

ADB

BANGLADESH  
Quarterly  
Economic  
Update

June 2007

Asian Development Bank

Bangladesh Resident Mission  
Asian Development Bank

All rights reserved

## Asian Development Bank June 2007

Bangladesh Resident Mission  
Plot E-31, Sher-e-Bangla Nagar  
Dhaka 1207  
Bangladesh

adbbrm@adb.org  
BRM website: <http://www.adb.org/BRM>  
ADB website: <http://www.adb.org>

*The Quarterly Economic Update (QEU) is prepared by the Economics Unit of the Bangladesh Resident Mission, Asian Development Bank (ADB). The views expressed in the QEU are those of the authors and do not necessarily reflect the views of the ADB or its member governments. The QEU is published in March, June, September and December.*

The logo of the Asian Development Bank (ADB), consisting of the letters 'ADB' in white serif font on a black square background.

ADB

BANGLADESH  
Quarterly  
Economic  
Update

June 2007

Asian Development Bank

## CONTENTS

	Page
MACROECONOMIC DEVELOPMENTS	1
Highlights	1
Sector Performance and Economic Growth	1
Agriculture	1
Industry	2
Services	5
Economic Growth	5
Fiscal Management	6
Monetary and Financial Developments	8
Balance of Payments	10
Inflation and Exchange Rates	11
Capital Market	12
THE FY2008 BUDGET	14
Revenue Measures	15
Tax and Tariff Policy Reforms	15
Income Tax	15
Import Duty Structure	16
Value-Added Tax	17
Expenditure Measures	17
Social Sectors	18
Physical Infrastructure	18
Agriculture and Rural Development	19
Social Empowerment and Social Safety Net	19
Fiscal Deficit and its Financing	20
OVERSEAS WORKERS' REMITTANCES	21
Migrants' Destinations	21
Effect on Balance of Payments	22
Absorption of Oil Price Shocks	22
Effects on Households	23
Incentives	23
Recent Surge in Migration	24
Hurdles of Official Transfers	25
Challenges and Threats	25
Improving Inflow of Remittances	26
Conclusion	28

## NOTES

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

<b>Vice President</b>	L. Jin, Operations Group 1
<b>Director General</b>	K. Senga, South Asia Department (SARD)
<b>Country Director</b>	H. Du, Bangladesh Resident Mission (BRM), SARD
<b>Team leader</b>	R. K. Khan, Head, Economics Unit, BRM, SARD
<b>Team members</b>	M. Z. Hossain, Senior Economist, BRM, SARD
	S. Anwar, Economist, BRM, SARD
	B. K. Dey, Assistant Economics Analyst, BRM, SARD

## MACROECONOMIC DEVELOPMENTS

### Highlights

- Gross domestic product (GDP) growth is estimated at 6.5% in FY2007.
- Growth performance was underpinned by steady expansion of manufacturing and services.
- Although Bangladesh carried out a few fiscal reform measures, revenue performance remains weak.
- Even with a cautious monetary policy, broad money growth remains high.
- Robust growth in exports and workers' remittances contributed to a favorable balance of payments outcome.
- Rising domestic demand pressures and an increase in international prices fueled inflation.

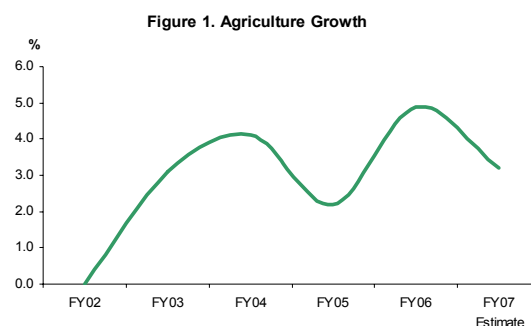
### Sector Performance and Economic Growth

1. During FY2007, economic performance remained strong, propelled by rising domestic and external demand. Robust growth in services and export industry offset lower growth in agriculture. The growth was supported by rising private investment, bolstered by credit growth and a surge in workers' remittances.

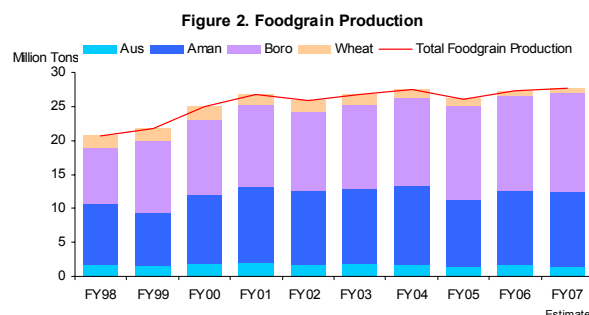
#### Agriculture

2. Agriculture growth during FY2007 is estimated at 3.2%, lower than the postflood high growth of 4.9% in FY2006 (Figure 1). Lack of adequate rainfall and disruption in agriculture inputs, including fertilizer and irrigation, adversely affected production. Although growth in crops and animal farming subsectors slowed, growth in forest and fisheries subsectors rose compared with the preceding year. The avian flu outbreak in the country affected the output of animal farming. The steady rise in inland and marine catches contributed to higher growth in fisheries.

3. Production of food crops is estimated at 27.6 million tons, implying a 1.1% increase over the last year (Figure 2). *Aus*, the first rice crop of the year, was planted on 0.9 million hectares. Production of 1.5 million tons was 16.7% less than the 1.8 million tons in FY2006. This was the result of insufficient rain during the flowering stage and



continued diminishing area of cultivation, giving way to competing and more profitable crops and vegetables such as *boro* (winter rice crop), maize, summer vegetables, and spices. The *aman* (summer rice crop) was planted on 5.3 million hectares, with production at 10.8 million tons, the same as in FY2006. Although the area under aman cultivation was slightly smaller than in the previous year, the yield rate was stable. Aman cultivation has been hampered in many parts of the country due to drought during the entire transplantation period and short supply of fertilizer, insecticide, and other inputs. Also, the supply of electricity was inadequate for the operation of irrigation pumps.



4. The harvesting of the boro crop, which is traditionally the largest crop of the year, is complete. Encouraged by higher domestic prices, farmers brought more land under boro farming. The Department of Agriculture Extension (DAE) fixed an all-time record boro farming target following last year's bumper production. DAE and other government agencies encouraged increased use of high-yielding-variety seeds by ensuring adequate supply of seeds and necessary inputs, including fertilizer and insecticides. Plantation areas under boro crop increased to 4.4 million hectares, an increase of 7.3% over FY2006. Despite the sterility of paddy reported in some districts and some disruption in the delivery of key inputs, such as diesel fuel and fertilizer, the boro crop is expected to be 14.6 million tons, an increase of 4.3% over 14.0 million tons in FY2006. Although the area under wheat cultivation declined, wheat production is estimated at 0.7 million tons, unchanged from FY2006. Because of the increasing commercial viability of maize cultivation compared with wheat, farmers are substituting maize for wheat in their crop rotations.

5. Among other crops, jute production increased by 5.7% and potato production by 5.8%. The production of minor crops such as pulses, spices, sugarcane, fruits, vegetables, and tobacco, which contributed 30% to the total output of the crop subsector, is expected to be similar to that of the preceding year.

## Industry

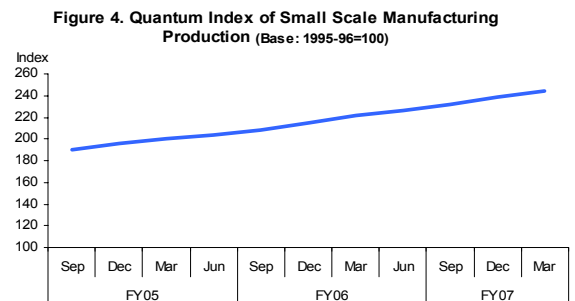
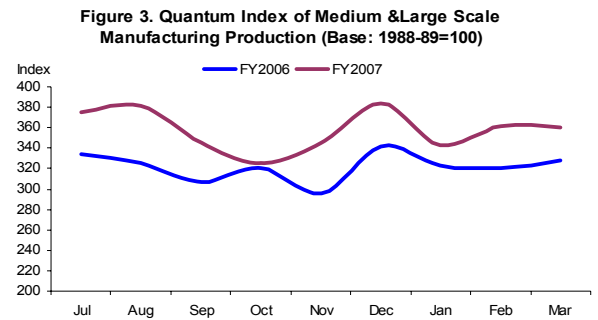
6. The industry sector recorded robust growth caused by a steady expansion in export-oriented manufacturing and a rise in domestic demand. Sector growth during FY2007 is estimated at 9.5% compared with 9.7% in FY2006. The growth of mining and quarrying (10.0%) and manufacturing (11.2%) was higher than 9.3% and 10.8%

respectively in the preceding year. Although manufacturing expanded at a steady pace, it performed below its potential because of infrastructure constraints, particularly electricity shortages and disruptions. The growth in power, gas, and water supply together slowed to 5.4% from 7.7% last year because of a setback in electricity generation. The growth in construction declined to 7.1% from 8.3% because of the higher price of construction materials and downsizing of the annual development program (ADP).

7. Growth in manufacturing was largely lifted by a steady increase in external demand for garments. In the first 9 months (July 2006–March 2007) of FY2007, output of medium- and large-scale manufacturing expanded by a strong 11.2% compared with the same period of FY2006 (Figure 3). Production of woven garments, knitwear, textiles, pharmaceuticals, wood products, iron and steel, ceramic, cement, and plastic products recorded steady growth. The output of small-scale manufacturing increased by 10.8% (Figure 4), with production of rice milling, dairy products, knitwear, leather products, footwear, wooden furniture, paper and paper products, and nonmetallic mineral products increasing significantly.

8. Garment exports grew by a robust 28% during the first half of FY2007. But growth slowed to 17% during July–May of FY2007 (Figure 5). According to Bangladesh Garment Buying Houses Association, buy orders dropped by about 30% during the first half of 2007. Several factors are responsible for this slowdown including labor unrest in the garment industry in mid-2006 and political turmoil during October–December 2006 at the end of the tenure of the last elected government. As shipments and deadlines were delayed, some buyers may have moved to other countries such as the People’s Republic of China (PRC) and Viet Nam. Some buyers curtailed orders because of decreased sales and buildup of inventory in their outlets. Major garment owners are optimistic that orders will pick up from July 2007 with demand for summer and fall. The industry’s ambition to double exports to \$16 billion in 3 years will require improving international credibility, productivity, and infrastructure.

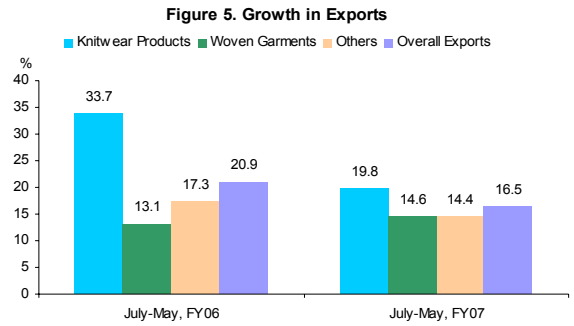
9. Despite a few setbacks, buyers still report satisfaction with Bangladesh suppliers and their ability to produce quality garments in a reasonable time and to permit flexibility in orders. Many also describe Bangladesh as the lowest cost supplier. Some major international buyers recently established a permanent presence in Bangladesh. But the country still runs the risk of facing tough competition in its two largest markets—the European



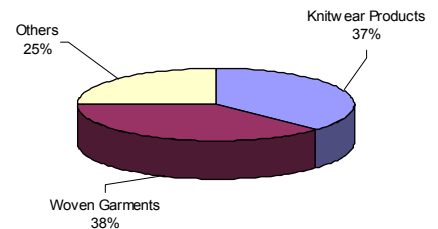
Union (EU) and the United States (US)—in the near future as the safeguard quota on the PRC is due to expire in 2008. Much of Bangladesh’s competitive advantage currently depends on its abundant low-cost labor, flexible exchange rate, and close ties with some large buyers. To deal with the intense competition from the PRC, the industry needs to increase productivity—the ultimate deciding factor. This will require major investments in technology and vocational training programs. Improving roads, rail, ports, and power supply; and streamlining customs procedures at all points of entry and exit are also critical. Power shortages hamper production and increase cost because in-house power generation (using mostly diesel generators) is expensive. Infrastructure constraints and cumbersome customs procedures severely handicap the industry’s competitiveness by slowing export/import activities, and increasing lead time. Lead time for local exporters is about 1 month more than that of major competitors. Reducing lead time is critical if Bangladesh wants to produce high-value-added products that require prompt availability of quality fabrics and other materials.

10. Weak vertical integration in the woven industry means that meeting the rules of origin requirements in the EU is difficult; the EU has granted duty-free access to Bangladesh. Although knit garments can generally meet the eligibility requirements because they have high domestic value-added content (strong backward linkage), woven garments that heavily rely on imported fabric encounter problems. But the situation is set to improve as new investments in textile recently increased. The country currently depends too heavily on EU and US markets. Producers should try to explore new opportunities in other parts of the world. The PRC has offered Bangladesh duty-free access for 84 items, including some garment and textile products. India recently agreed to allow export of 6 million pieces of apparel duty free. These markets need to be researched and accessed.

11. A generally improved business climate—ranging from better infrastructure to better governance—will attract more foreign direct investment (FDI) in the sector; this may boost competitiveness of the entire industry. Evidence of a strong correlation between foreign investments (and technology) and productivity improvement is compelling.



**Figure 6. Share of Exports (Jul-May, FY07)**



## Services

12. Growth in the services sector in FY2007 is estimated at 6.7%, up from 6.4% in FY2006. Rapid growth in industry and foreign trade aided steady expansion in the sector. Wholesale and retail trade; transport; telecommunications; and community, social, and personal services increased substantially. The mobile phone services market continued to drive telecommunications because of strong consumer demand for mobile phones. Increased production of drama and telefilms for private television channels fuelled growth of community, social, and personal services. The increased number of health care service providers also contributed to sector growth.

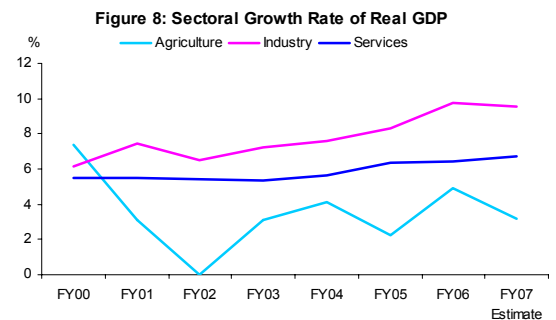
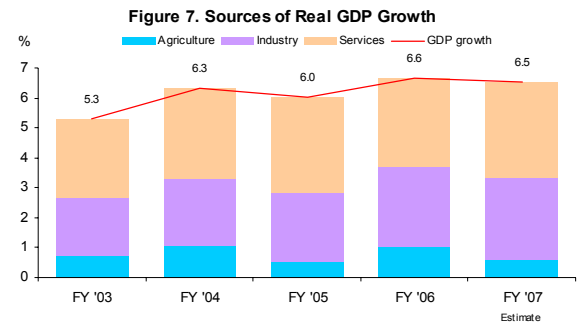
## Economic Growth

13. GDP growth is estimated at 6.5% in FY2007, slightly lower than 6.6% in FY2006 because of moderating growth of agriculture following the postflood high growth of FY2006 (figures 7 and 8). Growth was underpinned by steady expansion in manufacturing and continued buoyancy in services. Private consumption was the main driver of growth, bolstered by strong remittance inflows. At 24.3% of GDP, investment during FY2007 was lower than 24.7% in the preceding year caused by a decline in public investment while private investment rose modestly (Figure 9). Showing an upsurge in remittance inflows, gross national savings in FY2007 increased sharply to 29.2% of GDP (Figure 10).

14. Bangladesh holds strong potential for higher GDP growth of 7%–8% over the medium term. Risks that could affect growth prospects include political uncertainty, infrastructure constraints, and vulnerability of the garment subsector to intensified global competition.

15. A recent survey by Japan External Trade Organization found that the cost of investment in Bangladesh is getting cheaper. The survey of investment-related cost comparison, conducted in 30 Asian cities on 32 cost components,<sup>1</sup> rates Bangladesh as the cheapest for nine components, including legal minimum wages;

<sup>1</sup> The cost components include workers' wages; engineers' salaries; salaries of midlevel managers; legal minimum wages; social security ratio; nominal wage increase rate; cost of land area of an industrial estate; fee for office space; telephone installation fee; mobile connection fee; per minute call charge for fixed and mobile telephones; Internet connection fee; monthly basic fee for using the Internet; cost of 1 kilowatt-hour of electricity; cost of gas and water; container freight cost; per liter cost of gasoline and diesel; corporate and personal income tax rate; percentage of value-added tax; percentage tax on interest remitted to Japan; percentage tax on dividend remitted to Japan; and other related costs.



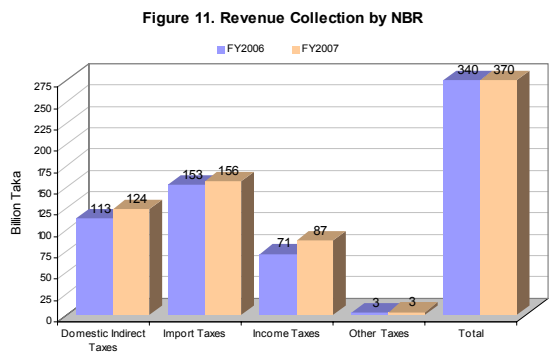
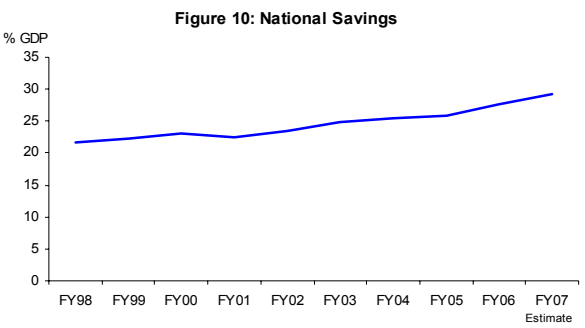
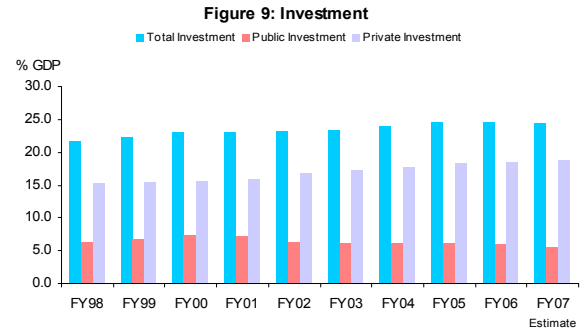
social security burden; office rent; and monthly basic charge for mobile phone, gas, and water. But some costs including that of land, broadband (512 kilobits per second) Internet service, new connection fee for fixed telephone lines, container transportation cost, and rate of corporate tax are high and need attention. For the route to the ports of Yokohama and Los Angeles, the cost of transportation from Chittagong Port is higher than that from Mumbai Port, even after offsetting the proportional cost due to geographical longer distance. This is because the large container ships cannot come to Chittagong Port due to its shallow draft; therefore, transshipment of containers becomes necessary either at Singapore or Colombo. The cost of container transport is a large element affecting the country's export competitiveness. Poor infrastructure and utility services, fragile law and order, sudden changes in government policies, delay in letter of credit settlement, and political volatility are among hidden costs that affect investors.

16. The decreasing investment cost is an important development for Bangladesh as foreign firms are increasingly looking for cheaper places to invest to cut cost and uplift competitiveness. But to take advantage of this, Bangladesh needs to upgrade infrastructure and extend a more supportive environment for new and existing FDI. The country has not yet decided on several very large FDI proposals amounting \$11 billion in important sectors, including coal mining, power, steel, fertilizer, hotel, tourism, and petrochemicals. Long delays may drive investors to other countries, which will further dim the FDI outlook in Bangladesh.

### Fiscal Management

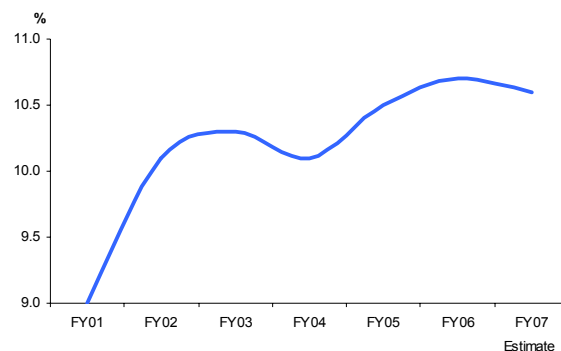
17. In FY2007, revenue collection fell short of projection. Despite an increase in current expenditures, overall expenditures were contained by decreasing development spending. As a result, the fiscal deficit remained on target at 3.7% of GDP with domestic financing of 2.1 % of GDP aided by an increase in foreign financing to 1.6% of GDP, rising from 1.2% in FY2006.

18. Although Bangladesh carried out a few fiscal reform measures over the past years, revenue performance remains weak. Bangladesh's tax effort (tax-GDP ratio) of 8.4% of GDP in FY2007 is much lower than the average for low income countries. This low tax effort reflects mainly low domestic taxes. Bangladesh's revenue (10.6% of GDP in FY2007) and its recent trend compare unfavorably with Asian (16.3% of GDP) and sub-Saharan African countries (18.4% of GDP). Although Bangladesh has high nominal tax rates for corporate income tax and value-added tax



(VAT), it has much lower revenue productivity (tax effort divided by the nominal tax rate) compared with other Asian countries. Unless revenue collection increases significantly, the higher expenditure needed for faster economic growth and rapid poverty reduction cannot be met without pushing fiscal deficits to unsustainable levels. Major reforms to address systemic problems, including those from narrow bases riddled with exemptions, exclusions, and incentives; and rigidities in the tax laws relating to main tax instruments, will be needed to ensure large increases in tax revenues. FY2007 revenue collection increased by 10.3% over FY2006; the targeted growth was 17.1%. Revenue collection from National Board of Revenue taxes increased by only 8.8%, although it was targeted to increase by 19.2% (Figure 11). According to the revised estimates, income tax collection increased by 28.2% and VAT by 10.4%. Supplementary duty collections actually declined by 4.7% as against projected growth of 20.5%. Customs duty increased by only 0.5% compared with targeted growth of 15.2%. Achieving the 15.8% revenue growth target for FY2008 will require extraordinary efforts from the tax mechanisms, with intensive supervision and monitoring of revenue collection, especially for indirect taxes.

Figure 12. Revenue-GDP Ratio



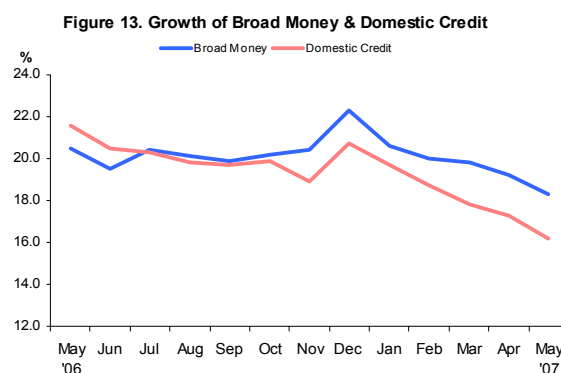
19. In FY2007, total expenditure was 4.2% below the budget target, with current expenditure higher by 5.2%, although the development expenditure (mainly ADP) was lower by a sizable 17.6% mainly due to resource inadequacy and implementation capacity constraints. At 14.3% of GDP, total expenditure fell short of the poverty reduction strategy target of 15.9%. Current expenditure growth exceeded the budget target of 14.1% and reached 20.1% due to the increased expenditure associated with the canceled elections and the slack in budgetary discipline during the first quarter of FY2007. In FY2008, development expenditure is targeted to increase by 21.6% compared with the 0.7% decline in FY2007. Accomplishing the development program will be a challenge and will require close attention and institutional capacity development to ensure faster project implementation with a focus on expediting project-related procurement.

20. The Government introduced a new mechanism for bank borrowing in FY2007, under the supervision of the Cash and Debt Management Committee. The new mechanism provides higher advance limits on ways and means, and auctioning of treasury bills and bonds based on volumes preannounced at the onset of the borrowing calendar. This separates Bangladesh Bank's role in government debt management from its monetary policy

functions, and makes the Government's borrowing requirements more predictable. However no automatic mechanism yet limits government borrowing within the budgetary ceiling. The Cash and Debt Management Committee's concurrence to allow Bangladesh Bank to off-load treasury bills and bonds held by it at a cut-off rate (to make up for the shortage of market supply of funds required by the Government) to primary dealers will encourage the latter to create a secondary market for government securities. This will reduce the need for Bangladesh Bank to absorb primary issues of government securities, and contribute to improved monetary management by Bangladesh Bank. To focus greater attention to budget implementation, the authorities in FY2008 budget allocated resources to ministries covering the key sectors for conducting special or performance audits through engaging private sector audit firms. The fuel price adjustments of 16%–21% implemented in April 2007 reduced Bangladesh Petroleum Corporation (BPC) losses, bringing domestic prices of diesel and kerosene to 83% of breakeven in June 2007. But BPC sold other products at profit. The Government's assumption of BPC's overdue bank loans through a bond issue of \$1.1 billion in the FY2008 budget is a desirable move. To avoid reaccumulation of BPC losses and nonperforming loans of nationalized commercial banks (NCBs), the Government needs to introduce an automatic price adjustment mechanism and improve BPC's operating efficiency.

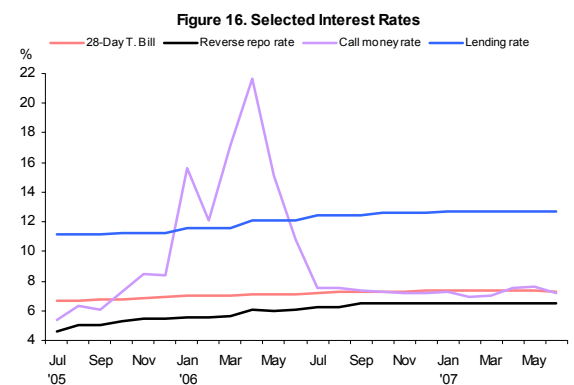
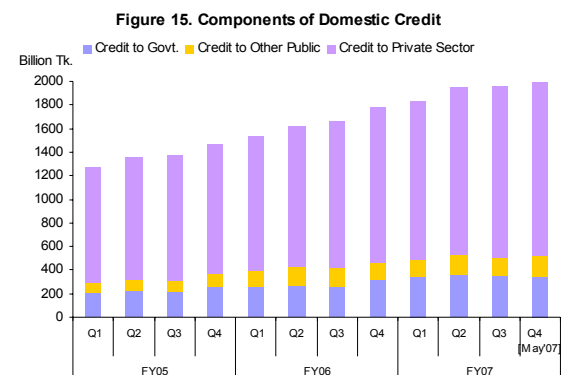
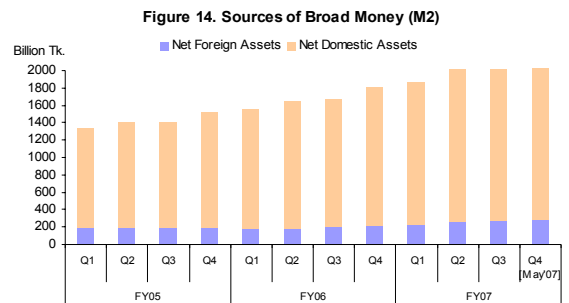
## Monetary and Financial Developments

21. In continuation of the trend during the past few years, money and credit growth rates remained high in FY2007. On a year-on-year basis, in December 2006 broad money growth reached 22% and domestic credit growth 21% (Figure 13). With better control in monetary management, growth in broad money decreased after March 2007, reaching 18.3% in May 2007; domestic credit was at 16.2%. Reserve money growth declined, reaching 23% in May 2007 from 38% in December 2006. Although growth in money supply fell, growth is much higher than programmed (14.7%) and the nominal GDP growth rate of 12.5% in FY2007. Growth in domestic credit has been contained, but growth in net foreign assets remained high at 39% in May 2007, in response to the surge in exports and workers' remittances leading to a sizable foreign exchange reserves buildup. Growth of credit to the private sector declined to 15.6% in May 2007 from 17.1% in May 2006; but growth of credit to the Government remained high at 22.6% in May 2007 to make up for the shortfall in revenue collection.



22. In implementing monetary policy to provide adequate liquidity to the economy, while attempting to moderate inflationary pressures, Bangladesh Bank conducted auctions of treasury bills of different maturities along with repo and reverse repo operations. The yield on 28-day treasury bills increased from 7.1% in June 2006 to 7.3% in June 2007 (Figure 16). The reverse repo rate also increased from 6% in June 2006 to 6.5% in June 2007 (Figure 16). The tightened policy stance and reintroduction of Bangladesh Bank bills in October 2006 somewhat succeeded in decelerating growth of money and private sector credit and limiting inflation despite rising international prices. Call money rates declined from 10.8% in June 2006 to 7.2% in December 2006, and then rose to 7.7% in June 2007. The fourth half-yearly monetary policy statement (mid-July 2007) aims to continue the cautious monetary policy stance keeping in view the prevailing price situation and excess liquidity in the banking system, while supporting sustainable output growth. Attention is also given to the need to adjust smoothly to the likely internal and external shocks to the economy. Monetary policy is centered on a targeted real GDP growth rate and sustainable rate of inflation. The annual monetary program of the central bank, based on these targets, employs reserve money and broad money as intermediate targets while tracking other asset and liability indicators.

23. In the backdrop of broad and reserve money growth exceeding monetary program targets during FY2007, as explained in the fourth monetary policy statement, Bangladesh Bank might review the policy interest rates and revise interest rates of shorter tenure instruments and statutory liquidity ratio and cash reserve requirements upward to ease pressure on domestic prices. Domestic credit is projected to increase in FY2008 by 13.8% and private sector credit by 14.5%, while broad money is projected to increase by 15%. Bank borrowing to finance the fiscal deficit, if contained within the programmed growth of 11%, will not create major obstacles in the smooth operation of monetary policy. Despite adopting a cautious monetary policy stance, Bangladesh Bank is committed to ensuring flows of credit to agriculture, small and medium-sized enterprises (SMEs), and housing; sectors traditionally not adequately served by the market. The planned introduction by Bangladesh Bank of refinancing schemes for housing loans for lower and middle income groups will, while addressing the acute housing problem, provide employment to many people.



24. Despite improvement, gross nonperforming loans (NPLs) of the banks remain high. NPLs declined from 17.5% in first quarter of 2005 to 13.8% in the first quarter of 2007 (Figure 17). Net NPLs (net of provisions) declined to 5.1% from 8.6% in the period. Gross NPLs of NCBs remain high (24.9%). High lending rates due mainly to the large number of NPLs of state-owned banks and weak financial intermediation discourage investment and reduce the financial sector's contribution to economic growth. Interest rate spreads also remain high, reflecting banking inefficiencies that need to be addressed. Bangladesh Bank has made progress in adopting international best practice in prudential regulations and improving banks' compliance with reporting and risk management. Closer adherence is needed to best practice standards for banks' accounting, loan classification, and provisioning requirements (the provisioning ratio remains low except in foreign banks). Certain banks remain undercapitalized. The recent increase in the capital adequacy ratio to 10% is a positive step. So is the decision to have all commercial banks credit rated; this is to be updated annually by a reputable credit-rating agency to safeguard depositors' and prospective investors' interests. The sale of Rupali Bank (one of the four NCBs) has been concluded, although handover of the bank is experiencing unexplained delay. The Government has corporatized the other three NCBs, bringing them under Bangladesh Bank's supervisory and regulatory control and enhancing their operating autonomy and accountability.

### Balance of Payments

25. In the first half of F2007, export growth was 25.8%. But growth slowed as the year progressed; growth was 16.5% during July–May of FY2007. The main source of the slowdown was the progressively lower growth in knitwear, recording 32% growth until December 2006, but declining to 19.8% during July–May of FY2007. Woven garments exports grew by 24.1% until December 2006, but growth declined to 14.7% during July 2006–May 2007. To retain competitiveness, especially once the transitional safeguards on exports from the PRC expire in 2008 and given increased competition from Viet Nam following its accession to the World Trade Organization in January 2007, Bangladesh needs to reduce the lead time for garment producers, upgrade labor skills, and improve port infrastructure. Exports continue to concentrate on woven garments and knitwear, which have a 75% share in total exports. Despite potential, the share of other products remains limited. During the first 11 months of FY2007, exports of engineering products and frozen foods recorded

Figure 17. Gross Nonperforming Loan Ratios by Type of Bank

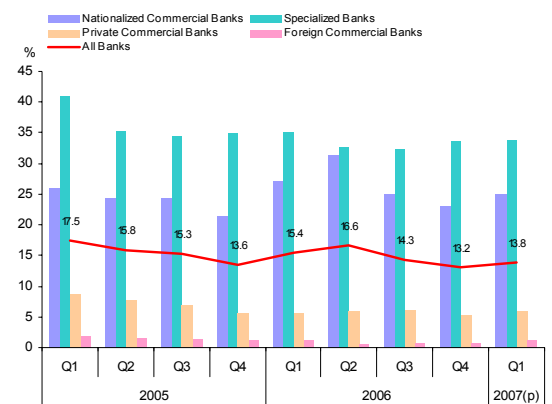


Figure 18: Trends in Export (fob) & Import (cif)

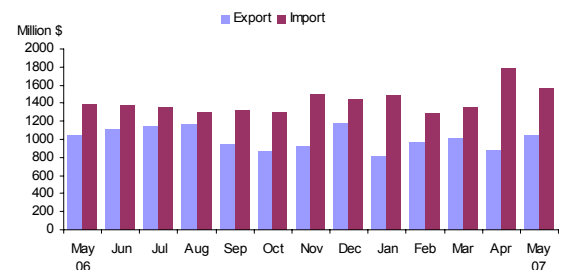
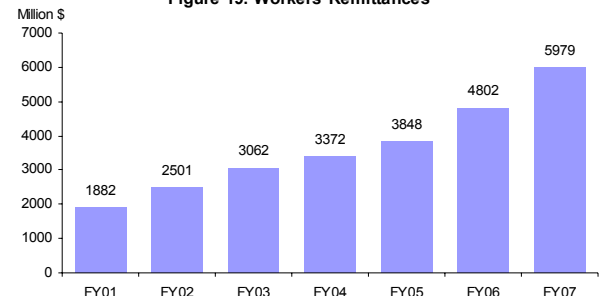


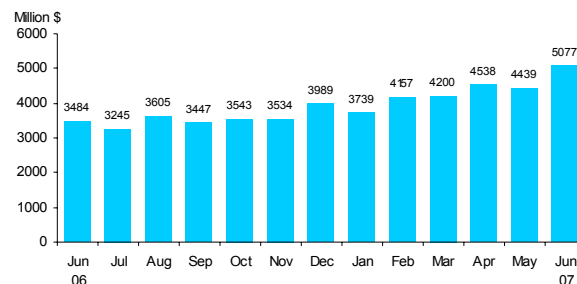
Figure 19. Workers' Remittances



impressive growth. The performance of traditional products, namely raw jute, jute goods, and tea, showed declining trends; while leather exports increased marginally. Imports grew by 17.4% in the first 11 months of FY2007. Imports of rice; wheat; and food items including sugar, pulses, and edible oil steadily increased. Growth in imports of these items seems to have a bearing on the price movements of these items in the domestic markets. Import of petroleum products, textiles, yarn, cotton, and capital machinery showed healthy growth.

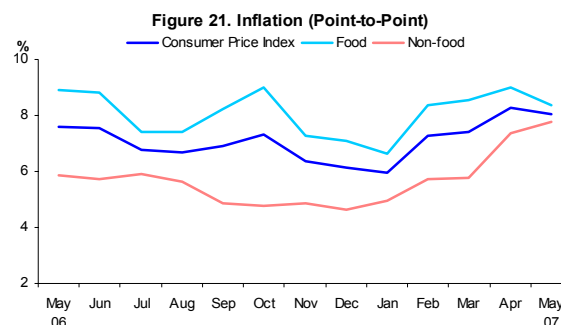
26. The trade deficit during July–May of FY2007 grew by 20.2% over the corresponding period of FY2006. This rise was more than offset by the surge in workers' remittances (25%) leading to a surplus of \$468 million in the current account, from a surplus of \$477 million in the same period of preceding year. The steep rise in the surplus in the financial account (mainly due to a surge in other short-term loans) coupled with the notable increase in the capital account surplus substantially increased the surplus in overall balance. Based on the latest balance of payments data, the current account surplus in FY2007 is estimated at 0.7% of GDP compared with 0.9% of GDP in the preceding year. Foreign exchange reserves stood at \$5,077 million on 30 June 2007, an increase of \$1,593 million from the end of June 2006 (Figure 20).

Figure 20. Gross Foreign Exchange Reserves



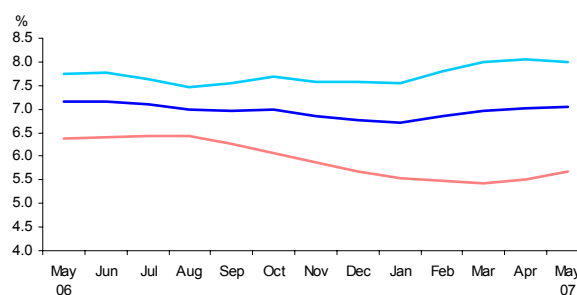
### Inflation and Exchange Rates

27. On a point-to-point basis, inflation increased to 8.1% in May 2007, from 5.9% in January 2007 (Figure 21). Food inflation increased from 6.7% to 8.4%, and nonfood inflation increased from 5% to 7.8%. On an annual average basis, the inflation rate reached 7.1% in May 2007 from 6.7% in January 2007 (Figure 22).



28. Inflationary pressures steadily mounted from the beginning of this decade from 1.9% in FY2001, to 2.8% in FY2002, 4.4% in FY2003, 5.8% in FY2004, 6.5% in FY2005, and 7.2% in FY2006. As GDP growth remained stable with a rising trend during the period, domestic supply-side developments are unlikely to have put major pressure on prices. The rising domestic demand pressures aided by higher incomes and continued high monetary and credit growth mainly fueled inflationary pressures in the domestic economy in FY2007, as in earlier years. Taka depreciation was not an important factor in FY2007, when the taka: dollar exchange rate remained fairly stable. The surge in exports and remittances that pushed up the growth of net foreign assets to 39.2% with a share of 25.4% in broad money growth in May 2007 contributed to

Figure 22. Inflation, 12-Month Moving Average



inflation in FY2007. As domestic prices are increasingly linked to international prices due to globalization, the increase in international food and commodity prices, due to rise in demand in emerging market countries and weak crop outlook in USA and Australia, also aided inflation.

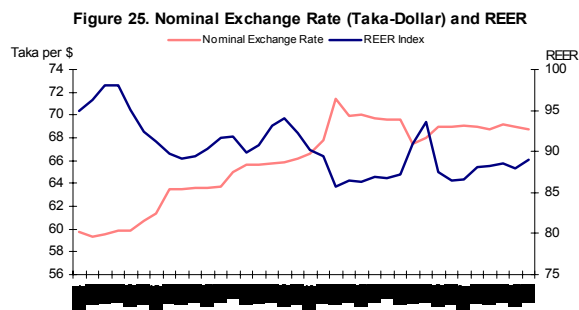
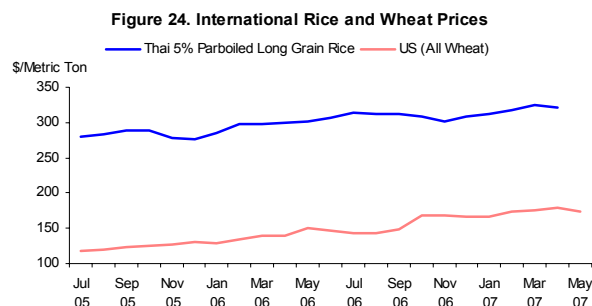
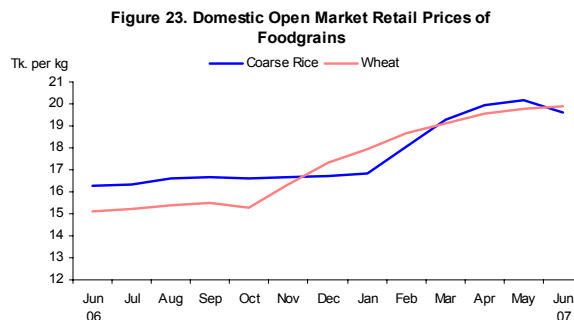
29. To stop rising prices, the Government initiated several measures including withdrawing duties on essentials, increasing public sector import of food grains, making provisions for diesel and fertilizer subsidies, resorting to actions against hoarding, and widening the safety net programs. Also the banks started providing credit facilities on softer terms to new importers, reduced letters of credit margins for food imports, and are expanding agriculture credit. In view of higher international food prices and given the large share of food in computing inflation, these measures are unlikely to have any major impact in terms of dampening inflationary pressures.

30. Containing prevailing inflationary trends is more of a demand management exercise, and requires cautious monetary policy. Bangladesh Bank's monetary program to contain annual average inflation within 6.5%–7.0% for FY2008 therefore appears well-advised (paras. 22–23). The healthy foreign exchange reserves allow scope for encouraging imports of necessities putting downward pressure on domestic prices. Letting markets for necessities function normally without administrative actions that cause disruptions to the supply chain will also be important.

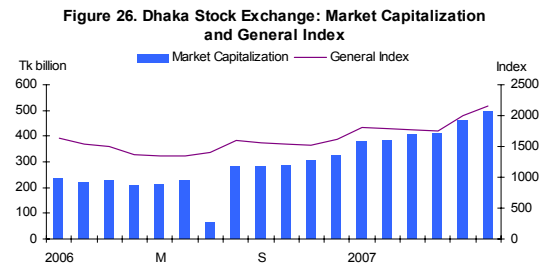
31. The pressure on the exchange rate moderated, reflecting the buildup of foreign exchange reserves because of the increase in remittances and export earnings. The taka appreciated (with fluctuations) by 1.3% against the US dollar between the end of June 2006 and end of June 2007 (Figure 25). Bangladesh Bank's purchase of sizeable foreign exchange from the market since January 2007, while restraining further taka appreciation, increased its net foreign assets contributing to increase in reserve money. The rate was Tk69.1: \$1 at end-January 2007, remaining stable and appreciating slightly to Tk68.8: \$1 at end-June 2007.

### Capital Market

32. The capital market registered a strong bullish trend during the second half of FY2007, and started the new fiscal year in similar style (figures 26 and 27). Turnover remained strong, while share prices soared. The Dhaka Stock Exchange general index climbed to 2,149.32 at the

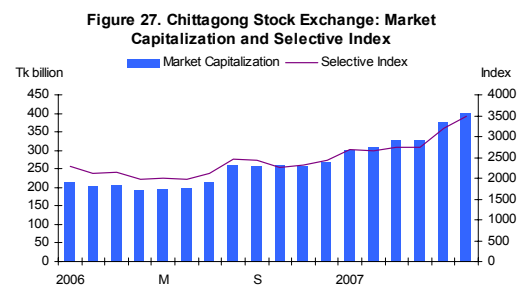


end of June 2007. It gained 539.81 points since December 2006, highlighting a 34% rise, and crossing the 2,000-point mark for the first time. Market capitalization went over \$7.0 billion, increasing the market capitalization to GDP ratio to about 11% from a meager 6% a year ago. Political volatility at the end of 2006 (October–December), during the transition from an elected to a caretaker government, took a heavy toll on the stock market and other sectors of the economy. But stock prices bounced back sharply at the beginning of 2007, when a new caretaker government took office. The market recovered from the prolonged bearish trend and trading activity was bolstered. Although market prices experienced temporary ups and downs, increased participation by institutional, retail, and foreign portfolio investors kept it buoyant in the end. Some liquidity in the banking system aided the process. Chittagong Stock Exchange, the other bourse located in the port city, followed similar trends.



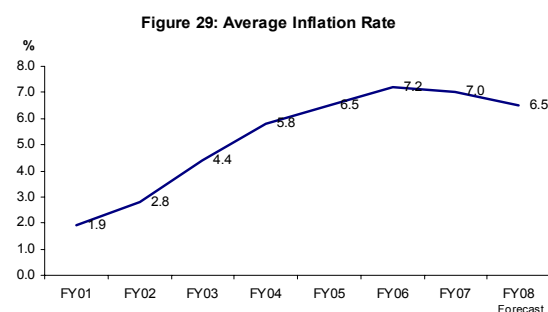
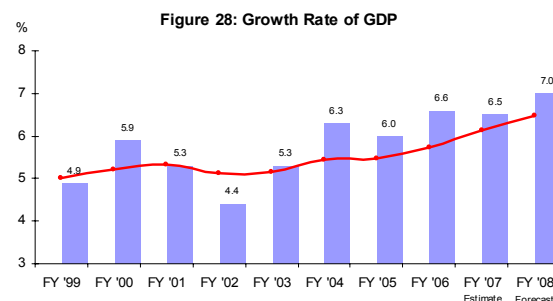
33. The supply of good quality shares needs to be increased to prevent any possible overheating of the market caused by high demand for shares, but limited supply. The supply-side constraints can be significantly reduced if major state-owned enterprises including the NCBs and some private sector telecommunications companies float their shares. The new caretaker Government has taken initiatives to encourage these entities to release shares and the investors to actively participate in the bond market. Biman Bangladesh Airlines, the state-owned airliner, is set to become a public limited company under this scheme. If successfully implemented, this will reduce some government budgetary pressure.

34. Policies may be geared to support financial deepening through workers' remittance securitization to channel this fund from consumption to investment. Remittance flows at \$6.0 billion in FY2007 are a stable source of foreign currency, which can be used to finance productive investments such as SME development. Still a major part of the remittances enter the country through illegal channels, which could be directed to legal routes if attractive savings instruments are designed. This can ease the financing constraints of small businesses with no access to banks stimulating economic growth



## THE FY2008 BUDGET

35. The advisor for finance presented the budget proposals for FY2008 on 7 June 2007. With no political agenda, the budget has been a challenging exercise for the caretaker Government in the backdrop of rising oil prices, higher domestic inflation, weak revenue outturn, and slow pace of project implementation. The budget adheres to the framework defined by the country's poverty reduction strategy (PRS), the duration of which is extended by a year to June 2008. The medium-term macroeconomic framework, within which the budget is defined, targets 7% growth and 6.5% inflation for FY2008 and assumes greater monetary and fiscal policy coordination, significant base expansion for taxes, and absence of major internal and external shocks (figures 28 and 29). The budget earmarks 57% of total resources to direct and indirect poverty reduction activities. The main thrust of the budget is to create a stable environment for accelerated economic growth, focusing on removing obstacles to smooth private sector operations and rapid poverty reduction. In the third year of PRS implementation, the budget is set at Tk796 billion (15% of GDP) with Tk265 billion for ADP expenditure and the remaining Tk531 billion for current expenditure, food for work, and employment generation and development programs outside the ADP. The domestic revenue earning of Tk573 billion (10.8% of GDP) will finance the major share of expenditure; the remainder will be financed by domestic borrowing and foreign financing (Table1).



**Table 1: Budget at a Glance**  
(Tk billion)

Item	FY2008 (A)	FY2007 Revised (B)	A/B%	A in % of GDP
<b>Total Revenue</b>	573	495	116	10.8
Tax Revenue	458	393	117	8.6
Nontax Revenue	115	102	113	2.2
<b>Total Expenditure</b>	796	668	119	15.0
Current Expenditure	529	445	118	10.0
ADP	265	216	122	5.0
Other Development Expenditures (net)	2	7	29	0.0
<b>Fiscal Deficit</b>	223	173	129	-4.2
External Resources (Net)	106	73	145	2.0
Foreign Grants	43	22	195	0.8
Foreign Loans	63	51	124	1.2
Financing of Deficit	223	173	129	4.2
Domestic Resources	117	100	111	2.2
Domestic Bank Borrowing	72	65	111	1.3
Domestic Non-Bank Borrowing	45	35	129	0.9

Source: FY2008 National Budget Documents.

## Revenue Measures

36. Total revenues are expected to increase by 16% in FY2008 compared with the revised estimates for FY2007, because of strengthening tax administration, streamlining collection systems, amending VAT laws and procedures, and widening VAT coverage. Tax revenues are expected to grow by 17% and nontax revenues by 13%. This will increase the revenue–GDP ratio to 10.8% in FY2008 from 10.6% in FY2007 (Figure 31). Even at 10.8% of GDP, revenue collection is low and has been a cause for concern, impeding efforts to mount desired public expenditure programs. Efforts need to be concentrated to substantially augment revenues, especially from indirect taxes. Although past and ongoing reforms reduced dependence on trade taxes by design, income tax and domestic consumption taxes have not yet assumed a compensating revenue role. While import taxes as a share of GDP are higher than comparators in the Asian region, the domestic direct and indirect tax collection is much lower than in comparators. Achieving the ambitious revenue target for FY2008 will be a challenging task considering the large shortage of field staff mainly in indirect tax administration.

## Tax and Tariff Policy Reforms

### Income Tax

37. Continuing the past trend, the budget seeks to shift emphasis away from reliance on trade taxes to income taxes and VAT. This is dictated by the irreversible trends of globalization and market reforms reducing revenues from import-based taxes; and the need to reduce dependence on these taxes, which distort resource allocation and make revenues hostage to balance of payments considerations. The budget seeks to simplify tax assessment and payment procedures and promote voluntary compliance, and attaches importance to enhancing transparency and accountability of tax authorities. Also the budget adopts measures to curtail the discretionary authority of tax officials. To provide relief to individual taxpayers and encourage tax payment, the budget raises the tax-exempt income limit and extends income tax brackets. To motivate voluntary tax payment, the budget introduces universal self-assessment procedures. Changes in income tax law are introduced to simplify and modernize tax collection procedures. To encourage disclosure of higher income, the measure introduced last fiscal year of allowing 10% tax rebates on additional tax paid by individuals at the highest rate of 25% who declare more than 10% additional income

Figure 30: Annual Growth in Revenue

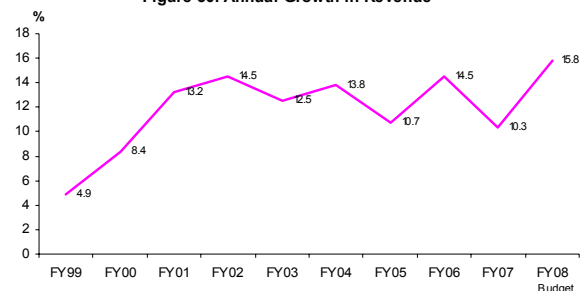
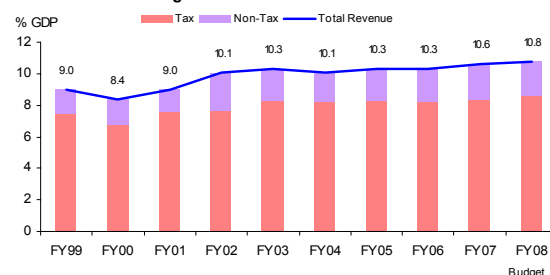


Figure 31: Revenue-GDP Ratio

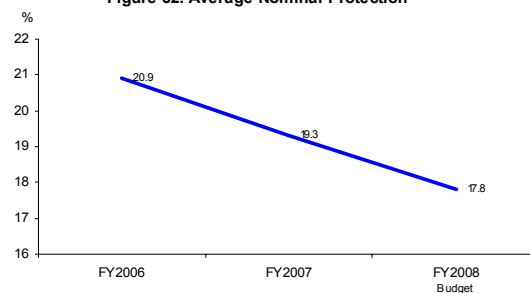


is retained. Tax rates for companies remain unchanged; but if mobile phone operators are listed with the stock exchange, the applicable rates for them will be reduced from 45% to 35%. The tax holiday facility extended to solar energy plants will promote alternative sources of energy use, reducing pressure on conventional energy and extending the tax rebate facility to nonresidents. The abolition of advance income tax on government bonds will help create a bond market, and the exemption from tax on income from zero coupon bonds will diversify investment sources.

### Import Duty Structure

38. The decision to abolish the infrastructure development surcharge (IDSC) will simplify the tariff regime. The compression of tariff bands by raising duties for raw materials from 5% to 10%, and intermediate goods from 12% to 15%, keeping duties for finished product unchanged at 25% (with no IDSC), will moderate effective protection of domestic industries. Under the new rate structure, 3.3% of total harmonized system tariff lines (8% in the FY2007 budget) will be assessed at 0% duty, 28.3% at 10% duty, 26.7% at 15% duty, and 41.7% at 25% duty. Under the budget, the average custom duty rate is increased to 13.44% from 12.21% in FY2007. But the average nominal protection will fall to 17.81% compared with 19.28% in the previous year because of abolishing IDSC (Figure 32). To remain competitive, domestic industries will need to increase efficiency. The merger of supplementary duty rates will simplify assessment of imported goods. Withdrawing zero duty on textile machinery, computers and computer accessories, and agricultural pumps—in the face of suggestions to keep them unchanged—reflects the authorities' desperate attempt to raise revenue. Withdrawing import duties on crude edible oil and lentils, and not changing the 0% duties on other necessities, will moderate market prices of these essentials. Reduction of duties on trucks using compressed natural gas from 25% to 10% will encourage import of these more environment-friendly vehicles; while increasing import duties from 5% to 15% on completely built unit, compressed natural gas buses will promote the assembly industry for such buses. Although not applied trade-neutrally and contradicting the spirit of the VAT law, the imposition of supplementary duty only at the import stage for metal-framed furniture and plastic products will provide protection to the domestic metal furniture and plastic industry. The extension of the bonding period up to 2 years will encourage export-oriented industry. Systemic improvements in bond procedures will streamline customs administration and help exports.

Figure 32: Average Nominal Protection



## Value-Added Tax

39. Simplifications in the VAT Act provisions and rules will encourage tax payments voluntarily and introduce greater transparency in tax administration. Withdrawing turnover tax facility for a large number of goods and services and bringing them under VAT purview irrespective of the annual turnover will widen the tax base and increase collection.

## Expenditure Measures

40. In the FY2008 budget, the Medium-Term Budgetary Framework (MTBF), which provides medium-term budget estimates with the objective of allocating resources to strategic priorities while ensuring consistency of allocations with overall fiscal objectives, was extended from 10 to 14 ministries. The MTBF is intended to strengthen fiscal management and grant greater autonomy to line ministries for more flexibly managing resource allocation. Serving as a link between the PRS and annual budget, and seeking to remove demarcations between revenue and development expenditures, the MTBF aims to establish consistency between policy, planning, and budgeting. As acknowledged in the budget speech, realizing the full benefits of the MTBF will take time and require enhanced institutional capacity of the ministries.

41. Public expenditure in FY2008 is projected to rise by 19% over the revised estimate for FY2007, with current expenditure increasing by 18% and ADP expenditure by 22%. The public expenditure to GDP ratio is projected to rise from 14.3% in FY2007 to 15% in FY2008. ADP implementation will present a difficult challenge in view of the weak institutional capacity and require concerted efforts to address impediments to timely and efficient project formulation and implementation. Emphasis in the budget on improving procurement and strengthening monitoring and evaluation of public spending will contribute to streamlining project implementation. Reducing the number of projects and increasing project selectivity in terms of pro-poor growth will improve development impact of resource allocation. The decision to post information on resource allocation and utilization by sector and geographic division for priority projects will enhance transparency and accountability of public spending and contribute to increasing the effectiveness of project implementation. The emphasis on regional parity in line with national priorities and resource availability together with the increased allocation for agriculture, rural

Figure 33: Annual Growth in Expenditure

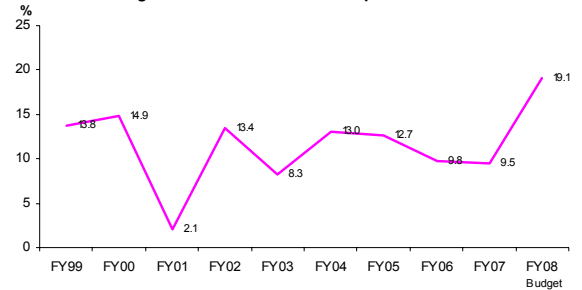
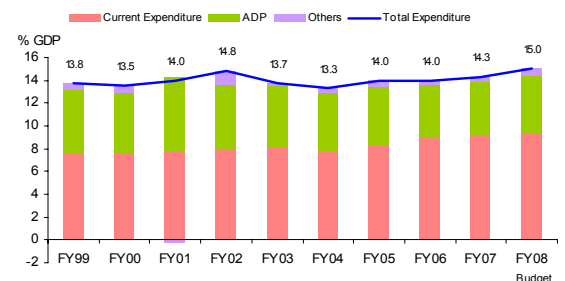


Figure 34: Expenditure-GDP Ratio

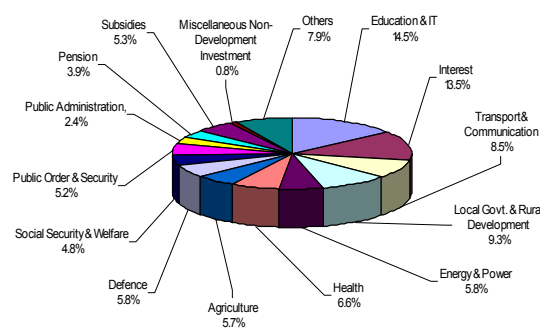


development, and water resources will improve the poverty reduction focus of the budget. Continuing past trends, priority is attached to sectors with potential for economic growth, poverty reduction, and human development.

### Social Sectors

42. For social infrastructure development, education and health receive priority, with 22% of the total allocation. The emphasis on research and investment in higher education and introduction of financial grants for research in physical, life, and mathematical sciences will encourage quality research in these important areas. The promotion of gender parity in primary and secondary education and the decision to appoint the majority of primary teachers from the female candidates will contribute to empowering women and allowing women to play greater roles in, and benefit from, the development process. Attention needs to be given to appointing qualified teachers to raise education quality, and stipends must reach the targeted beneficiaries. The decision to link performance with allocations for salary subventions for nongovernment schools will ensure that the large spending is properly utilized. The allocation for education and technology is increased by 13.5% over the revised FY2007 budget. In the health sector, a 10.3% higher allocation over the revised FY2007 budget is provided, but greater attention needs to be given to improving health service delivery. The decision to involve the private sector in delivering health services through management contracts will improve the quality of health services. Increasing the involvement of nongovernment organizations in population control and prevention of malnutrition and contagious diseases will help to more effectively address the human dimensions of poverty.

Figure 35: Sectoral Shares in Public Expenditure in FY08



### Physical Infrastructure

43. Power supply shortage is the most critical constraint to growth, employment creation, and poverty reduction. Measures adopted to add generation capacity and improve power plant maintenance to bridge the increasing gap between power demand and supply need to be implemented with utmost priority. In the communication sector, a large increase in allocations to road and railway maintenance is made; ensuring efficient and transparent utilization of these allocations is very important, along with attention to the cost and quality of work. The information technology subsector also receives attention in the budget considering its immense importance in disseminating information.

## **Agriculture and Rural Development**

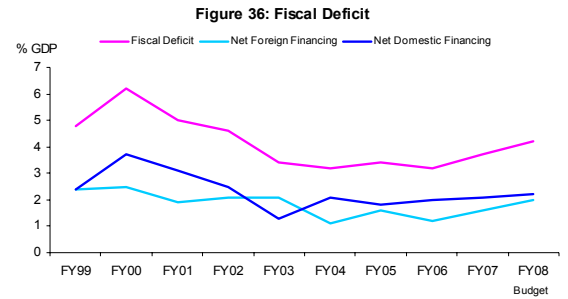
44. The emphasis on agricultural research and development for increasing yield and productivity is well-placed considering the growth and employment generation potential of this sector. The decision to subsidize farmers to offset the effects of increased cost of diesel will provide relief to them, although ensuring that the money reaches the intended beneficiaries will be a challenge. The budget focuses on increasing the fertilizer subsidy and enhancing the target for agricultural credit. The benefits of subsidies must reach small and marginal farmers. Minimizing harassment and irregularities in the provision of credit will be essential. Fisheries and livestock also have major employment and poverty reduction potential and this is addressed in the budget. The priority attached to improving rural communication is important for linking farms and production centers with markets and growth centers.

## **Social Empowerment and Social Safety Net**

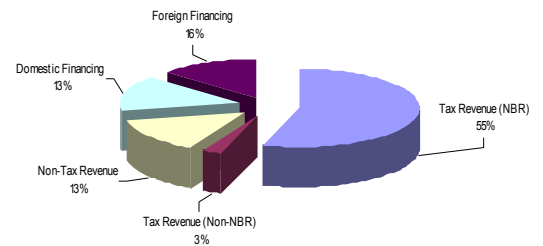
45. The budget seeks to highlight the share of total allocation devoted to gender equality expenditure (direct and indirect), which increases to 24% of the total budget from 22% in FY2007. Initiatives are under way to prepare gender budgeting. A pilot program to reduce maternal and infant mortality by providing an allowance is introduced, which will contribute to safe motherhood for poor mothers. The allowance for widowed and destitute women is increased, and the coverage of the scheme is widened. Allocations are made for microcredit programs to create employment opportunities for women. More funds are allocated for acid-burnt and disabled women, garment workers, stipends for female students, nutrition and vocational training for women, and creation of employment opportunities for destitute women. Increased allocations for child development, freedom fighters' welfare, and rehabilitation of senior citizens and displaced people are included. The budget provides sizable allocations for employment generation in rural areas under the Government's microcredit programs (outside ministry-based programs); these will create significant rural employment in the next fiscal year.

## Fiscal Deficit and its Financing

46. The fiscal deficit projected for FY2008 is 4.2% of GDP, higher than 3.7% in FY2007 (Figure 36). Although the Government assumed the accumulated default loans of BPC (\$1.1 billion) by issuing treasury bonds to the creditor banks, this will not affect the Government's budgetary position or the deficit in the current fiscal year, as no cash payments will be involved. This will also not affect the money supply position (these bonds do not qualify for meeting banks' statutory liquidity ratio). To finance the deficit of 4.2% of GDP, domestic bank and nonbank borrowing will meet the equivalent of 2.2% of GDP, and foreign loans and grants will account for 2% of GDP. Interest payments on domestic and foreign debts will increase from 15.9% of domestic revenue in FY2007 to 18.8% of the projected revenue in FY2008.



**Figure 37: Sources of Financing Public Expenditure in FY08**



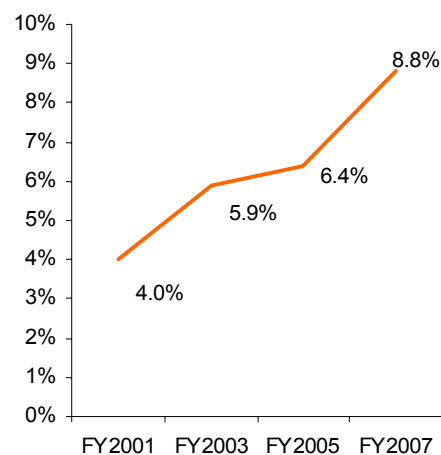
## OVERSEAS WORKERS' REMITTANCES

47. Workers' remittances are funds transferred by migrants working in foreign countries to their home country. Although these funds are often cyclical, they have helped many countries meet their international payment obligations while benefiting the migrants' family members. In Bangladesh, remittances have been a less volatile source of foreign currency compared with exports and foreign aid. Faced with unemployment, underemployment, and low wages at home, Bangladeshi workers have migrated, in large numbers, to countries with more buoyant labor market conditions. Between 1976 and June 2007, about 4.9 million workers went abroad. Cumulative remittances during this period amounted to around \$44.5 billion. From a meager \$848 million in FY1992, remittances rose to about \$6.0 billion or 9% of GDP in FY2007, averaging 20% growth during the last 5 years (Figure 38 and 39). On an average, remittances make up 3.5% of South Asia's GDP. Steady growth in remittances helped the country sustain comfortable external balances. Remittances are higher than the combined flows of FDI and aid disbursements. Increasing access of poor people to remittances fuelled poverty reduction and fostered human development.

### Migrants' Destinations

48. Most of the remittances in Bangladesh are generated from the Middle East, followed by the US, United Kingdom, Malaysia, Germany, and other countries. The boom in oil revenues in the Middle East since the mid-1970s has created many job opportunities for Bangladeshi workers. Between 1976 and June 2007, about 47% of all migrants went to Saudi Arabia, 16% to United Arab Emirates, and 10% to Kuwait. This highlights the dominance of the Middle East as the migrants' destination. About 63% of the remittance flow in FY2007 was generated from the region, although this share declined from a high of 80% in FY2001 because of a gradual rise in migration to other parts of the world. In FY2007, about 29% of the remittances came from Saudi Arabia, followed by 15% each from the US and United Kingdom, 13% from the United Arab Emirates, and 11% from Kuwait. Other Middle East countries contributed about 10%, with the rest of the world including Germany, Japan, and Malaysia contributing the remainder (Figure 40).

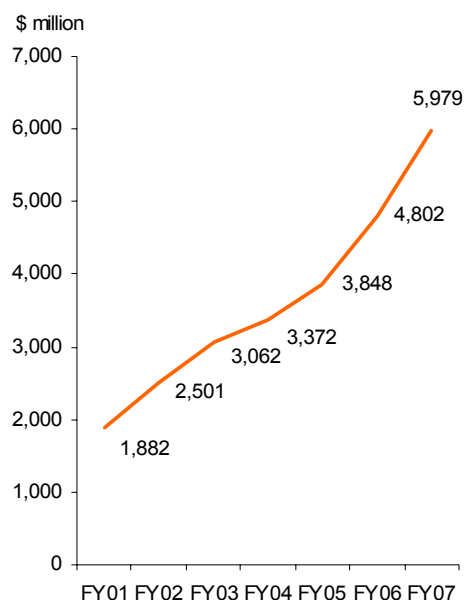
Figure 38. Remittances as % of Bangladesh's GDP



## Effect on Balance of Payments

49. The greater inflow of remittances helped sustain macroeconomic stability by improving the country's current account position, foreign currency reserves, and external debt servicing capability. \$44.5 billion in remittances received since 1976 is higher than \$43 billion of foreign aid received by the country in this period. Unlike foreign loans, remittances are unrequited transfers; and no future repayment liability exists. The country needs significant foreign exchange to import capital machinery, raw materials, and consumer goods, and to service external debt. In FY2006, the ratio of imports to GDP was 21% and exports to GDP 17%, resulting in trade account deficits. But because of strong inflow of remittances, the current account balance showed a surplus of 0.9% of GDP in FY2006. In FY2006, the remittance flows were about 167% of the trade deficit and 46% of merchandise exports. Despite heightened external pressures, continued buoyancy in remittances translated into a strong foreign currency reserve of about \$5.1 billion at the end of FY2007. Robust remittance flows helped reduce the debt service ratio to 4.1% in FY2006 from as high as 6.6% in FY2001. It has enabled the country to maintain balance of payment surpluses for more than 5 years in a row, despite trade imbalances and stagnant FDI.

Figure 39. Annual Remittance Flows to Bangladesh



## Absorption of Oil Price Shocks

50. Remittance receipts in Bangladesh provide a cushion against oil price shocks. Since the majority of its out-of-country workers are in oil-exporting countries, they are likely to earn and send home more when the oil price rises. Empirical evidence suggests a strong positive correlation between oil prices and remittance receipts in Bangladesh.<sup>2</sup> The correlation coefficient of detrended remittances and oil prices is 52%. Statistically significant regression models suggest that a \$1 rise in the oil price leads to \$8 million in additional remittance receipts. This increase in foreign financing helps cushion consumption and investment against permanent increases in the international oil price.

<sup>2</sup> International Monetary Fund (IMF). June 2007. Bangladesh: Selected Issues. IMF Country Report No. 07/230. Dhaka. Available: [www.imf.org](http://www.imf.org).

## Effect on Households

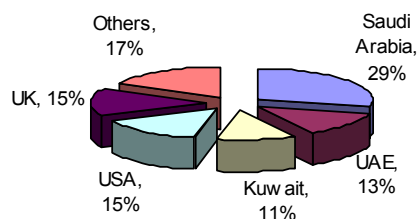
51. Remittances play an important role for households by increasing income and savings, improving the standard of living; and reducing poverty. Households receiving remittances are often among the poorest segment of the population, which makes this an effective buffer against earnings disparity. Poor recipients mainly use remittances to finance subsistence consumption. For many families, remittances constitute an essential source of extra income, allowing them to meet some basic necessities such as health and education; and open up opportunities for households to invest in productive activities or small businesses. This contributes to poverty reduction, both directly through transfers to low-income groups, and indirectly through the effects of remittances on the demand for labor and labor-intensive goods and services. It holds the potential to be a source of finance for developing SMEs in geographically dispersed locations. Most SMEs in Bangladesh still have difficulty obtaining loans from banks and other formal financial institutions, and have to rely on family borrowing for financing. Remittances can play a critical role in partly closing this gap. They can also finance the cost of sending other members of the recipient families for employment abroad.

52. Despite many benefits, remittances have some shortcomings. They often result in rise in consumption and not always in investment. Although remittances are procyclical, causing higher likelihood of consumer price inflation, the relationship between remittances and inflation in Bangladesh is not strong. But as a sizable part of the remittances is used to purchase land, they may lead to increased land prices in small villages with a high concentration of remitters. Farmers and other low-income groups involved in agriculture, livestock, fisheries, horticulture, or similar activities that rely heavily on the availability of land may suffer if a large area of land is owned by a few families. To make the best use of remittances, most needs to be diverted into productive uses such as SME development.

## Incentives

53. The Government has undertaken measures to increase the flow of remittances. Various schemes such as wage earners' development bonds, nonresident foreign currency deposit account, and national savings schemes were introduced to provide incentives to migrant workers to submit remittances. The principal amount of investment in wage earners' development bonds can be repatriated

Figure 40. Remittance Flows to Bangladesh by Country of Origin (FY2007\*)



\*July-May

without restrictions and the interest earned on the bonds is tax exempt in Bangladesh. Interest earned on nonresident foreign currency deposit accounts is also tax exempt, and both interest and principal of this account can be freely repatriated abroad. A nonresident investor's taka account was introduced to facilitate investment in shares and securities by out-of-country workers with their foreign exchange earned abroad. The balance in this account can be repatriated abroad in foreign exchange anytime. The US dollar premium bonds and US dollar investment bonds were introduced for expatriates. These bonds can be purchased against their foreign currency remittance accounts. For the premium bond, the principal is payable in US dollars, while the investment bond pays both principal and interest in dollars. Both bonds feature income tax exemption on capital and interest.

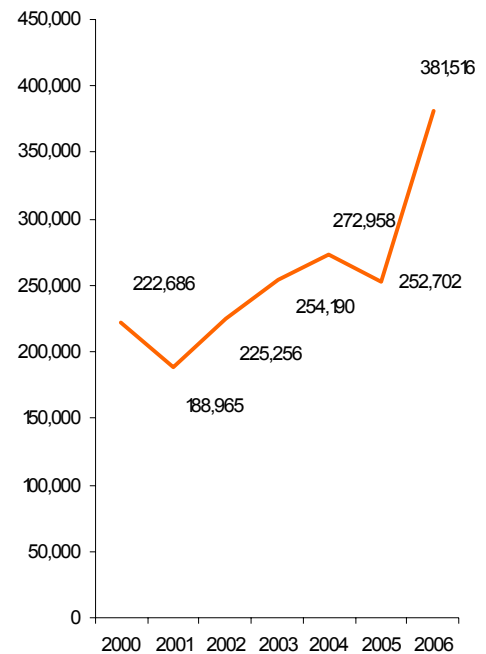
### Recent Surge in Migration

54. More than 381,500 workers migrated for foreign employment in 2006, which was 51% more than in 2005 (figures 41 and 42). About 335,400 left the country during the first half of 2007, an average of more than 1,850 a day. Remittances increased by 25% annually in FY2006 and FY2007, a result of the rise in oil price, some policy actions and improvement in banking, and stringent anti-money-laundering activity worldwide.

55. Bangladesh Bank has taken a number of measures to address bottlenecks in sending remittances through official channels. Steps have been taken to facilitate remittances from the major migrating countries including the US, United Kingdom, Italy, and Middle-Eastern countries through electronic fund transfer systems. Local banks have improved their networks through affiliations with international money transfer agencies and some foreign banks. Foreign remittance monitoring cells have been opened in different banks to track inflows of remittances and address obstacles to the smooth flow of remittances. Actions were also taken against *hundi*, the major unofficial (also illegal) mode of money transfer. Under this system, the hundi operators receive foreign currency from migrant workers, and their relatives receive local currency at home. This deprives the receiving country of the economic benefits of remittance as the foreign currency is likely to remain outside the country.

56. The crackdown on illegal money transfers in the context of the war on terrorism and the anti-money-laundering law, has also led to an increase in the flow of remittances through formal routes. People are now

Figure 41. Annual Labor Migrants from Bangladesh



becoming more cautious about the rules and regulations in the sending countries in fear of funds being frozen or confiscated in suspect of terrorism financing or money laundering.

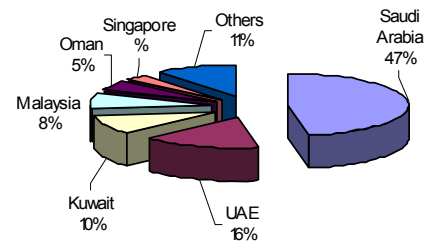
### Hurdles of Official Transfers

57. The remitters encounter numerous problems in sending their remittances through the official channel, especially to remote areas of the country. The process of sending remittances through banks is slower and more cumbersome than with the informal channels. Paper work and documentation requirements are heavy, which the workers find difficult to accomplish. Lack of knowledge of banking procedures is a hindrance, particularly for the less educated; while many recipients do not even have bank accounts. In addition, remittance documents (e.g., drafts and money orders) may get lost in transit. But the process of sending money through informal channels is simpler and quicker; and involves less paperwork. According to various estimates, remittances sent through the official channels constitute only 50% of total remittances including that remitted through hundi. While a week, on average, might be required to receive remittances sent through the banks, most informal channels do not take more than 3 days. The hundi system relies on trust and goodwill; and is efficient. Hundi operators maintain complete secrecy of transactions. The system requires much less documentation, speeding up the whole process. It is also more profitable as the remitters get a premium exchange rate, which is often significantly higher than the official rate. A prime reason why hundi is a thriving activity is the demand for hard currency to finance smuggling and other illegal trade. Despite improvement, the hundi-smuggling nexus still exists; and a large proportion of foreign exchange sent through informal channels supports a sizable illegal trade in goods. It is also believed to be aiding the process of capital flight out of Bangladesh. Absence of investment opportunities, political instability, and inadequate social security is also discouraging the inflow of remittances through the official channels.

### Challenges and Threats

58. Remittances have increased very rapidly during the last decade. If the country can sustain the present pace in migration, remittances will continue to rise. But some challenges exist. The global economic slowdown, particularly in the developed countries and Middle East, may have an adverse impact on labor recruitment from labor-exporting countries. Future economic downswings

Figure 42. Destination of Emigrants from Bangladesh (Cumulative: 1976–June 2007)



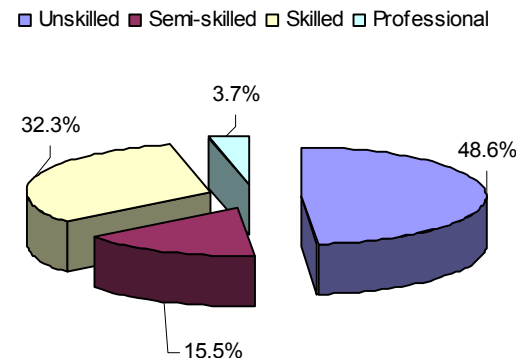
may result in layoffs or depressed wages for low-skill labor. Mostly unskilled and semiskilled laborers migrate from Bangladesh (Figure 43). This type of labor is available in other least developed countries too. Unless Bangladesh can slowly move to exporting skilled labor, a potential threat of losing to other countries always exists.

59. The increase in terrorist activities in some regions has made obtaining visas and entering many countries difficult. A significant slowdown in migration was noticed immediately following the 11 September 2001 terrorist attacks in the US. Any recurrence of a similar event may aggravate the already tense cross-border migration situation, which might affect the high flow of remittances to Bangladesh. The immigration authority needs to put adequate surveillance and monitoring in place to ensure that only genuine migrants/workers leave the country. Bangladesh cannot afford to lose its credibility in the international community because of a few incidents of fraud and inadequate border control. The Government recently decided to decentralize the passport issuing process. This is an encouraging move, and will ease the migration process for the rural population. But surveillance has to remain strong to prevent forgery.

### Improving Inflow of Remittances

60. Efforts need to be mounted to divert the huge amount of remittances channeled through the illegal networks to the official route. Boosting the capacity and efficiency of financial institutions is crucial to direct more funds under the formal network. Banking services in the country should be improved with emphasis on computerization of the banking system, connecting branches through the computer network, and developing an electronic money transfer system. Private commercial banks that are more efficient service providers, but have a limited number of branches in rural areas, need to create a better network in partnership with licensed microfinance institutions or even local post offices to broaden the service area coverage. The increasing volume of remittances processed by private banks is encouraging (Figure 44). The wide network of mobile phone companies can be used as official remittance distribution centers. The six mobile phone companies have numerous kiosks, billing centers, and regional offices nationwide. These outlets, equipped with computers, printers, and Internet access, can be used to channel remittances in rural areas with no bank branches. The Philippines has been a major success in implementing a mobile phone-based remittance distribution system, which can be remodeled in Bangladesh.

**Figure 43. Types of Workers Migrating from Bangladesh (Cumulative: 1976–May 2007)**

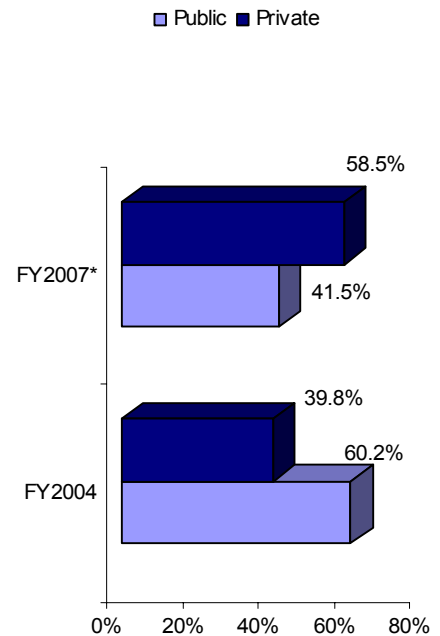


61. The hundi-smuggling network needs to be addressed and dismantled on a priority basis. Since the survival of the hundi system depends to a great extent on the demand for remittance money to finance illegal international transactions, policy actions must focus on reducing incentives for such trade. As long as incentives for smuggling and other illegal transactions in international trade remain, hundi operators will find innovative ways to transfer remittances through informal channels. The market-oriented floating exchange rate system has provided a good incentive for official transfer of remittances, and discouraged illegal trade to a large extent. Increasing public awareness of the benefits of the legal banking system and potential hazards of informal transfers will greatly help those who are unaware. Although international efforts to disarm money laundering have already created much concern among many, others still need to be properly informed.

62. Regulators and financial institutions of source and destination countries need to harmonize their legal and compliance frameworks to enable better functioning of the whole system. Institutional mechanisms should be strengthened to increase labor exports. Workers currently employed abroad need to be helped to retain their jobs and understand the legal and cultural requirements of the country. The new workforce needs to be encouraged to get training and become skilled. More vocational training centers with public-private partnerships need to be in place. To compete with other countries like the PRC, India, and Philippines, Bangladesh needs to focus on exporting more skilled labor.

63. The country can significantly bolster the existing benefits of remittances by making fund transfers easier and cheaper, directing flows from consumption to investments, and shifting the existing informal flows into the formal route. An electronic remittance clearinghouse is urgently needed to ensure standardized remittance instructions among participants in the delivery system. Innovative delivery agents such as courier/postal service, nongovernment organization offices, mobile phone outlets, points of sale, and bank ATM/booths need to be used to compensate for the limited rural banking network. Institutional effectiveness, accountability, and transparency of government organizations involved in out-of-country employment and expatriate welfare need to be strengthened to facilitate safe migration and reduce illegal human trafficking. Policies should also support financial

**Figure 44. Volume of Remittances Processed by Public and Private Banks in Bangladesh**



\*July–January

deepening to provide savings instruments for remittances, such as remittance securitization.

64. To meet the challenges and increase remittances, new avenues of employment need to be explored. Priority should be given to sending more skilled workers to command higher wages. The demand for different types of workers in different countries should be assessed. Many countries have a high demand for workers proficient in welding, electrical works, carpentry, house painting, air-conditioning, refrigeration, and similar work. Some countries need highly skilled professionals, including doctors, nurses, engineers, accountants, and information technology experts. Although getting these jobs may require expensive education and training, the payoffs are high.

### **Conclusion**

65. International migration has enabled millions of Bangladeshi workers to find better employment in other countries. Their remittances have helped the economy by providing a big chunk of foreign financing. They have provided a cushion against some external shocks such as oil price increases. Workers' remittances are a good source of funds and should be fostered through proper policies. But remittances cannot substitute for good macroeconomic policies, and can be vulnerable to political uncertainty and external shocks.

## **About the Asian Development Bank**

The work of the Asian Development Bank (ADB) is aimed at improving the welfare of the people in Asia and the Pacific, particularly the 1.9 billion who live on less than \$2 a day. Despite many success stories, Asia and the Pacific remains home to two thirds of the world's poor. ADB is a multilateral development financial institution owned by 67 members, 48 from the region and 19 from other parts of the globe. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their citizens.

ADB's main instruments for providing help to its developing member countries are policy dialogue, loans, technical assistance, grants, guarantees, and equity investments. ADB's annual lending volume is typically over \$7 billion, with technical assistance usually totaling over \$240 million a year.

ADB's headquarters is in Manila. It has 26 other offices around the world and has more than 2,000 employees from over 50 countries.