Bangladesh

Natural disasters have worsened growth and inflation indicators, but the uncertainty created among investors by the caretaker Government's anticorruption drive has started to ease. In macroeconomic management, the major goal is to curb inflation, which has been lifted by higher international prices and a domestic foodgrain shortfall. Sustaining higher growth and reducing poverty require, among other elements, large investments in physical infrastructure, especially power and transport.

Economic performance

Still robust, GDP growth in FY2007 (ended June 2007) decelerated to 6.5%, largely reflecting agriculture's moderation from the postflood outturn of the previous year (Figure 3.15.1). It was underpinned by steady expansion in manufacturing and continued buoyancy in services, on the base of rising domestic and external demand. Rapid growth in manufacturing and foreign trade aided services.

On the demand side, private consumption was the main driver of growth, bolstered by strong remittance inflows. At 24.3% of GDP, investment during FY2007 was marginally lower than in the immediate past, mainly due to a decline in public investment following a downsizing of the annual development program. Net exports of goods and services remained negative.

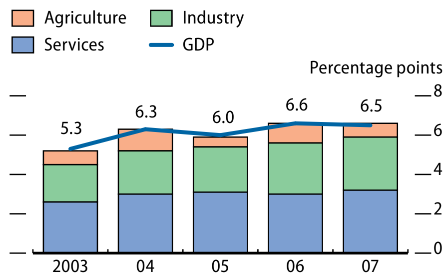
Inflation averaged 7.2% in FY2007 owing to rises in both food and nonfood prices (Figure 3.15.2). Domestic demand pressures on the back of higher incomes and strong monetary and credit growth were among the main causes. After June, however, escalating international commodity prices, especially for food, were dominant, taking inflation to 11.4% (year on year) in January 2008.

Reflecting the uncertainty created by the January 2007 declaration of a state of emergency and installation of a new caretaker Government, growth in monetary aggregates crawled downward in the second half of FY2007. Year-on-year growth in broad money fell from 22.3% in December 2006 to 17.0% in June 2007 (Figure 3.15.3), though still above Bangladesh Bank's target of 14.7%. Growth in credit to the private sector followed a similar trajectory, from 19.4% to 15.1%, and while this tended to relieve demand-side pressures, it led to some problems on the supply side, including curtailed imports and shortages of some products.

The central bank made no changes to policy rates and reserve requirements in FY2007. The weighted average yield of 28-day Treasury bills and the reverse repo rates for 1–2 day maturity remained unchanged. Nor was there much movement in weighted average lending rates, which stood at 12.8% at end-June 2007. The weighted average deposit rate of 6.9%

This chapter was written by Rezaul Khan of the Bangladesh Resident Mission, ADB, Dhaka.

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, June 2007.

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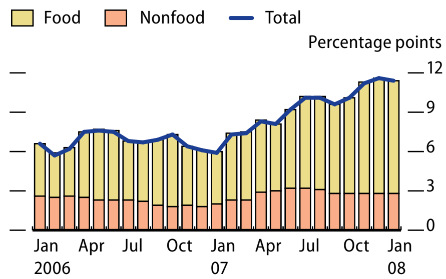
3.15.2 Contributions to inflation



Source: Bangladesh Bureau of Statistics.

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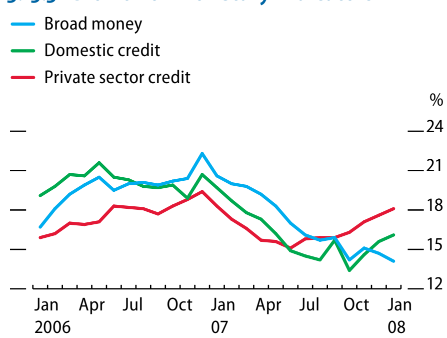
3.15.3 Growth of monetary indicators



Source: Bangladesh Bank, *Economic Trends*, available: www.bangladesh-bank.org, downloaded 17 March 2008.

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was negative in real terms while the interest spread of the banking system remained high at 5.9% reflecting banking's high nonperforming loans, inefficiencies, and market segmentation.

The downward pressure on the nominal exchange rate of the taka to the United States (US) dollar has subsided since April 2006 due to a strengthening capital account and a buildup of foreign exchange reserves. In fact, the taka appreciated by 1.3% against the dollar in the year to end-June 2007.

In FY2007, revenue collection slipped to 10.3% of GDP from 10.7% in the previous year (Figure 3.15.4). Despite an increase in current expenditures, total spending was contained by a reduction in outlays for the annual development program (which undermines public investment though). As a result, the fiscal deficit stayed at 3.2% of GDP.

In recent years, the low tax-to-GDP ratio has shown little improvement, despite efforts to upgrade tax administration, including the introduction of a large taxpayers' unit. This lack of buoyancy is attributed to fundamental structural problems, including extensive tax incentives and exemptions. Comprehensive reform of the system is required to lift the tax ratio meaningfully.

Exports grew by 15.8%, driven by robust performance in garments. Woven garments and knitwear still dominated, with a 75.6% share in total exports. Imports grew by 16.6%. The rise in the trade deficit was outweighed by a surge in workers' remittances of 24.5%, leading to a surplus of $952 million or 1.4% of GDP (Figure 3.15.5). A large surplus in the capital and financial accounts (including a sizable negative errors and omissions item) further raised the surplus in the overall balance to $1.5 billion. This boosted foreign exchange reserves to $5.1 billion at end-June 2007 (Figure 3.15.6).

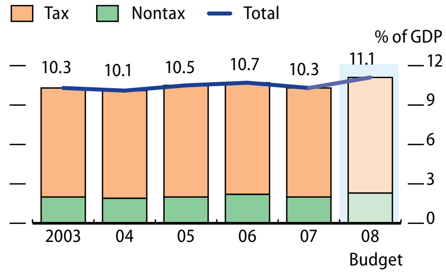
Based on a recent joint World Bank–International Monetary Fund debt-sustainability analysis, the risk of external debt distress is low, and that of total public debt distress (i.e., domestic plus external) is moderate. Total central government debt in FY2007 was 45.9% of GDP, a 3.1 percentage point decline from FY2003 owing to a 3.6 percentage point fall in external debt. Because of continued strong performance in exports and workers' remittances, the external debt service ratio amounted to just 3.6% of foreign exchange earnings in FY2007.

Even though banks' performance has improved a little in recent years, with strengthened regulation and supervision, their gross nonperforming loans remained high at 13.2% at end-December 2007. Restructuring and divestiture of four nationalized commercial banks has proceeded slowly, and the sale of Rupali Bank (one of the four) has been canceled. The remaining three have been transformed into public limited companies and their financial performance has improved.

Debt management was separated from monetary management in 2007, enabling the central bank to conduct open-market operations purely to manage monetary aggregates without considering government financing needs. An act was passed to improve the efficiency of the banking system; it includes provision for raising banks' minimum capital requirement to Tk2 billion.

The Dhaka Stock Exchange surged by 64% in the year to end-February 2008 (Figure 3.15.7), led by banking, power, and pharmaceutical

3.15.4 Government revenues



Sources: Ministry of Finance, *Budget in Brief 2007–08*, available: www.mof.gov.bd; International Monetary Fund, *Bangladesh Country Report No. 07/234*, available: www.imf.org; World Bank, *Bangladesh PRSP Forum Economic Update* November 2005, available: www.worldbank.org; all downloaded 5 February 2008.

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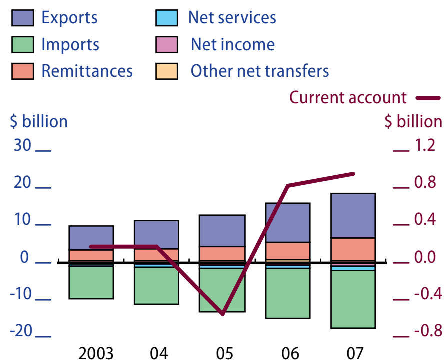
3.15.5 Components of the current account balance



Source: Bangladesh Bank, *Annual Report*, available: www.bangladesh-bank.org, downloaded 22 February 2008.

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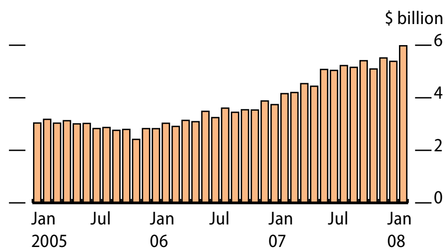
3.15.6 Gross foreign exchange reserves



Source: Bangladesh Bank, *Economic Data*, available: www.bangladesh-bank.org, downloaded 17 March 2008.

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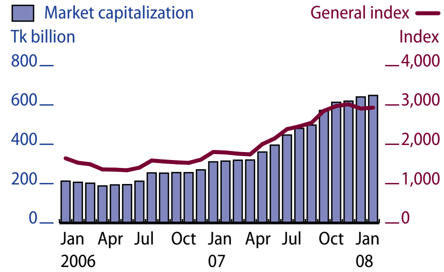
shares. In the same period market capitalization more than doubled to Tk648.3 billion. While greater activity is welcome, strong demand in the face of a limited supply of stocks may push prices too high. Deficiency in financial disclosure, weak corporate governance, and lack of investor confidence in fixed-income securities are deterring the growth of a vibrant capital market.

3.15.7 Dhaka Stock Exchange indicators



Source: CEIC Data Company Ltd., downloaded 10 March 2008.

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Economic prospects

The forecasts for FY2008 and FY2009 rest on several country-specific assumptions. The most important is that the caretaker Government will take measures to further boost business confidence. It is assumed that substantial external assistance will be available to cushion the flood and cyclone effects on economic growth, inflation, and external and domestic balances (Box 3.15.1).

It is also assumed that the authorities will pursue well-coordinated fiscal, monetary, and exchange rate policies with a focus on curbing inflation and raising revenues. A final assumption is that the Government will at least partly rationalize fuel prices.

Based on the above assumptions, GDP growth is forecast to decline slightly to 6.0% in FY2008. The deceleration is attributed to the erosion of business confidence and the effects of the natural disasters. GDP growth in FY2009 is forecast to improve to 6.5% due to strengthening in external and domestic demand and, assuming normal weather, some recovery in agriculture. Strong remittance inflows are expected to continue to buoy consumer spending.

The caretaker Government (appointed in January 2007) has generally enjoyed widespread public support for its anticorruption campaign, measures for strengthening due electoral process, and reinvigorating stalled economic reforms, but the extensive campaign has caused some fear and uncertainty within the business and investor community. The Government has recognized the problem and is undertaking several measures, among others to safeguard from investigation those firms that follow “better practices.” A Better Business forum was set up to facilitate systematic feedback from the private sector on major issues affecting its development. It also set up a commission to streamline the regulatory and legal framework that governs business conduct. This has started to lift business confidence.

Industrial expansion in the 2 forecast years will depend heavily on a strengthening of export-oriented manufacturing and of business confidence. Growth in production and exports of garments and knitwear, the industrial mainstays, came in weak in the first 7 months of FY2008, with exports growing by only 9.9%, or well below the 21.2% gain for the year-earlier period (Figure 3.15.8). A combination of factors was responsible: very weak demand from the US, some buyers shifting to other countries because labor turmoil in Bangladesh disrupted their shipments in FY2006, and higher raw materials import costs. The price increases were especially important for woven garments, which (unlike knitwear) have few domestic backward linkages. Such increases not only raise costs but also make it harder for woven garments to meet domestic content requirements to qualify for low tariff rates in importing countries

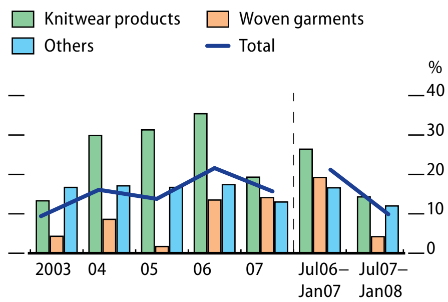
3.15.1 Natural disasters

In the span of a few months in the first half of FY2008, two devastating floods and a cyclone, as well as a tidal wave, hit the country. The combined loss is estimated at $2.8 billion, or equal to about 4% of GDP.

The disasters heavily disrupted agriculture by affecting crops, livestock, poultry, and fish farms. The estimate of *aman* rice production (harvested in November–January) is for a crop of 9.6 million tons, 1.2 millions tons lower than the preceding year. The effect of this on agricultural growth, as well food availability and cost, will be substantial unless the loss is offset by a bumper *boro* crop (harvested in April–May).

The Government has striven to boost *boro* rice production by ensuring adequate supplies of agricultural inputs such as credit, diesel, fertilizer, and seeds to farmers. It has also tried to protect the poultry sector, which has been hit by a widespread outbreak of avian influenza.

3.15.8 Growth in exports and components



Source: Bangladesh Export Promotion Bureau.

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under the Generalized System of Preferences. Woven garments have shown modest growth in the first 7 months of FY2008.

Though the garment subsector's order books are reported to be full for the remainder of the fiscal year, the lost ground cannot be fully recovered and this will be a drag on industry sector growth for the year. However, large expenditures for rehabilitation will boost construction output and be partly offsetting. Nevertheless, industry growth in FY2008 will likely slow to 8.7%. Agricultural growth, for its part, is likely to fall to 2.4% this fiscal year.

A continuation of strong remittance-driven consumption expenditure as well as a revival in bank advances to importers and the transport, communication, and trade subsectors indicate that services will continue to show strong growth at just over 6%, though somewhat below the rate of FY2007.

In FY2008, inflation is projected to rise to 9.0% before moderating to 8.0% in FY2009 (Figure 3.15.9). It has trended up so far in FY2008, to a 12-month average of 9.6% in January 2008 with food inflation rising to 11.1% and nonfood inflation to 7.3%. Higher international commodity prices, especially for foodgrains and oil, the domestic foodgrain shortfall, as well as the lagged effects of higher than programmed monetary expansion are pushing inflation higher. The Government has tackled the shortcomings of domestic supply by, for example, cutting import duty on food items, raising foodgrain imports, and launching an extensive flood and cyclone recovery program for crop production. Their impact should be felt in the latter part of FY2008. It has also widened social safety net programs.

The monetary policy statement (MPS) announced by the Bangladesh Bank in January this year projects inflation at 8.0–8.2% in FY2008 and stressed that rising inflation is attributed more to supply constraints than to significant demand pressures because banks continue to hold substantial excess liquidity. The MPS underscores the need for stimulating economic activity by encouraging adequate credit flows to all productive sectors including imports, especially for recouping the losses caused by the natural disasters.

Strong growth in overseas workers' remittances continues to provide a cushion to the external balance. Despite a higher trade deficit, the current account balance is projected to show a surplus of 0.7% of GDP in FY2008 and 1.0% of GDP in FY2009 (Figure 3.15.10).

Export growth during the first 7 months of FY2008 was only 9.9%. With recent strengthening and a better outlook for garment exports, growth in total exports is projected to reach 12.0% in FY2008—still lower than the rate of the preceding year. Imports in the first half of FY2008 rose by 15.9%. Higher import prices for foodgrains and fuel are boosting import growth, which is projected at 20.0% for the full year.

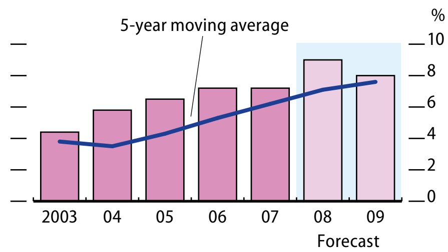
Data in the first half of FY2008 are consistent with the projected annual outcome. Despite a surge in the trade deficit, a sharp rise in current transfers, particularly workers' remittances, resulted in a surplus of $287 million in the current account. Higher net foreign aid helped strengthen the overall balance-of-payments surplus and official foreign exchange reserves increased by $437 million to $5.5 billion at end-

3.15.1 Selected economic indicators

	2008	2009
GDP growth	6.0	6.5
Inflation	9.0	8.0
Current account balance (% of GDP)	0.7	1.0

Source: Staff estimates.

3.15.9 Inflation



Sources: Bangladesh Bank, *Economic Trends*, available: www.bangladesh-bank.org, downloaded 17 March 2008; staff estimates.

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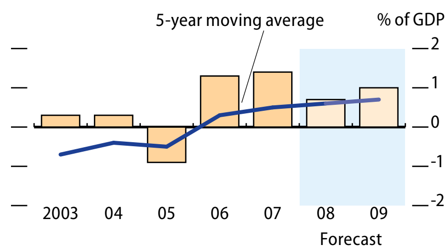
3.15.10 Current account balance



Sources: Bangladesh Bank, *Economic Trends*, available: www.bangladesh-bank.org, downloaded 17 March 2008; staff estimates.

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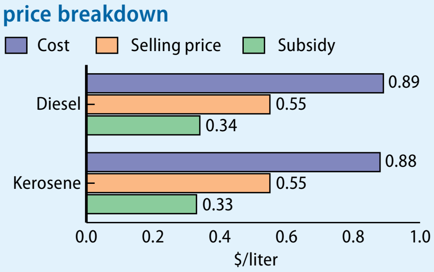
3.15.2 Administered prices

Administered prices of fuel and fertilizer are a substantial fiscal and quasi-fiscal cost to the Government. In the budget for FY2008, it has assumed liabilities of Bangladesh Petroleum Corporation (BPC) amounting to $1.1 billion and allocated the same amount in the budget as non-cashable bonds exchanged with BPC's creditor banks. In February 2008, BPC's current liabilities to domestic and international banks were estimated at about $1.3 billion. If BPC fails to meet these obligations, the Government is liable for them.

In April 2007, the Government raised prices by about 21% for diesel and kerosene, and about 16% for premium and regular gasoline. Even after this adjustment, the implicit subsidy for diesel and kerosene remained high: using the average domestic and international prices of the two products for January 2008, it is estimated at $1.2 billion, or 1.6% of GDP in FY2008. The implicit subsidy for diesel is $0.34 a liter and that for kerosene $0.33 a liter (Box figure 1).

1 Bangladesh Petroleum Corporation fuel price breakdown



Note: Based on average fuel prices in the international market as of January 2008.

Sources: Bangladesh Petroleum Corporation; Ministry of Energy and Mineral Resources.

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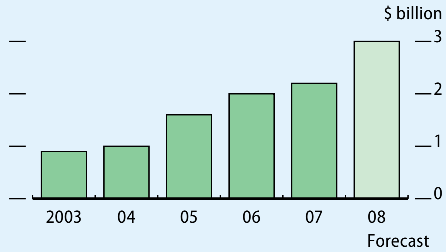
The Government has attempted to reduce the oil import bill by, among other steps, encouraging vehicles to use locally available compressed natural gas. The number of vehicles using this fuel rose to 123,573 by 30 November 2007. Consumption of oil marginally declined to 3.6 million tons in FY2007 from 3.8 million tons a year earlier. The oil import bill is projected to rise by 36% in FY2008 (Box figure 2).

2 Oil import bill



Sources: Bangladesh Bank, *Economic Trends*, available: www.bangladesh-bank.org, downloaded 5 February 2008; staff estimates.

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The fertilizer subsidy is also inducing fiscal pressure due to the sharp rise in international urea prices. The Government is selling urea at $77 a ton compared with its import cost of $370 a ton, implying a subsidy in FY2008 estimated at $400 million, as against $172 million in the preceding year.

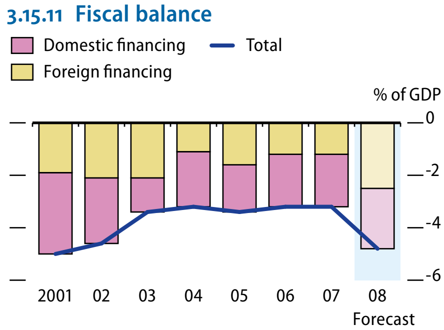
Continuing these high subsidies will undermine the domestic and external balances, resulting in reduced expenditures on social and physical infrastructure, thus markedly curtailing long-term growth. Funding subsidies through bank borrowing is much more inflationary than passing on international market price increases to domestic consumers. The hardships of the poor arising from any withdrawal of subsidies need to be carefully assessed against the likely macroeconomic imbalances of continuing subsidies. If the subsidies are scrapped, targeting mechanisms are needed, but in practice these are difficult to implement. To offset the impact of price adjustments on farmers and the poor, straight cash transfers through social safety net programs from the budget is often a better method.

December 2007 and, lifted by further foreign aid, to $6.0 billion at end-February 2008.

Government revenues were highly buoyant, rising by 25.9% in July–January FY2008 compared with the same period of FY2007. The caretaker Government's drive to raise coverage of taxpayers and bringing undisclosed income under the tax net were important factors in this. But spending prompted by the floods and cyclone, and a rise in subsidies (Box 3.15.2) following the increases in oil and fertilizer prices in international markets is amplifying spending and fiscal pressures. For FY2008 the budget deficit is likely to be pushed up to 4.8% of GDP (Figure 3.15.11).

The economic outlook faces several downside risks that could derail

3.15.11 Fiscal balance



Sources: Asian Development Outlook database; staff estimates.

Click here for figure data

projections. The main risk is political developments in the leadup to the general elections scheduled to be held by end-2008, and their outcome. Growing infrastructure constraints, including worsening power shortages, could deter investment and crimp growth. The expiry of the European Union and United States safeguard quotas on the PRC at the end of 2007 and 2008, and growing weakness in the United States economy, pose significant risks for sustaining rapid growth in the country's garments industry. In macroeconomic management, the major risk is rapidly growing inflation: failure to rein it in could seriously undermine macroeconomic and political stability. The perennial vulnerability to natural disasters also presents a risk.

Development challenges

Still a poor country with 40% of the population below the poverty line, and per capita GDP of only $482 in FY2007, Bangladesh needs productive employment for a labor force growing by 1.5 million a year. GDP growth must be raised to 7–8% for faster poverty reduction and job creation. Moreover, climate change increasingly looms as a major development challenge (Box 3.15.3).

Greater investment is required, especially in power and transport. Power needs faster progress in structural reforms as well. In FY2007, maximum served generation was only 3,717 megawatts (MW) as against peak demand of 4,500 MW, resulting in up to 1,212 MW of load shedding on 364 days. The Government estimates that $6.4 billion of investment in generation and transmission will be required by 2015.

Recent reforms at Chittagong port have improved efficiency by 30% and cut costs by 40%, yet there is still much slack. The port needs to continue contracting out operations and management to the private sector, including those of the new mooring container terminal.

The country remains an underperformer in foreign direct investment (FDI). In FY2007, FDI inflows amounted to only $760 million. The authorities have yet to decide on several large FDI proposals amounting to $11 billion in important sectors, including coal mining, power, steel, fertilizer, tourism, and petrochemicals. Formulation of an appropriate coal policy is especially important, so as to expedite decisions on some of the other proposals. Yet long delays in obtaining decisions is likely to drive investors away, further dimming FDI prospects.

Corruption, too, holds back growth, and has been the most telling indicator of poor governance in Bangladesh for a long time. The caretaker Government has declared, and showed political willingness, to fight corruption and to institute systemic reforms. It reconstituted the Anti-corruption Commission and acceded to the United Nations Convention against Corruption. In a landmark development, effective 1 November 2007, it separated the judiciary from the executive. The public expectation increasingly is that the Government will not only punish corrupt people but will also put in place a mechanism to deter the pervasive corruption that has been the hallmark of public life.

3.15.3 Climate change

The recent severe flooding and cyclone are premonitions of future possible catastrophe in Bangladesh. According to the United Nations *Human Development Report 2007/2008*, a 1-meter rise in sea level would inundate 18% of the land area, directly threatening 11% of the population.

A rising sea level and exposure to climate disasters could result in over 70 million people being permanently or temporarily displaced. These impacts are envisaged to raise the country's vulnerability to natural disasters, thus stressing the need for improved disaster preparedness and risk mitigation.