Bangladesh

Economic growth and the current account surplus were close to earlier projections as the economy showed resilience in recovering from natural disasters. However, inflation and budgetary pressures grew. The caretaker Government that was appointed when parliamentary elections were postponed in January 2007 has undertaken economic reforms, pursued a marked anticorruption effort, and has pushed through important electoral reforms in preparation for elections expected by end-2008. For FY2009, this *Update* maintains the earlier projection for growth, but expects higher inflation and a somewhat lower current account surplus. Future economic performance will depend on the Government's ability to deepen the economic reforms recently started.

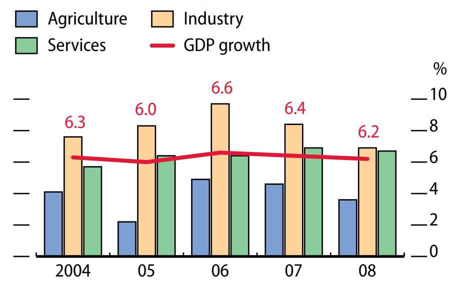
Updated assessment

At an estimated 6.2% in FY2008 (ended June 2008), GDP growth was slightly lower than the preceding year (Figure 3.2.1) but slightly above the projection of 6.0% made in *Asian Development Outlook* (*ADO 2008*) of April this year, which sought to take into account the effects of natural disasters in the first half of the fiscal year. The *aman*, the second most important rice crop, was severely damaged by floods and a cyclone, and its output declined by 10.9% to 9.7 million tons in FY2008 from a year earlier. In the second half of FY2008, agriculture and services performed better than expected and contributed to recovery. Agriculture's full-year growth of 3.6% was mainly due to a bumper *boro* (spring) rice crop helped by good weather and timely government support to farmers.

Services grew by 6.7%, aided by an expansion in transport and storage, in mobile phone services, and in wholesale and retail trade. Industrial growth rebounded in the second half of FY2008, driven by a surge in garment exports and a rise in private sector credit. A slump in garment production and exports in the first half of the fiscal year stemmed from buyers shifting orders to other countries (following labor turmoil in Bangladesh that disrupted shipments in FY2006), and from higher raw material import costs. Full-year industrial growth of 6.9% was lower both than a year earlier (8.4%) and than the *ADO 2008* projection of 8.7%, as the lost ground was not recovered.

Power shortages have increasingly blocked industrial expansion, and therefore the country crucially needs a large expansion in generation capacity, as well as an upgrading of transmission and distribution networks. More immediately, power supply is likely to improve somewhat in FY2009 with several public and private sector projects coming on stream. Industrial growth was also restricted by lower contribution from construction activity as growth fell (to 5.9%) from the prior year on a slowing in private sector investment, the high price of construction

3.2.1 GDP growth by sector



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, June 2008.

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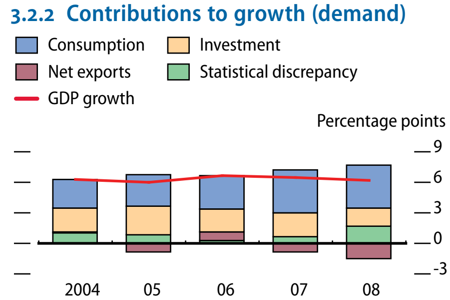
3.2.2 Contributions to growth (demand)



Source: Staff estimates.

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This chapter was written by Mohammad Zahid Hossain of the Bangladesh Resident Mission, ADB, Dhaka.

materials, and a downsizing of the Government's Annual Development Program (ADP).

On the expenditure side, GDP growth stayed largely driven by private consumption (Figure 3.2.2), (about 75% of GDP in FY2008), which rose by 6.0%, only marginally faster than a year earlier despite a sharp gain in workers' remittances. Public consumption as a share of GDP declined slightly. However, preliminary estimates of expenditure included a sizable statistical discrepancy, which if reduced in final data, would provide a more comprehensive accounting of factors affecting growth.

A decline in public investment was pronounced (from 5.5% of GDP to 5.0%), reflecting a deep cut in the ADP. Growth in private investment slowed to 7.5% from 12.2% in FY2007, partly because of lingering uncertainty created by the Government's anticorruption drive. Total fixed investment, as a share of GDP, dipped to 24.2% from 24.5% in FY2007, moderating for the second successive year. Foreign direct investment, which was equivalent to about 3% of fixed investment, also fell. After long negotiations, Tata Group of India abandoned, in July 2008, its $3 billion investment proposal for a package of power, steel, and fertilizer projects in Bangladesh. Declining export volumes of goods and services damped growth more than in the previous year.

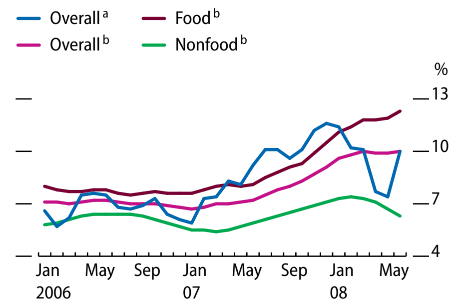
Inflation moved up to 10.0% on a 12-month moving average basis in March 2008 (Figure 3.2.3). Supply-side factors dominated, particularly higher international commodity prices and the shortfall in domestic food grain production (Box 3.2.1). Large spending on flood and cyclone rehabilitation; higher bank credit for agriculture, industry and services; and the rise in demand from the rapid growth in remittances were also factors. In response, among other measures the Government reduced import duties on food items; and for food grain, subsidized sales, lowered the interest rate on import credit, and boosted imports.

In FY2008, Bangladesh Bank, the central bank, continued an accommodative monetary stance permitting strong expansion in credit growth to the private sector. Growth of net credit to the Government rose steadily throughout the year reaching 30.4% in June 2008. Money supply (M2) growth at 17.6% was higher than the Bank's annual program target of 16% and private sector credit grew sharply at 25.2%, higher than the target of 16% (Figure 3.2.4). Private sector credit largely reflected expansions in the areas of transport and communications, working capital, and consumer credit. Bangladesh Bank aimed at ensuring ample bank credit to the private sector to sustain economic growth, while seeking to keep demand-side pressures broadly in check. It relied on open-market operations, keeping reserve requirements, the liquidity ratio, and the main policy rate (reverse repurchase) unchanged.

Yields on treasury bills rose marginally over the year and banks' weighted average lending rate declined from 12.7% in March 2008 to 12.3% in June 2008, staying positive in real terms (Figure 3.2.5). The weighted average deposit rate of 7.0% remained negative in real terms and the interest spread between lending and deposit rates of the banking system remained high at 5.3 percentage points, reflecting the sector's high administrative costs, institutional inefficiencies, and the burden of nonperforming loans.

Revenue collection in FY2008 jumped to 11.2% of GDP, or

3.2.3 Change in consumer price index and components



a Year on year. b 12-month moving average.

Source: Bangladesh Bank, *Economic Trends*, available: http://www.bangladesh-bank.org, downloaded 15 August 2008.

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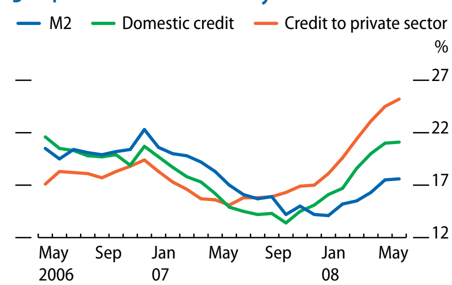
3.2.4 Growth of monetary indicators



Source: Bangladesh Bank, *Economic Trends*, available: http://www.bangladesh-bank.org, downloaded 15 August 2008.

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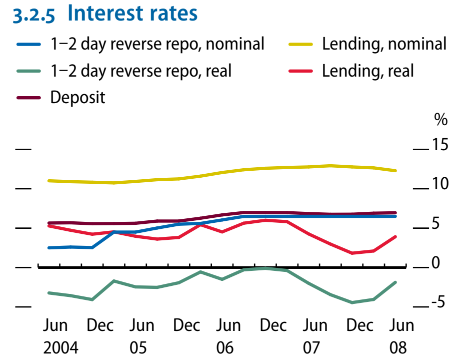
3.2.5 Interest rates



Source: Bangladesh Bank, *Economic Trends and Major Economic Indicators: Monthly Update*, July 2008, available: http://www.bangladesh-bank.org.

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1.0 percentage point of GDP higher than in FY2007. Nevertheless, the revenue-to-GDP ratio remains low, even compared with other South Asian countries, and it continues to constrain a non-inflationary expansion in spending on areas such as infrastructure, which is needed to sustain solid growth. Further reforms in value-added tax (VAT) and income tax laws, simplifying tax procedures, and modernizing tax administration will be needed to mobilize greater revenues.

The good performance in FY2008 resulted from reform-oriented interventions such as identifying large taxpayers, promoting voluntary compliance through creating social awareness, intensive monitoring of tax collection, and one-time measures such as opportunities for declaring legally earned undisclosed income (which started in June 2007). In the FY2009 budget, the opportunity for declaring undeclared legal income has been extended up to 31 October 2008.

On the expenditure side in FY2008—and despite the cut in the ADP—added spending for relief and reconstruction stemming from the natural disasters, expanded safety net programs to counter the impact of the sharp jump in the price of rice, and higher subsidies for fuel and fertilizer raised public spending to 15.9% of GDP, or about 1.2 percentage points higher than had been budgeted. This resulted in the widening of the fiscal deficit to 4.7% from 4.2% originally projected (both excluding assumption of state-owned enterprise [SOE] debt discussed below). Domestic financing of the deficit was 2.3% of GDP (slightly over half from banks) and foreign financing 2.4% of GDP. As ADP downsizing over the past few years has also been due to a lack of implementation capacity, overcoming this constraint as well as boosting domestic revenues will be required to stimulate infrastructure development.

In FY2008, the net losses of all 44 non-financial SOEs more than doubled to an estimated $769.2 million or about 1% of GDP, primarily reflecting administered prices of products and services, especially fuel, power, and fertilizer (the three SOEs with the largest losses are shown in Figure 3.2.6). Fuel prices were raised in July 2008 (Box 3.2.2), which will help limit Bangladesh Petroleum Corporation losses. But the Bangladesh Power Development Board losses are rising unabated, as no power tariff adjustments have been made since 2007. In April 2008, the Government nearly doubled the prices of natural gas and urea fertilizer; the latter will help limit, to a degree, the losses at Bangladesh Chemical Industries Corporation.

From FY2008, the Government started providing some cash subsidies to SOEs to partly reimburse them for their losses. However, the SOEs' losses will still result in a growing fiscal burden unless the principle of setting cost-reflective prices for fuel, fertilizer, and electricity is adopted.

The trade deficit widened by about 60% in FY2008 to an estimated $5.5 billion, as the import bill rose much more than export earnings. In the first 7 months of the year, exports showed single-digit growth but rebounded strongly during the remainder of the year posting full-year 15.9% growth, driven by a rise in knitwear exports (Figure 3.2.7). Imports grew by 26.1%, showing a steep rise in the imports of food grains (mainly rice and wheat), other food items, and fertilizer. The robust growth in workers' remittances (of about one third, to $7.9 billion) offset the higher

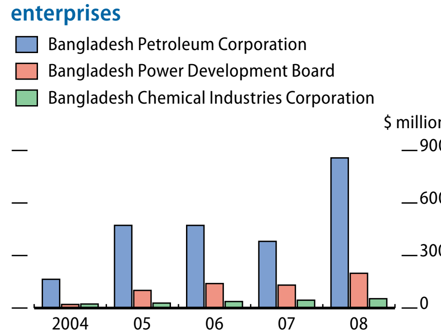
3.2.1 Impact of food price increases

Failure to contain Bangladesh's substantial food inflation could deepen the hardship of the poor and seriously undermine macroeconomic and political stability of the country.

Although the market availability of food grains in FY2008 was higher than needs, high prices—rice and wheat were up by about 50–60% in FY2008—hindered food security for all. The international donor community has, though, agreed to provide a sizable sum in emergency food financing to Bangladesh.

Over the short term, the Government will focus on targeted interventions for protecting the poor and vulnerable from rising food prices. In the medium to longer term, it should aim to improve productivity (by, for example, disseminating modern production technologies; developing rural infrastructure, especially irrigation; and ensuring rural financial services).

3.2.6 Losses at selected state-owned enterprises



Note: 2008 fiscal year figure is as of May 2008.

Source: Ministry of Finance, *Bangladesh Economic Review 2008.*

Click here for figure data

3.2.2 Fuel price increases

The limited adjustments in administered prices for oil products have resulted in increasing, substantial fiscal and quasi-fiscal costs to the Government in recent years. The bill for oil, all of which is imported, rose by 54.7% to $3.2 billion in FY2008, widening the trade deficit (although by volume, oil imports declined by 12.7%, from 3.8 million tons to 3.3 million tons). The import bill is projected to rise by 23.6% in FY2009 relative to FY2008.

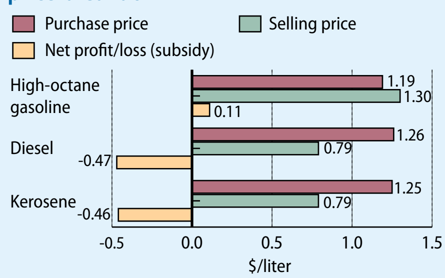
In FY2008, the Government assumed accumulated liabilities of $1.1 billion of Bangladesh Petroleum Corporation (BPC) owing to losses made in prior years. It also began providing a cash subsidy to BPC in the FY2008 budget of $775 million to cover its estimated loss for the year, and $885 million for FY2009.

The Government raised fuel prices by 34–50% from 1 July 2008, sharply cutting subsidies. This will cut BPC losses, but an international price of oil above $100 a barrel will still generate large losses. After the price hike, based on the average domestic and international prices for July 2008, the implicit subsidy for diesel is $0.47 a liter and that for kerosene $0.46 a liter (Box figure).

In the case of octane, there will be a small profit. The increase in prices will boost inflation through raising transportation costs, but will also lead to an adjustment in consumption and help check smuggling of petroleum products to neighboring countries.

The still-high fuel subsidy results in lower spending on social and physical infrastructure, thus undermining the country's long-term growth potential. The Government should consider adopting a market-based automatic price adjustment mechanism that reflects international prices, which would promote energy efficiency. Targeted support should be provided to the poor (rather than general subsidies).

Bangladesh Petroleum Corporation's fuel price breakdown



Note: Figures are based on average fuel price in the international market as of July 2008.

Source: Ministry of Energy and Mineral Resources.

Click here for figure data

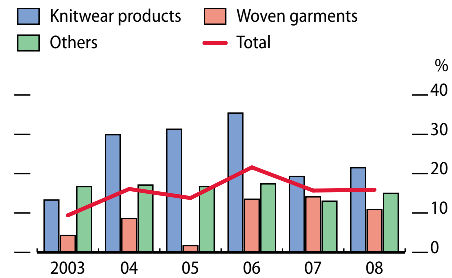
trade deficit and provided for a moderate (estimated) current account surplus of $0.7 billion, or 0.9% of GDP.

The capital account surplus fell to $145 million from $1.3 billion in FY2007, mainly because of sizable net outflows in other short-term loans and trade credit. On 30 June 2008, foreign exchange reserves amounted to $6.1 billion, rising by $1.1 billion during the fiscal year, partly reflecting the increase in liabilities of Bangladesh Bank (Figure 3.2.8).

In FY2008, the foreign exchange market remained largely stable, with the taka appreciating by about 0.5% against the US dollar (Figure 3.2.9). In FY2008 the real effective exchange rate depreciated by about 3%, mainly due to higher relative domestic inflation.

The Dhaka Stock Exchange general index rose by 39.6% in FY2008 (Figure 3.2.10). The market capitalization-to GDP-ratio reached 18% in June 2008, up from 10% a year earlier, bolstered by 12 IPOs. But, as investors still must largely depend on bank financing, further strengthening of the capital market is needed.

3.2.7 Growth in exports and components



Source: Bangladesh Bank, *Annual Report* and *Major Economic Indicators: Monthly Update,* available: www.bangladesh-bank.org; both downloaded 17 July 2008.

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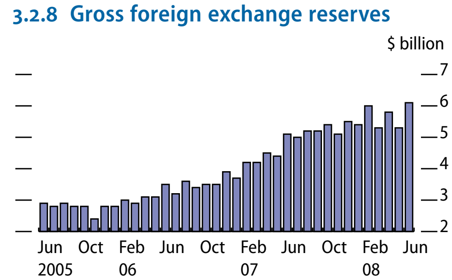
3.2.8 Gross foreign exchange reserves



Source: Bangladesh Bank, *Major Economic Indicators: Monthly Update,* July 2008, available: http://www.bangladesh-bank.org.

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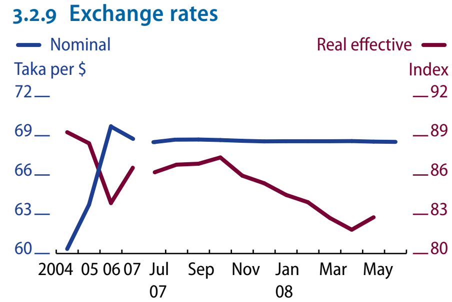
3.2.9 Exchange rates



Source: Bangladesh Bank, *Major Economic Indicators: Monthly Update,* July 2008, available: http://www.bangladesh-bank.org.

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Prospects

The FY2009 forecasts are based on several fundamental assumptions. Despite the uncertainty in the lead-up to the planned December 2008 election and its outcome, it is assumed that a smooth transition between governments will be seen. Moreover, it is assumed that the authorities, before and after the transition, will be able to maintain macroeconomic stability (with an emphasis on controlling inflation), to adjust policies for successfully managing the impact of higher commodity prices, to adopt measures for accelerating ADP implementation, and to encourage higher private investment. A final assumption is that adequate external assistance will continue to support public spending for infrastructure and social sector programs.

GDP growth is forecast at 6.5% in FY2009, the same level as in *ADO 2008*, and slightly higher than the 6.2% outturn in FY2008. Agriculture is expected to grow at 4.0% assuming normal weather, farmers responding to higher market and government procurement prices, and continuation of government programs for inputs, credit, and extension services.

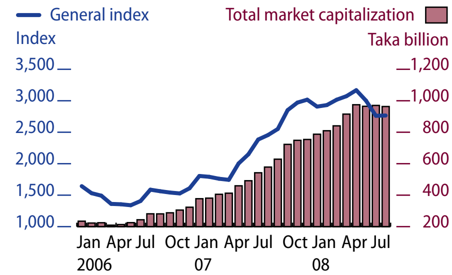
Industry is expected to pick up with further strengthening in business confidence, moving back toward the higher growth path seen in FY2005 to FY2007. For FY2009, industry is expected to post 7.9% growth, reflecting higher growth in export-oriented manufacturing such as garments and textiles, expansion in small and medium enterprises and light engineering, and growth in relatively new sectors such as shipbuilding, which has emerged as a promising export industry in recent years. Services are forecast to grow by 6.8%, slightly faster than FY2008, in step with the pickup in agriculture and manufacturing. Domestic demand expansion will be underpinned by higher consumer spending, aided by growing workers' remittances and strengthening investment spending.

The FY2009 budget adopts an expansionary stance, seeking both to accelerate growth and to protect the poor from the effects of rising prices for food, fuel, and fertilizer. To boost production and investment, it has reduced income tax and import duty rates and has raised the sales threshold for VAT on smaller enterprises. It also provides various tax incentives to stimulate business activity and investment.

On the expenditure side, the budget has expanded safety net programs and introduced new programs with large allocations for a job creation program for the poor. In fact, it earmarks nearly three fifths of spending for direct and indirect poverty reduction activities. It boosted allocations for food subsidies substantially and continued cash incentives for exports. It also significantly raised special development assistance to regions in extreme poverty to address regional disparities in growth and income distribution. To assist farmers in dealing with higher prices for fuel and fertilizer, the budget raised subsidies on these items in an effort to boost food production. Guided by past trends in underutilization, the ADP has been trimmed further.

In FY2009, revenue is projected to decline to 11.1% of GDP from the 11.2% in FY2008, as new tax incentives offset the intensified collection efforts begun in FY2008. Public spending at 16% of GDP will be slightly higher, resulting in a marginally higher deficit of 4.9% of GDP

3.2.10 Dhaka Stock Exchange indicators



Source: Bangladesh Bank, *Major Economic Indicators: Monthly Update,* July 2008, available: http://www.bangladesh-bank.org.

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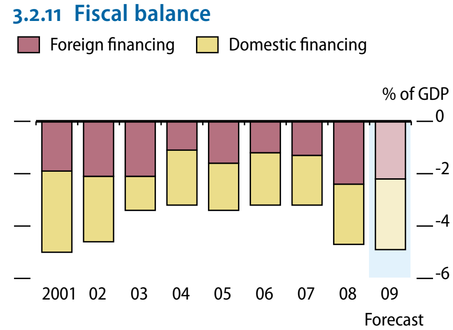
3.2.1 Selected economic indicators (%)

	2008		2009	
	ADO 2008	*Update*	*ADO 2008*	*Update*
GDP growth	6.0	6.2	6.5	6.5
Inflation	9.0	9.9	8.0	9.0
Current acct. bal. (share of GDP)	0.7	0.9	1.0	0.5

Source: Staff estimates.

3.2.11 Fiscal balance



Source: Asian Development Outlook database.

Click here for figure data

(Figure 3.2.11). Foreign financing is 2.2% and domestic financing is 2.7% of GDP, with about four fifths from bank sources. Reaching the FY2009 revenue target will likely be a challenge, partly because several contributors to the jump in FY2008 revenue collection, such as taxing legally earned undisclosed income and special drives for collecting income tax and arrears, could be of a one-time nature.

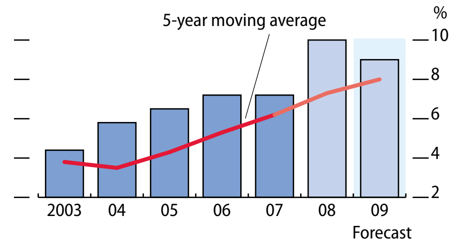
This *Update* raises the average inflation projection for FY2009 to 9.0% (from 8.0% in *ADO 2008*), though improved from the 9.9% outcome in FY2008 (Figure 3.2.12). The projection takes into account the likely effects of the July 2008 domestic oil price rise but assumes no further price adjustments. The Monetary Policy Statement of Bangladesh Bank stresses that an accommodative credit policy will stimulate production of essential food and other basic consumer items and thus will soften inflation pressures.

Substantial risks are involved in this supply-side approach to stabilizing the economy as its first-round effects of expanding credit without a quick or substantial supply response could trigger higher inflation. There are also risks that policies and assumptions could be upset by higher than expected prices for international commodities and misjudgment about the second-round effects of the July 2008 fuel price hike. The central bank may need to raise interest rates to anchor inflation expectations and keep second-round effects under control.

Imports are expected to grow by 21% with higher bills for oil, food grain, and other raw materials, while exports are expected to grow by 16.5% mainly owing to stronger growth in knitwear and garments. The larger trade deficit is expected to be offset by higher remittances, resulting in a continued moderate current account surplus of 0.5% of GDP (Figure 3.2.13). Although the US safeguard quota on the PRC is set to expire at the end of this year, the appreciating yuan and the PRC's move out of the low-end of the garment market could allow fast export growth for Bangladesh given its sound track record in this market segment. Yet in the face of rising labor and raw material costs, garment producers need guaranteed access to electricity and programs to address labor shortages, especially at the supervisory and mid-management levels, to retain their competitiveness.

Several risks facing the economic outlook could undermine the projections, including higher than assumed oil and commodity prices (stressing the balance-of-payments and fiscal positions), a budget revenue shortfall, lack of a supply response by farmers, and greater than expected shortages in power and gas (affecting investment and growth). Political disruptions in the runup to the parliamentary election and their outcome are a major risk. Natural disasters are a perennial risk.

3.2.12 Inflation



Sources: Bangladesh Bank, *Economic Trends*, Table VIII; available: http://www.bangladesh-bank.org; staff estimates.

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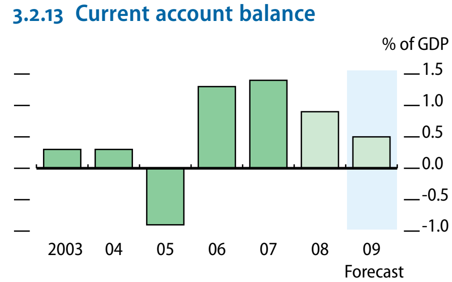
3.2.13 Current account balance



Sources: Bangladesh Bank, *Annual Report 2006–2007*, Appendix-2, Table II, available: http://www.bangladesh-bank.org; staff estimates.

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