low, could increase by about \$150 million to \$200 million and reach \$1.6 billion (providing cover of about two months of imports).

36. Over the medium term, i.e., in FY2002 and FY2003, growth prospects for the economy should improve after the general elections. The Government is expected to adopt a more prudent fiscal stance, and progress in pushing ahead with sectoral reforms should be considerable. The Government is likely to favorably resolve the issue of export of gas, which will have a positive impact on the balance of payments in the subsequent years. With renewed emphasis on policy reforms, economic growth is likely to pick up and could average 6-6.5 percent over the medium term. This scenario assumes that agricultural growth would continue to grow at 5 percent per annum, manufacturing growth will increase to 8.5-9.0 per annum, and the services sector will grow at about 7 percent. This scenario also assumes that the Government will be able to reduce the fiscal deficit to more sustainable levels of 4.5-5.0 of GDP. Government borrowing to finance the fiscal deficit will correspondingly decrease, leaving more resources for the private sector to increase investment. Provided the exchange rate is appropriately managed, export growth could be in the range of 13-15 percent per annum and import growth is likely to average 8-10 percent per annum. The current account of the balance of payment is expected to deteriorate to about 2 percent of GDP, due mainly to higher payments for the various contractual obligations against investments in the gas and power sectors. The Government should have no difficulty financing the deficit, and with higher direct foreign investment, foreign exchange reserves could rise to about \$2 billion.

37. If Bangladesh is to achieve higher economic growth and consequent reduction in poverty over the medium term, bold moves will be required to push ahead with comprehensive reforms of the financial sector, governance, public sector management, and private sector development. The gas subsector is poised to open up immense economic opportunities for Bangladesh provided the Government initiates policies to expand the gas market, including gas export.