Bangladesh

At 6% over the past 4 years, strong GDP growth has been underpinned by more market-oriented economic policies, a dynamic garment sector, and substantial inflows of overseas workers' remittances. The lead-up to the parliamentary elections was generally expected to be a rough patch given the country's contentious political environment; the constitutional mechanism of a neutral caretaker government was expected to help smooth the way. Deepening political deadlock culminated with the president in January declaring a state of emergency and calling off the elections. But the new caretaker Government has continued with established economic policies and expedited structural and sector reforms. It has taken a broad agenda of activity, including an extensive anticorruption drive that it sees necessary to establish better foundations for holding the elections. GDP is forecast to maintain its recent momentum over the medium term.

Economic performance

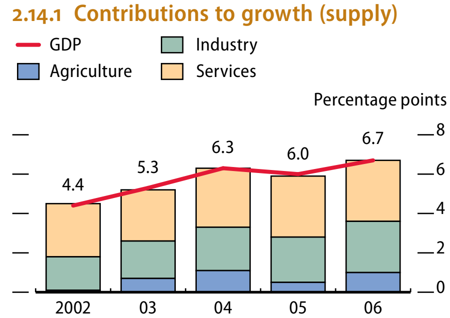
Growth in GDP has trended up in recent years, reaching 6.7% in FY2006 (ended 30 June 2006), driven by improved domestic and external demand. This performance was reflected in a steady expansion in industry, lifted by export-oriented manufacturing, and in continued services buoyancy (Figure 2.14.1). A marked reduction in poverty accompanied growth: the headcount poverty rate declined by about 1.8 percentage points a year between 2000 and 2005 to 40%, compared with a decline of only about 1 percentage point a year in the preceding decade (Figure 2.14.2). The improvement was somewhat faster in rural than urban areas. Rising access of the poor to microcredit, a rapid expansion in overseas workers' remittances, and improvements in physical and social infrastructure all contributed to the sharp drop in poverty.

In FY2006 on the expenditure side, private consumption propelled growth. Investment rose by 0.5 percentage points to 25.0% of GDP, bolstered by a rise in private investment. Gross national savings increased by 0.8 percentage points to 26.6% of GDP, lifted by a rise in workers' remittances. Net exports of goods and services remained negative.

Inflation moved up steadily to average 7.2% (Figure 2.14.3). This exceeded the 7.0% limit set by Bangladesh Bank, the central bank, in its first Monetary Policy Statement (MPS) issued in January 2006. Demand pressures generated by excess money, a sharp depreciation in the taka (Tk) against the US dollar (of 8.5% in FY2006), and a rise in global commodity prices (including oil), all heightened inflationary pressures. Rising exports of some consumer items, pulling their domestic prices to higher global levels, also added to price pressures.

Despite attempts to tighten monetary policy, both money and credit aggregates expanded rapidly in FY2006 (Figure 2.14.4). Broad money grew by 19.5%, as against the MPS program target of 14.3% and prior-year actual growth of 16.8%. Private sector credit grew sharply because of rising credit demand in support of domestic economic activity, while the public sector borrowed in excess of the credit target, mainly to

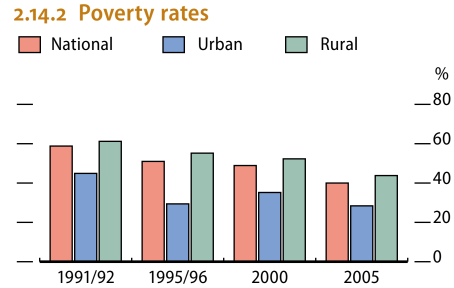
2.14.1 Contributions to growth (supply)



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

Click here for figure data

2.14.2 Poverty rates



Source: Bangladesh Bureau of Statistics, *Preliminary Report on Household Income and Expenditure Survey 2005*.

Click here for figure data

finance the high cost of imports by state-owned Bangladesh Petroleum Corporation (BPC). To tighten credit, Bangladesh Bank raised key policy rates over the course of the year: the 28-day treasury bill rate from 6.6% in the last quarter of FY2005 to 7.1% in the last quarter of FY2006, and the reverse repo rate from 4.5% in June 2005 to 6.0% in June 2006. Yet because of excess liquidity in the system, these measures failed to fully restrain credit growth.

The second MPS, announced in mid-July 2006, again aimed to tighten monetary policy, both to control inflation and to ease pressures on the exchange rate, at the same time sustaining domestic output growth. The introduction of the MPS is a welcome development as it seeks to bring greater predictability to the policy regime and to avoid policy surprises, which should aid the private sector in making its investment decisions. However, to derive greater benefit from the MPS, the Government needs to allow Bangladesh Bank greater operational autonomy and to establish greater coordination between monetary and fiscal policies.

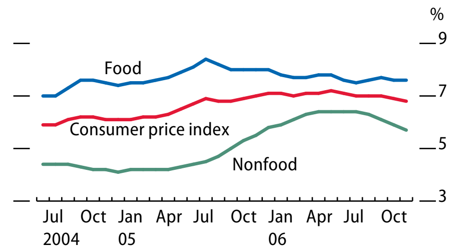
At 3.3% of GDP, the central government deficit in FY2006 came in below the budgeted 4.5%. This was because of lower than planned growth in both current and development expenditures, and in spite of underperformance in revenue collection. Current expenditures were lower as a result of tighter budgetary discipline and reductions in unproductive outlays through austerity measures. Development spending was kept at a lower than projected level by large cost reductions in nonpriority projects, fewer unproductive expenditures, and slow project implementation.

Revenues fell short of target because expected increases in collection arising from reforms and administrative improvements failed to materialize. So while tax-reform efforts yielded some gain in domestic value-added tax and income tax collection, overall targets were missed in part because of lower customs receipts stemming from tariff cuts. Domestic financing (borrowing from bank and nonbank sources) of the budget deficit amounted to 2.1% of GDP, while foreign assistance (both loans and grants) financed the remaining 1.2%.

The exchange rate came under increasing pressure during much of FY2006, because of slowing financial account inflows and higher import prices for oil and some other products. The currency stabilized in the last quarter of the fiscal year, as the tighter monetary policy started to have an effect, and the current account strengthened notably. The exchange rate stood at Tk69.7/$1 in June 2006, representing an 8.5% depreciation against the US dollar in FY2006 (Figure 2.14.5). The marked depreciation in the nominal rate offset Bangladesh's higher inflation relative to its trading partners, and the real effective exchange rate of the taka depreciated by 5.3% in FY2006, boosting the country's external competitiveness.

Import growth fell sharply to 12.1% in FY2006 from 20.6% (Figure 2.14.6) in FY2005 as administrative controls on letters of credit were imposed and unproductive imports discouraged. In addition, lower imports of foodgrains and most other edible products offset higher imports of oil, industrial raw materials, and capital machinery. Export growth surged to 21.6% from 14.0%, reflecting robust performance of knitwear and woven garments. A decline in the trade deficit and a steep rise in remittances (24.8%) turned the current account balance from a deficit of 0.9% of GDP to a surplus of 0.9%. Foreign exchange reserves

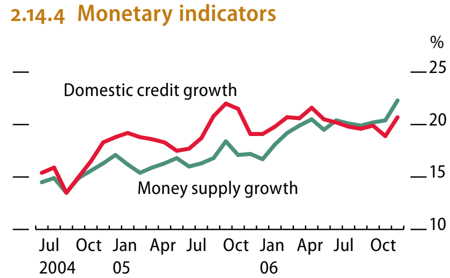
2.14.3 Inflation, 12-month moving average



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

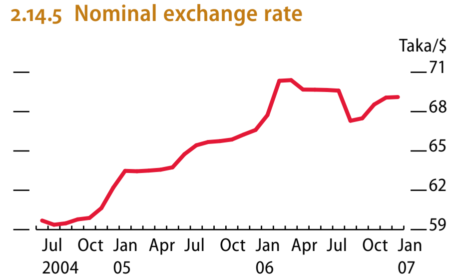
2.14.4 Monetary indicators



Source: CEIC Data Company Ltd., downloaded 7 March 2007.

Click here for figure data

2.14.5 Nominal exchange rate



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

rose to $3.5 billion at end-June 2006 from $2.9 billion a year earlier (Figure 2.14.7).

In the FY2007 budget (announced in June 2006), the Government shaved duties on intermediate goods from 13% to 12% and on raw materials from 6% to 5%, as part of trade reforms agreed with the World Bank. It also cut supplementary duties. These measures should improve profitability and competitiveness of domestic industries, though they add to the effort needed to raise the budget's low revenue ratio.

Financial sector reforms to strengthen the regulatory and supervisory framework for banks made headway in 2006, though at a slower than expected pace. The health of the banking system has improved since 2002, as seen in the declines in gross nonperforming loans (NPLs) from 28% to 14% and in net NPLs (i.e., less provisions) from 21% to 8% (Figure 2.14.8). This led to significant rises in profitability ratios. Although the private commercial banks improved to record low NPLs of 6%, the four nationalized commercial banks (NCBs) are still weak and show very high NPLs of 25%. The NCBs have large capital shortfalls with a risk-weighted capital asset ratio of just 0.5% in June 2006 (as against the required 9%), compared with 10% for the private banks.

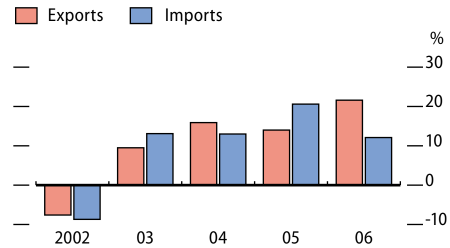
The performance of the four NCBs is monitored under memorandums of understanding signed by each of them and the central bank, in relation to tightened prudential norms and lending limits. It has been mixed, though, in part because of government-directed extensions of credit, particularly to BPC to finance its higher import costs.

The divestment of Rupali Bank, an NCB, moved forward and the sales and purchase agreements are expected to be signed. The Government has taken steps to corporatize the remaining NCBs and make them more autonomous while keeping them under the regulatory purview of the central bank, with an eye on their eventual privatization.

Other areas have shown progress. Bangladesh Bank has completed a comprehensive plan to switch over to the new international standard framework for assessing banks' capital adequacy under Basel II, which the Government intends to implement from early 2009. It established a settlement system for secondary bond trading in May 2005 and introduced mark-to-market valuation guidelines for treasury securities effective February 2006, which have improved operations of the interbank and treasury bill markets. It also introduced market-based auctions of treasury bills in September 2006 to bring greater flexibility to liquidity management.

Unlike many other bourses in Asia, the Dhaka Stock Exchange has not recorded significant gains, though January 2007 (Figure 2.14.9) saw a rise in response to prospects of an improved political situation. Still, as indicated by the low 7.5% market capitalization-to-GDP ratio, the equity market remains underdeveloped, largely because of weak corporate governance, lack of high-quality share listings, and a dearth of large institutional investors. While governance issues need to be tackled, increasing the supply of listed shares by privatizing state enterprises through public share offerings would help boost market capitalization and trading activity. Two major power sector entities—Dhaka Electric Supply Company and the Power Grid Company of Bangladesh—have already

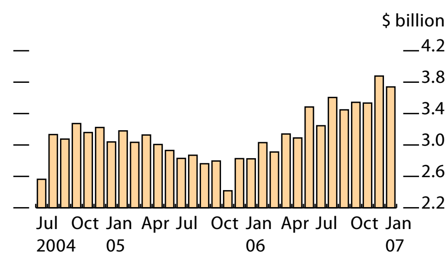
2.14.6 Export and import growth



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

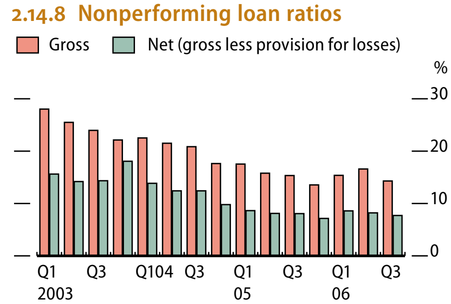
2.14.7 Gross international reserves



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

2.14.8 Nonperforming loan ratios



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

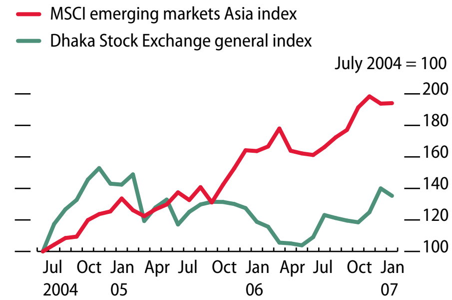
Click here for figure data

set an example by selling shares in the equity market in 2006, under the Government's broader goal of privatizing state enterprises.

Modernization of the National Board of Revenue gathered pace. Large taxpayers' units for value-added tax and income tax have already been established in Dhaka, and branches of these units are being set up in Chittagong (the second biggest city and main port). The board is being reorganized along functional lines and an audit cell has been set up. The central intelligence cell has detected several tax evasion cases and secured unpaid taxes. These actions are expected to strengthen the tax machinery and raise revenues over the medium term. In an attempt to curb corruption among tax officials and redress taxpayers' grievances, the country's first tax ombudsperson was appointed in July 2006.

The Customs House in Chittagong is being split into two entities to strengthen customs administration: one for imports and one for exports. Computerization of customs administration has improved tax assessment and appraisal functions.

2.14.9 Stock market indicators



Sources: Bloomberg, downloaded 7 March 2007; Dhaka Stock Exchange, *Monthly Review.*

Click here for figure data

Economic prospects

The economic forecasts for FY2007 and FY2008 are based on several policy assumptions. The most important is that the new caretaker Government will maintain its resolve to preserve macroeconomic stability. Continuing the reforms agreed with the International Monetary Fund under the ongoing Poverty Reduction and Growth Facility, the central bank will retain its tightened monetary policy stance to control inflationary pressures. At the same time, it will aim to support economic growth of around 7% by ensuring adequate credit to the private sector but restraining credit to the public sector.

The inflationary consequences of monetary policy will depend both on how political events unfold and on stability in labor and financial markets. At 10.7% of GDP (Figure 2.14.10), weak revenues hamper government efforts to provide resources for physical and social infrastructure development and for poverty reduction.

The second assumption is that, as agreed under the current Poverty Reduction and Growth Facility, the Government will attempt to lift revenues by 0.5 percentage points of GDP this fiscal year by adopting many tax and nontax measures, and by streamlining tax machinery, to offset reductions in customs duties. The authorities are expected to continue reorienting spending to support growth. They are also likely to strengthen institutional capacity for project formulation and administration, and to improve fund-release procedures for programs on infrastructure development and poverty reduction. In FY2007, domestic financing of the fiscal deficit will be capped at 2.5% of GDP.

A third assumption is that the Government will further rationalize energy prices to improve the financial position of state enterprises. In addition to the 5% increase in urban power tariffs of March 2007, it is likely to raise diesel and kerosene prices to bring them more into line with international prices and to reduce BPC's losses, at the same time attempting to address equity concerns.

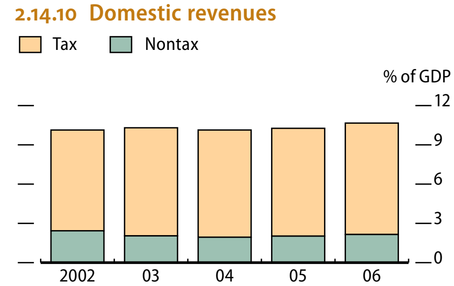
Fourth, it is assumed that the Government will continue in its efforts to shore up foreign exchange reserves. It will encourage remittances and

2.14.1 Selected economic indicators

	2007	2008
GDP growth	6.5	7.0
Inflation	7.0	6.0
Current account balance (% of GDP)	1.0	0.2

Source: Staff estimates.

2.14.10 Domestic revenues



Source: Asian Development Outlook database.

Click here for figure data

exports by measures such as allowing the exchange rate greater flexibility and further improving banking services.

On the above basis, GDP growth is forecast at 6.5% in FY2007 and 7.0% in FY2008, driven by a robust performance in industry and services (Figure 2.14.11). Trends in the first half of FY2007 point to a significant pickup in economic activity. Although agricultural growth in FY2007 is likely to moderate from the postflood recovery in FY2006, it is still expected to be above trend. The harvest of the major summer crop—*aman*—has been good, though slightly below that of a year ago. The production of the major winter crop—*boro*—will depend on weather conditions and availability of inputs, though developments to date suggest that it—and the output of other crops including wheat, maize, pulses, and spices, as well as fisheries—is on track for an above-average outturn.

The conditions for expansion in industry (supported by new capacity in garments and textiles, chemicals, cement, and engineering) are favorable, though infrastructure constraints may pose problems. Manufacturing has shown a strong performance, as suggested by healthy growth in manufactured exports, imports of industrial raw materials, and private sector credit. Services output appears to be expanding impressively, in line with industry.

In the first quarter of FY2007, output of medium and large manufacturing, driven by export-oriented industry, rose by 14%, and that of small-scale industry by 11%, year on year (Figure 2.14.12). Uptrends were also noted in the production of nonmanufacturing items, namely gas (9.3%) and electricity (5.1%).

The garment industry grew rapidly, with 28% growth in its exports in the first half of FY2007. Successful diversification of products and markets, increased backward linkages, and a supportive policy regime are among the forces driving the industry. Yet sustaining such growth needs improved infrastructure to help producers cut the present excessive lead times, while more investment in design, equipment, training, and marketing is required if the industry wants to move from producing low- or medium-priced products to high-value-added items.

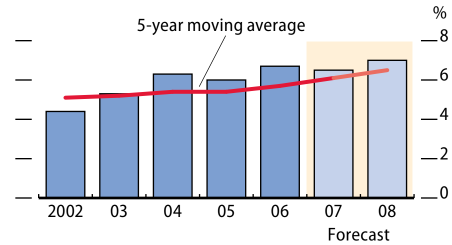
Entering and keeping its place in the market for these items, offering competitive prices and quality, and addressing social compliance issues are crucial if the garment industry is both to remain competitive internationally and to continue generating high employment and income growth for the country.

The pickup in external trade, bank advances to transport and trade, and mobile phone subscribers implies that high growth in services will continue.

In FY2007, inflation is projected to decline slightly to 7.0% and to 6.0% in FY2008 (Figure 2.14.13). After the heightened price pressures of FY2006, inflation has trended down in the early months of FY2007; on an annual point-to-point basis the national consumer price index fell from 7.5% in June 2006 to 6.1% in December 2006, with declines in both food and nonfood prices. The anticipated sustained moderation in price trends is based on a continued tight monetary policy, an easing in international oil prices, a softening of nonfuel commodity prices, and a continued buildup in foreign exchange reserves.

The authorities have announced a broad money growth target of 14.7%

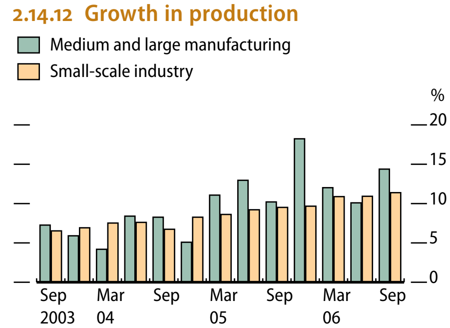
2.14.11 GDP growth



Sources: Bangladesh Bureau of Statistics, *National Accounts Statistics*, May 2006; staff estimates.

Click here for figure data

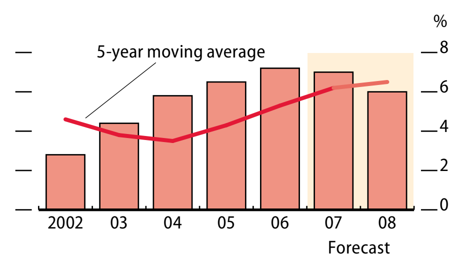
2.14.12 Growth in production



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

2.14.13 Annual inflation



Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 2 February 2007; staff estimates.

Click here for figure data

and a domestic credit growth target of 14.1% in FY2007. Reflecting its restrained monetary policy stance, the central bank raised policy interest rates between June and December 2006: the 28-day treasury bill rate from 7.1% to 7.3%, and the reverse repo rate from 5.5% to 6.5% (Figure 2.14.14). Commercial banks' lending and deposit rates also rose over the same period, from 12.1% to 12.4% and 6.7% to 7.0%. Even with this cautious policy, a healthy flow of credit to the private sector was sustained with growth of 19.4% year on year in December 2006.

The current account balance in FY2007 is expected to record a surplus of 1.0% of GDP and moderate to 0.2% of GDP in FY2008 (Figure 2.14.15). The outcome will be aided by a continued reduction in the trade deficit and robust growth in remittances. Exports are projected to grow at 20% and 18% in FY2007 and FY2008. In the first half of FY2007 they were up by 26% from a year ago, buoyed by high growth in knitwear (32%) and woven garments (24%) (Figure 2.14.16). Import growth in FY2007 and FY2008 is forecast at 15% and 14%. In the first 6 months of FY2007, imports grew by 20%. Workers' remittances rose by 31.3% in the same period (Figure 2.14.17). Foreign exchange reserves strengthened by $0.4 billion in the same period, touching $3.9 billion at end-December 2006.

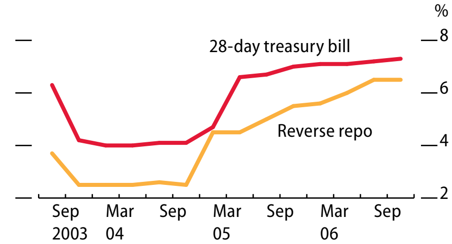
The taka/dollar exchange rate was little changed between June 2006 and February 2007. Bangladesh Bank limits its market interventions to countering disorderly movements and to building a more comfortable reserves position consistent with the macroeconomic program agreed with the International Monetary Fund. A managed floating exchange rate system in force since May 2003 has served the economy well, enabling it to adjust relatively smoothly to the changing external environment, especially in absorbing the oil price shock, supporting export growth, and protecting reserves.

BPC's large losses continue to mount. The Government has not granted any upward adjustments to domestic fuel tariffs since June 2006, when diesel and kerosene (together making up 75% of domestic consumption) were put up by 10% and gasoline by 30%. Even after the fall in prices in the international market, the prices of diesel and kerosene were about 80% of the breakeven level as of mid-January 2007, with a loss of $0.11 a liter for diesel and $0.12 a liter for kerosene (Figure 2.14.18). BPC sells other products at a profit.

Driven by growing economic activity, the demand for various fuel products is projected to rise to 4.0 million tons in FY2007, up by 5.3% from the preceding year. In FY2006, BPC incurred losses estimated at $474 million; this fiscal year losses are projected at $340 million. BPC's losses, which have been financed mainly by NCB credits, will eventually become government obligations. In a policy shift, the FY2007 budget includes an allocation equivalent of $86 million, which though inadequate, could cover part of the oil company's losses. The urgently needed policy change, however, is to implement automatic pricing formulas (on the line of those adopted in 2003 but largely ignored) to recover BPC's full costs while providing for social safety net measures to mitigate the impact on society's most vulnerable groups.

From a longer-term perspective, the economy has gently picked up its rate of growth, from 3.7% in 1981–1990, to 4.8% in 1991–2000, and to 5.7%

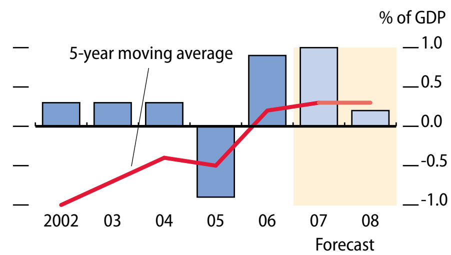
2.14.14 Interest rates



Source: Bangladesh Bank, available: http://www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

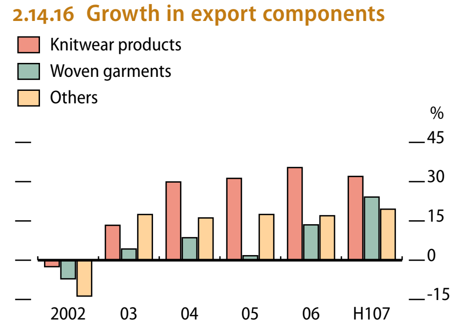
2.14.15 Current account balance



Sources: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007; staff estimates.

Click here for figure data

2.14.16 Growth in export components



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

in 2001–2006 (Figure 2.14.19). Savings and investment played their part, rising from 11.6% and 17.5%, respectively, in 1981–1983 to 19.9% and 24.5% in 2004–2006. Greater openness, with exports aided by the dynamic garments industry, also provided stimulus to growth. All sectors, especially industry and services, contributed. Factor productivity also increased sharply, reflecting sounder policies and a higher rate of capital accumulation. The Government stepped up policy and sector reforms to create a more market-oriented economy, paving the way for faster private sector-led growth. Significant reductions in tariff and nontariff barriers and deregulation fostered competition in the economy.

The steady growth record, despite internal and external shocks, provides a sound basis for Bangladesh's medium-term growth prospects of 8% GDP growth. However, for this to be achieved, investment needs to be augmented and economic and structural reforms accelerated to improve productivity and competitiveness in the economy.

Several downside risks to medium-term growth prospects could derail projections, implying slower growth, a weaker balance of payments, and higher inflation. An upsurge in political conflict and associated disturbances would clearly affect economic activity. Growing infrastructure constraints, particularly worsening power shortages, could deter new investments and hold back growth. Externally, stiff competition in garments and textiles in the wake of the end of the quota system poses significant risks. The competition in the world textile market will be further intensified after 2008, when temporary quotas imposed by the European Union and United States on the People's Republic of China expire.

Development challenges

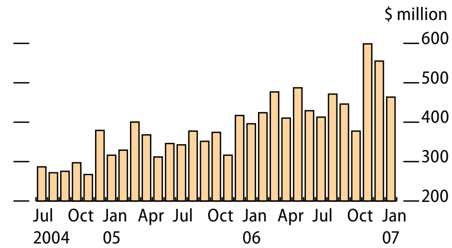
Key development challenges facing Bangladesh include upgrading the physical infrastructure, augmenting efficiency in the financial sector, stimulating greater foreign direct investment (FDI), and strengthening governance. Deficiencies in key infrastructure, such as power (Box 2.14.1), ports, railways, and roads, seriously hamper export growth, investment, and opportunities for transport integration with neighbors.

In the ports segment, Chittagong port, which handles nearly 85% of imports and 80% of exports, suffers from low productivity, labor problems, and weak management, exacerbated by the practice of stuffing and unstuffing containers in the port (because of limited off-dock facilities and costly railway services to move containers). Chittagong port is below the UNCTAD productivity standard of 230 lifts per berth a day.

Bangladesh Railway is unable to carry containers efficiently and on time because of limited locomotive and freight-car availability, congested network on major corridors such as Dhaka–Chittagong and the corridor to India, lack of operational efficiency, and infrastructure constraints. The main constraints facing the road sector are inadequate maintenance funding and weak management.

As a result of weaknesses in transport operations, the country is tardy in exporting and importing, requiring 35 and 57 days, respectively, measured from start to completion of export/import procedures and shipment. This compares ill with neighboring countries such as India

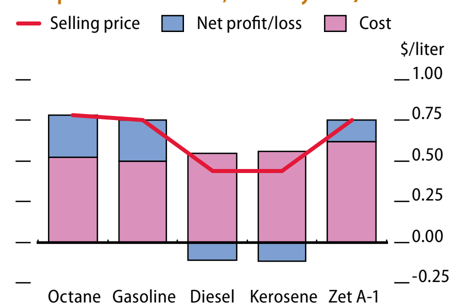
2.14.17 Workers' remittances



Source: Bangladesh Bank, available: www.bangladesh-bank.org, downloaded 7 March 2007.

Click here for figure data

2.14.18 Bangladesh Petroleum Corporation fuel price breakdown, January 2007

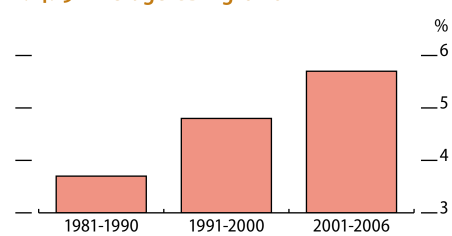


Note: Figures are based on average fuel price in the international market as of 12 January 2007.

Source: Ministry of Energy and Mineral Resources.

Click here for figure data

2.14.19 Average GDP growth



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, various years.

Click here for figure data

(27/41 days export/import, respectively), Pakistan (24/19 days), and Sri Lanka (25/27 days). Similarly, costs are high. For example, the cost of export for each container in Bangladesh is $902, compared with $864 in India, $797 in Sri Lanka, $481 in Malaysia, and $335 in the People's Republic of China.

For Chittagong port, the focus should remain on contracting out operations to the private sector, on allowing private operators to invest in port infrastructure, and on restructuring its management. The caretaker Government has, in fact, transferred the operations of Chittagong container terminal to the private sector, and has also signaled its intention to do the same for the new mooring container terminal.

For Bangladesh Railway, the emphasis should be on ensuring greater commercial orientation, outsourcing some business to private companies, and introducing modern management and financial systems. In roads, the priority should be on approving an integrated multimodal transport policy and creating a road maintenance fund.

Despite some progress, Bangladesh is yet to establish a healthy and efficient financial system. Ongoing banking sector restructuring must be strengthened. In the capital market, the thrust should be on improving financial reporting and corporate governance, and strengthening monitoring and enforcement by the Securities and Exchange Commission. Many government-owned enterprises, including the petroleum distribution companies and Biman Bangladesh Airlines, as well as major private companies such as mobile phone companies with huge annual turnover, could be prime candidates for selling shares, stimulating the equity market.

From already low levels, FDI inflows further declined in FY2006, depriving the country of much-needed capital resources along with the associated transfer of technology, skills, and access to new export markets. Despite the seriousness of the position, the country is yet to accord political decisions on several large FDI proposals.

Corruption is an important factor that prevents Bangladesh from achieving its potential for higher economic growth and faster poverty reduction. The caretaker Government has taken an extensive anticorruption stance, and as part of this will need to address the shortcomings of the Anticorruption Commission, giving it greater independence, scope, and resources.

2.14.1 Power problems

Power is the biggest logjam in physical infrastructure. Per capita power generation is only about 158 kilowatt-hours a year, among the world's lowest.

Only a third of the population has access to electricity, and even they have a poor, unreliable service suffering from frequent power outages and low voltage.

This stems from inadequate power generation capacity and poor transmission and distribution systems. In FY2006, maximum served generation was only 3,812 megawatts (MW) as against peak demand of 4,693 MW, resulting in up to 1,312 MW load shedding on 347 days. Most industrial manufacturers have to rely on costly generators, and small enterprises that cannot afford backups have no alternative but to shut down during prolonged power outages.

Over the last decade, net energy demand has grown by 8.1% a year. Yet for an expected average annual GDP growth rate of 8% over the next two decades, the needed average annual energy growth rate is 12%.

Bangladesh faces a momentous task meeting this burgeoning energy demand, which will need substantial investment with reforms in various areas, including introducing an energy pricing policy to recover operating costs, reducing the Government's outstanding dues to power entities, further corporatizing power entities, and making the Bangladesh Energy Regulatory Commission fully operational.