Bangladesh

Despite the impact of higher oil prices and the end of textile and clothing quotas, the development outlook remains broadly positive. Gross domestic product growth is likely to increase sharply in the 12 months to June 2006 on account of strong domestic and external demand. Inflationary pressures will persist, as monetary policy is set to remain broadly accommodative so as to support strong credit demand and economic expansion. Although the trade deficit will widen, pressures on the balance of payments are expected to remain at a manageable level, aided by strong remittance inflows. Major development challenges need to be tackled if investment is to be stepped up to move the country onto the higher growth path required for rapid poverty reduction—including substantial improvements to infrastructure, public policy, and governance. In the near future, national elections scheduled for early 2007 will likely limit major policy initiatives. Risks to medium-term prospects include external shocks and domestic political uncertainties.

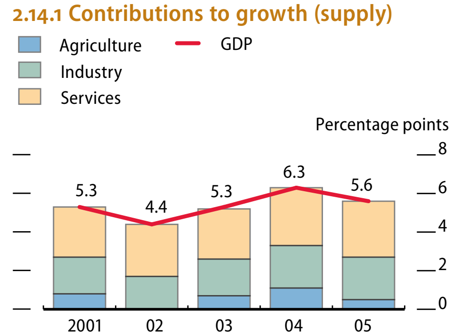
Economic performance

Gross domestic product (GDP) growth in FY2005 (ended June 2005) at 5.6% was broadly in line with recent experience, despite devastating floods at the start of the year that reduced foodgrain production, rapidly escalating international oil prices, and the termination of quotas on textiles and clothing on 31 December 2004. In recent years, economic growth has been underpinned by steady expansion in industry and services (Figure 2.14.1), reflecting improvement in both domestic and external demand. On the expenditure side, growth was sustained primarily by increased consumption spending, as net exports turned negative (Figure 2.14.2). At 24.4% of GDP, investment in FY2005 was modestly higher on an increase in private sector funding. High interest rates on savings certificates and an improvement in banking services helped nudge up the domestic savings rate.

Inflation, which had been on a slowly rising trend, climbed further to 6.5% in FY2005, mainly on increases in food prices (Figure 2.14.3). A rise in imported goods prices stemming from taka/dollar depreciation also fed into price pressures. The direct effects of increased global oil prices were limited due to the low weight (4%) of petroleum products in the national consumer price index and the incomplete pass-through to consumers. An accommodative monetary policy in support of increased private sector credit demand likewise fueled inflationary pressures and depreciation.

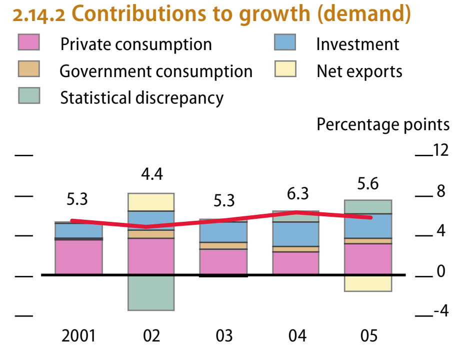
Reflecting the accommodative monetary policy, broad money growth rose to 16.8% year on year in June 2005, well above the authorities' program target (14.2%) and rates generally experienced in recent years. Bangladesh Bank raised the cash-reserve requirement from 4.0% to 4.5% in March 2005, and between then and June increased treasury bill and central bank policy rates, though these steps had little influence on

2.14.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, June 2005 (revised).

2.14.2 Contributions to growth (demand)



Source: Bangladesh Bureau of Statistics, *National Accounts Statistics*, June 2005.

reining in the monetary expansion. Commercial banks also adjusted upward their deposit and lending rates.

The fiscal deficit was contained to 3.5% of GDP, slightly lower than had been budgeted, due to the sizable underperformance in development spending in the face of a near stagnant revenue outturn. Domestic borrowing from bank and nonbank sources financed 54% of the fiscal deficit and foreign assistance (both loans and grants) the balance.

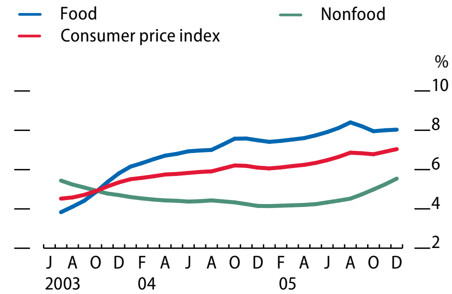
Imports grew by 20.6% in FY2005, much faster than in recent years. The high import bill was caused by the jump in oil imports (up 57% to $1.6 billion) and a large increase in non-oil imports—mainly foodgrains, chemicals, fertilizer, raw cotton and textiles, iron and steel, and capital goods. Total exports continued their healthy growth, at 14.0%, during the year. Expansion in exports of woven garments slowed markedly after the ending of quotas, but knitwear exports offset this, growing by 31.2% over the year. Although a 14.1% rise in workers' remittances (Figure 2.14.4) virtually matched the large increase in the petroleum import bill, the large trade deficit moved the current account balance to a deficit of 1.0% of GDP in FY2005, in contrast to the small surpluses seen in the previous few years. External debt at end-June 2005 stood at 30.9% of GDP and the debt service ratio at 4.7%.

Financial sector reforms have made progress, mainly through measures to strengthen the banking system. The authorities have raised minimum capital requirements, taken steps to reduce insider lending, and improved the institutional framework for prudential supervision of the financial system. As part of the bank restructuring program adopted under the International Monetary Fund's Poverty Reduction and Growth Facility, Rupali Bank has been taken to the point of divestment through issuance of an information memorandum, while management support teams have been appointed for the three other nationalized commercial banks (NCBs). Memorandums of understanding signed by Bangladesh Bank with the four NCBs set a ceiling to the growth in each bank's lending portfolio of 5–8%, restricted single-party exposure to only 5% of the paid-up capital, and placed targets on cash recoveries from defaulters. Implementation has been satisfactory, though there is room for further increasing cash recoveries. Gross nonperforming loans in the banking system declined from 21.5% of total loans and advances at end-June 2004 to 15.8% a year later (Figure 2.14.5).

A National Steering Committee led by Bangladesh Bank has been formed to proceed with the implementation of Basel II banking standards. Bangladesh Bank has in addition strengthened its capacity to supervise and regulate banks, by means of performing comprehensive audits and taking action against banks that violate regulatory and prudential norms.

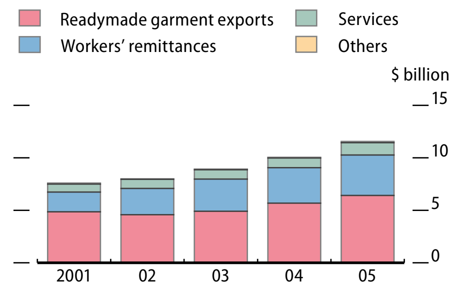
Institutional reforms for strengthening the National Board of Revenue are under way, and include setting up a Large Taxpayers' Unit for income tax and value-added tax, and a Central Intelligence Cell. However, for these reforms to have a substantial impact on revenue collection, staffing and resources need strengthening, and enforcement and audit streamlining. FY2005 saw progress on trade reform when the levels and dispersion of duties were reduced with the introduction of a three-slab duty structure and the lowering of the top duty rate

2.14.3 Inflation, 12-month moving average



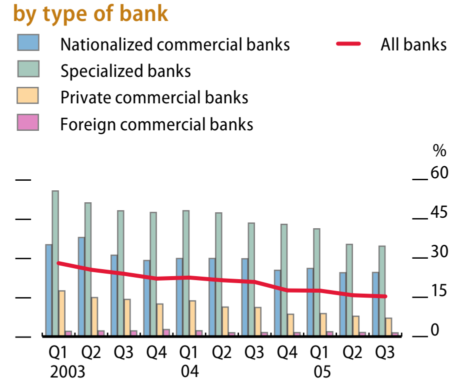
Source: Bangladesh Bureau of Statistics.

2.14.4 Foreign exchange receipts



Source: Bangladesh Bank, *Annual Report 2004/2005*, available: http://www.bangladesh-bank.org/pub/annual/anreport/ar0405/index0405.html, downloaded 21 February2006.

2.14.5 Gross nonperforming loan ratios by type of bank



Source: Bangladesh Bank, *Bangladesh Bank Quarterly*, various issues, available: http://www.bangladesh-bank.org/pub/quaterly/bbquarterly/bbquaterly/bbquarterly.html, downloaded 21 February 2006.

from 30% to 25%, along with a reduction in supplementary duties. The Government streamlined quantitative restrictions on imports, simplifying administrative procedures and cutting back significantly the number of restricted products. The greater use of information technology in customs administration should help increase efficiency and transparency.

Economic outlook

Prospects for FY2006 and FY2007

The economic forecasts for FY2006 and FY2007 make several assumptions. As part of reforms under the Poverty Reduction and Growth Facility agreed with the International Monetary Fund, Bangladesh Bank is expected to tighten monetary policy, both for ensuring stability in the money and foreign exchange market and for containing inflation. It will do this mainly by crimping public sector credit growth while, at the same time, ensuring healthy credit flows to the private sector.

The authorities are expected to maintain fiscal sustainability, by expanding the tax base and improving tax administration, in pursuit of enhanced annual tax revenue of about 0.5% of GDP in the forecast period. The Government is also likely to rationalize administered prices of petroleum, natural gas, and power to reduce losses at state enterprises, and to control current spending growth through curtailing low-priority disbursements and containing public wage bills. It is also expected to strengthen expenditure management by improving project selection and execution.

The forecasts assume that the Government will undertake policy adjustments to boost foreign exchange reserves, such as more flexibly managing the exchange rate, encouraging greater remittance inflows (through more efficient banking services), and reducing anti-export bias in trade policy (while addressing other impediments to export growth). A generally peaceful election campaign that will not seriously jeopardize normal economic activities is a fundamental assumption.

GDP growth is expected to reach 6.5% in FY2006 (Figure 2.14.6), reflecting a steady increase in domestic and external demand. Private consumption will be the main driver, bolstered by strong remittances. Trends for the first half of FY2006 point to a significant improvement in economic activity. The *aus* rice crop (harvested in July–August) was planted on 1.03 million hectares and production reached 1.75 million tons, an increase of 16.7% over the preceding year. Aided by good weather, *aman* production (November–December) is estimated at 10.8 million tons, an increase of 10%. The outcome of the *boro* crop (April–May) will depend on weather conditions and a sufficient supply of inputs, such as diesel and fertilizer. The outlook for other crops and fisheries seems promising, and overall crop production is expected to rebound sharply.

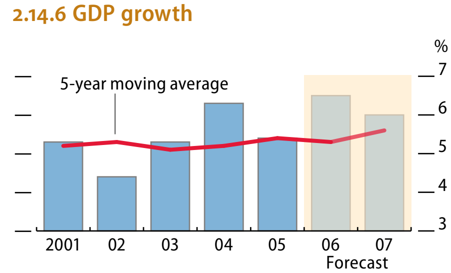
The performance of industry, driven by export-oriented manufacturing, is projected to strengthen, as confirmed by various early indicators. In the first 4 months of FY2006, the output of medium- and large-scale manufacturing expanded by a strong 13.3%, electricity and gas production experienced a substantial upsurge, and small-scale

2.14.1 Selected economic indicators

	2006	2007
GDP growth	6.5	6.0
Inflation	7.5	6.0
Current account balance (% of GDP)	-0.8	-1.0

Source: Staff estimates.

2.14.6 GDP growth



Sources: Bangladesh Bureau of Statistics, *National Accounts Statistics*, June 2005 (revised); staff estimates.

manufacturing increased by 9.5%. Indicators also showed strong performance in services.

GDP growth is forecast to moderate to 6.0% in FY2007, mainly reflecting political uncertainty over investment and business decisions in the lead-up to the general elections in January 2007. Moreover, the newly elected Government will also probably require some time before embarking on substantive initiatives.

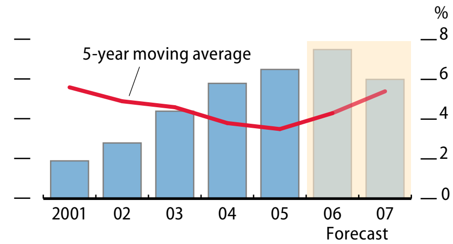
For FY2006, annual average inflation is forecast to rise to 7.5% (Figure 2.14.7). Consumer price inflation reached 7.1% in December 2005 year on year, fueled by higher food prices and a partial pass-through of higher oil prices. Despite a favorable outlook for food crops, average inflation for the year is expected to pick up due to continued high growth in money and credit, since the stance of monetary policy is mainly oriented to sustaining growth. Possible upward revision in energy prices could add to inflation. Even then, it is forecast to moderate to 6.0% in FY2007, induced by a tightening of monetary policy after the elections and less steep price rises in the administered prices of petroleum products and electricity. Public sector borrowing from the banking system is likely to rise, largely because of the funding requirement for imports by Bangladesh Petroleum Corporation (BPC), suggesting that the exchange rate is likely to weaken further, thereby adding to inflationary pressures.

The current account deficit in FY2006 and FY2007 is expected to remain modest at 0.8–1.0% of GDP (Figure 2.14.8), aided by a strong improvement in workers' remittances, and in spite of a rise in the trade deficit. Export growth is forecast to remain relatively strong at about 12–13% (Figure 2.14.9). Subdued in the early months, export performance improved to achieve 12.7% growth over the July–November period of FY2006 from a year earlier. Although growth in exports of woven garments continued slowing to only 1.2%, that of knitwear was strong at 24.7%. Some of the traditional exports such as raw jute, jute goods, and leather also showed robust performance.

Growth in imports in FY2006 and FY2007 is forecast at 15–16%. In the first 5 months of FY2006, import growth was 11%—significantly lower than the prior year's outcome. Notably, imports of foodgrains and consumer products declined, as the depreciation of the taka and tight conditions in the foreign exchange market damped import demand. Imports are, however, expected to pick up as BPC has received government support in mobilizing funds; lack of such support had previously limited its ability to import crude oil and oil products. From early 2005, the foreign exchange market strained under the mounting pressure of demand for import payments for oil and other commodities, despite the relatively strong earnings from exports and workers' remittances. Gross international reserves declined from $2.9 billion at end-June 2005 to $2.4 billion at end-November (Figure 2.14.10). They recovered to $2.8 billion at end-December, mainly on the back of a release of funds from the World Bank.

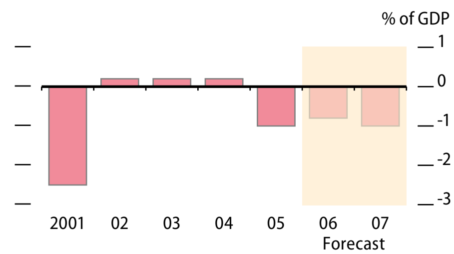
The taka/dollar exchange rate depreciated by about 8% between June 2005 and February 2006 (Figure 2.14.11). Although no formal foreign exchange rationing was imposed, short supply of currency led banks to adopt a more cautious approach in opening letters of credit for major items, such as oil, as well as for sugar and other consumer

2.14.7 Inflation



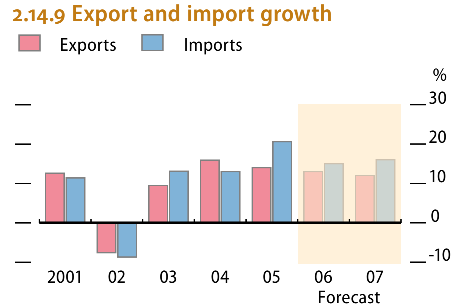
Sources: Bangladesh Bank, *Economic Trends*, January 2006, available: http://www.bangladesh-bank.org/pub/monthly/econtrds/econtrdsviiia.html, downloaded 27 February 2006; staff estimates.

2.14.8 Current account balance



Sources: Bangladesh Bank, *Bangladesh Bank Quarterly*, July–September 2005, available: http://www.bangladesh-bank.org/pub/quaterly/bbquarterly/bbquaterly/tables.pdf, downloaded 27 January 2006; staff estimates.

2.14.9 Export and import growth



Sources: Bangladesh Bank, *Bangladesh Bank Quarterly*, July–September 2005, available: http://www.bangladesh-bank.org/pub/quaterly/bbquarterly/bbquaterly/tables.pdf, downloaded 27 February 2006; staff estimates.

items. In addition to discouraging imports of nonessential commodities, Bangladesh Bank made sales in the market to fund demand and slow the taka's depreciation. It tightened monetary policy in October 2005 by raising the cash-reserve requirement from 4.5% to 5.0% and the statutory liquidity requirement from 16.0% to 18.0%.

The Government made incremental upward adjustments to administered prices of petroleum products, raising taka prices of diesel and kerosene by about 50% and gasoline by about 28% between May 2004 and September 2005. However, in dollar terms, the price increases were in the range of 16–35%, well below the 90% surge in world prices over the period. Despite the price adjustments, the oil subsidy costs were about $520 million or 0.8% of GDP in FY2005, and without further moves BPC's losses will remain heavy, and are estimated at $380 million for FY2006. BPC has so far financed its losses by borrowing, which will eventually end up as a government obligation, though for now it is masked from budget deficit calculations.

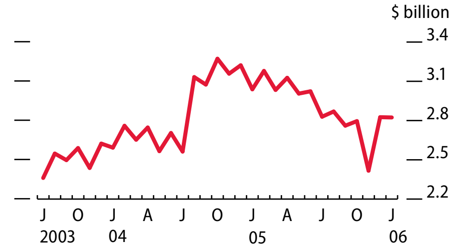
The oil import bill for FY2006 is projected to rise to $2.0 billion. BPC, however, has found it increasingly difficult to open letters of credit at the NCBs due to its large volume of outstanding loans. In January 2006, the Government instructed the NCBs to open letters of credit for BPC's imports as a temporary solution, and BPC has approached foreign commercial banks. Other signs of stress that are partly related to high oil prices are the deep losses and financial troubles at state-owned Bangladesh Biman Airline, which have resulted in payment arrears to BPC, exacerbating that company's cash-flow problems.

Medium-term outlook

The Government approved in October 2005 its Poverty Reduction Strategy Paper (PRSP). Consistent with the Millennium Development Goals, the PRSP aims to cut by half the number of poor people by 2015 (Figure 2.14.12), and to achieve substantial improvements in all aspects of human development. The broad objectives of the medium-term macroeconomic framework in the PRSP are to promote economic growth and employment, including among small and medium enterprises, that jibe with the poverty reduction goal. This requires channeling an increasing share of government expenditure into social and infrastructure sectors and into activities that reduce poverty directly. The PRSP envisages that GDP growth momentum will gradually pick up from 5.6% in FY2005 to 7.0% in FY2009. Yet this will require the authorities to augment domestic resource mobilization, enhance the efficiency of the financial sector, upgrade infrastructure, and improve governance.

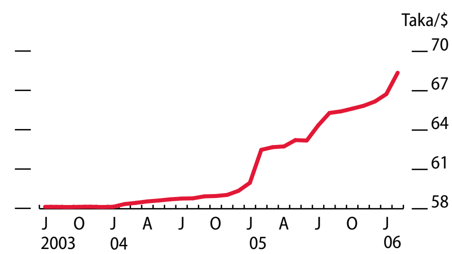
Government revenue, at 10.3% of GDP in FY2005 (Figure 2.14.13), is lower than in most other South Asian countries: India collects about 20% and Pakistan about 15%. The planned annual 0.5% of GDP expansion in tax receipts is crucial for supporting provision of infrastructure, social services, and other basic public goods. Recent reforms in tax administration have not, however, translated into the necessary revenue gains. Prospects for improved tax mobilization will hinge on reform in tax administration, including modernizing the National Board of Revenue along functional lines, and reducing tax exemptions and incentives so as

2.14.10 Gross international reserves



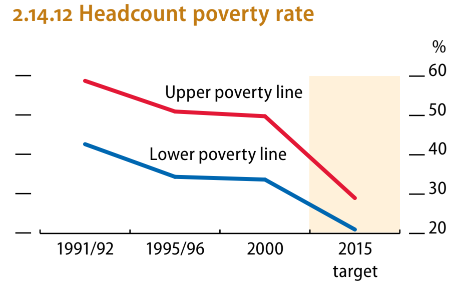
Source: CEIC Data Company Ltd., downloaded 8 March 2006.

2.14.11 Nominal exchange rate



Source: Datastream, downloaded 8 March 2006.

2.14.12 Headcount poverty rate



Source: World Bank, *Bangladesh PRSP Forum Economic Update*, November 2005, available: http://siteresources.worldbank.org/INTBANGLADESH/Resources/EconomicUpdate-Forum-102705.pdf, downloaded on 8 March 2006.

to broaden the tax base. Some measures have already started, including the creation of the Large Taxpayers' Unit. Its operations now need to be strengthened: more resources will be required to introduce audit procedures and computerized systems.

Some improvement at the NCBs is evident (Figure 2.14.14), but their generally poor financial performance—they had a nonperforming loan ratio of 24.5% at end-September 2005—spotlights the urgency of reforming them. Given the long delays already encountered, successful banking sector reform, including privatization of the Rupali Bank, as well as restructuring and eventual privatization of other NCBs, will require strong political support.

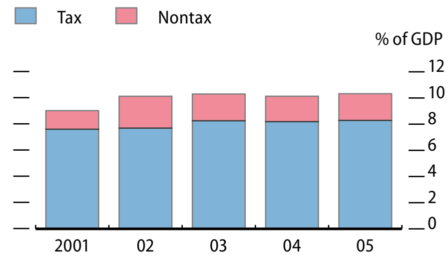
Securing higher investment requires major reforms in infrastructure. Despite progress, the power sector continues to suffer from high system losses, poor quality of supply, weak financial management, and significant payment arrears. Supply and reliability of power also need to be improved. Further corporatizing sector entities, fully operationalizing the Bangladesh Energy Regulatory Commission, and adopting a pricing policy to recover operational costs are all necessary components. The gas sector, too, needs to be reorganized to delink regulation from operation, create a conducive environment to encourage private sector involvement in transmission and distribution, and link domestic prices to international levels.

Chittagong port, which handles nearly 85% of the country's seaborne traffic, is faced with serious problems of poor infrastructure, low labor productivity, weak management, and myriad restrictive labor practices. Recent initiatives by the port authority should increase port capacity, but more needs to be done to improve vessel turnaround time and container idle time. In roads, faster progress is needed in reform initiatives for improving governance, creating an autonomous user-financed road maintenance fund, and approving a multimodal transport policy. Elsewhere, Bangladesh Railway must adopt a more commercial focus to take advantage of increased domestic and cross-border demand for railway services.

Weak governance continues to hinder the country's potential achievements in terms of faster growth and poverty reduction. The key challenge in this area is to make the Anti-Corruption Commission fully operational, with appropriate organizational structure, incentives, and staffing.

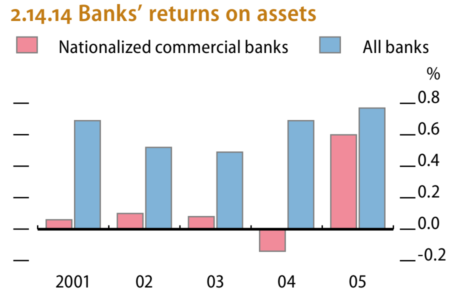
Bangladesh faces several downside risks to its medium-term prospects. The ending of quotas poses a risk to the garment industry, the major contributor to the country's growth over the last decade, unless the Government takes action to ease the constraints on cost competitiveness. A continued high global petroleum price is a considerable hazard, as heightened pressures on the country's balance of payments could affect imports of capital goods and raw materials, hitting growth and investment. Another major liability arises from natural disasters, which affect not only agriculture and rural life but also cause damage to infrastructure and disrupt operations in the urban economy. Finally, political uncertainty is considerable, as the country enters an election period with the formation of a caretaker government in October 2006, and the holding of general elections in early 2007.

2.14.13 Government revenue



Source: Asian Development Outlook database.

2.14.14 Banks' returns on assets



Source: Bangladesh Bank, *Bangladesh Bank Quarterly*, July–September 2005, available: http://www.bangladesh-bank.org/pub/quaterly/bbquaterly/bbquaterly/bbquaterly.html, downloaded 14 March 2006.

Trade issues

Earlier concerns about the potential adverse effects of the ending of quotas have not been realized. The growth of woven garments has indeed fallen, but knitwear exports have continued to register strong expansion (Figure 2.14.15). Textile and clothing exports to the European Union (EU) and to the United States have likewise remained robust (Figure 2.14.16). On balance, the garment industry is continuing to expand. Despite current uncertainty about the long-term impact of quota termination, the situation should become clearer after 2008, when the temporary quotas for the People's Republic of China (PRC) expire.

In the quota-free world, the survival of the country's garment industry will depend on improved competitiveness. Exports are still competitive against those from countries such as PRC, India, and Viet Nam because of substantially lower domestic labor costs. But Bangladesh loses out badly in terms of the lead time required to execute an order, which for local exporters is about 1 month more than among major competitors. The principal reasons are the limited availability of local fabrics (i.e., vertical integration is weak) and poor logistics infrastructure. Consequently, the industry needs quicker access to supplies of raw material as well as upgraded infrastructure. One option is to establish central bonded warehouse facilities in export processing zones.

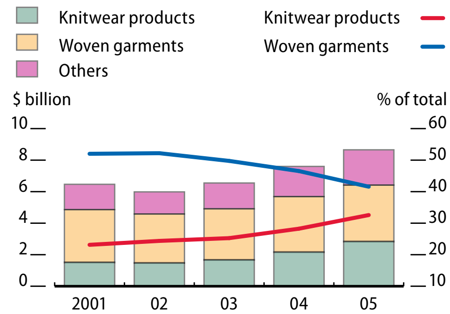
Success in encouraging foreign direct investment flows into the garment sector would also be beneficial, in terms of accessing superior technology and management and securing closer links to EU and United States buyers. To make this happen, foreign direct investment (FDI) needs to be encouraged and tariffs on textiles and yarn reduced significantly. Generating FDI flows is, however, a challenge that transcends the garment and textile industry and requires improvements in infrastructure, the regulatory environment, and governance (Box 2.14.1).

Although Bangladesh enjoys duty-free access to the EU under the Everything But Arms initiative, rules of origin present a barrier. Knit garments can generally meet the eligibility requirements because they have high domestic value-added content, but woven garments, which rely heavily on imported inputs, face problems. In this context, the Government should consider the EU offer to provide member countries of the South Asian Association for Regional Cooperation with a regional cumulation facility for rules-of-origin purposes.

The garment sector is under pressure from international buyers and development partners to ensure compliance with social and labor standards, an issue that has been highlighted in the international press. Compliance with social standards not only contributes to workers' welfare, which is a positive development in itself, but can also help raise productivity and quality levels as a direct result of their improved welfare.

The Government should revisit its trade promotion and industrialization policies and strategies in light of the outcomes of the Doha Development Round. Since promoting exports through tariff concessions will be difficult, it now needs to put more emphasis on acquiring competitive advantages through efficiency gains in trade-supportive infrastructure. Given exports' overwhelming dependence on textiles and garments, the real possibility of their exclusion from

2.14.15 Exports



Source: Bangladesh Bank, *Annual Report 2004/2005*, available: http://www.bangladesh-bank.org/pub/annual/anreport/ar0405/index0405.html, downloaded 21 February 2006.

2.14.16 Exports of textiles and clothing

Sources: US Census Bureau, available: http://censtats.census.gov/cgi-bin/sitc/sitcMonth.pl; Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1090,30070682,1090_30298591&_dad=portal&_schema=PORTAL, downloaded 10 March 2006.

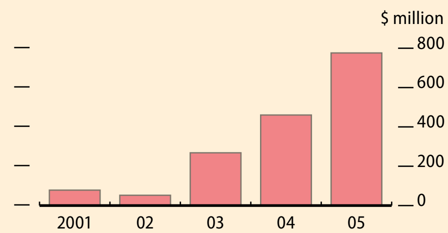
2.14.1 Foreign direct investment

Although Bangladesh is an underperformer in attracting foreign direct investment (FDI), such flows have shown an improvement in recent years. According to UNCTAD's 2005 *World Investment Report*, the country has advanced by 10 places, to 122 in 2004 from 132 in 2003, in its Inward FDI Performance Index. Bangladesh attracted $456 million of net FDI in 2004 (box figure), a 72% gain over the 2003 level. This is attributed to an improved investment environment and privatization of state enterprises. Bangladesh's rate of growth in FDI inflows in 2004 was the second highest in South Asia (albeit from a low base).

In view of the improved economic situation, a better policy environment, and significant regional integration efforts, the report forecasts that Bangladesh will receive still higher inflows, primarily because of FDI from India. The latest data indicate that FDI inflows increased to $776 million in FY2005.

FDI is expected to maintain steady growth in FY2006 and FY2007, but could pick up significantly if ongoing negotiations over several large investment projects prove successful. Flagship companies like Microsoft, Orascom, and Singapore Telecom have recently begun to invest in the country. The Government has received a host of large FDI proposals from various business groups, such as Tata of India, Asia Energy of the United Kingdom, Dhabi Group of the United Arab Emirates, and Kingdom Group of Saudi Arabia. The Board of Investment estimates that total foreign investment proposals are worth about $10 billion, well in excess of historical levels.

Net foreign direct investment inflows



Note: Data for 2005 are from the balance-of-payments accounts.
Sources: United Nations Conference on Trade and Development, 2005, *World Investment Report*, New York and Geneva; Bangladesh Bank, *Bangladesh Bank Quarterly*, July–September 2005, available: http://www.bangladesh-bank.org/pub/quaterly/bbquarterly/bbquaterly/tables.pdf, downloaded 27 January 2006.

preferential market access opportunities underlines the industry's need to identify, develop, and market new product lines.

In addition, the Government has to address three major behind-the-border barriers to trade, all of which affect export competitiveness. The first barrier, weakness in governance, includes corruption and a weak state of law and order, which vitiate the business environment and long-run growth. Moreover, although the regulatory procedures involved in starting a business in Bangladesh compare favorably with other benchmark countries, the cost of transacting business in terms of per capita income is one of the highest. On other indicators too, Bangladesh lags behind comparator countries, particularly on the measures relating to regulatory quality.

Second, the country is behind most comparator countries in terms of physical infrastructure for power, gas, ports, and telecommunications, which significantly increases the cost of production, impedes productivity growth, and, thus, hampers export competitiveness. The third main barrier stems from high operating costs, partly due to steep bank borrowing charges, in turn grounded in long-standing structural and other problems, particularly among NCBs. Such high operating costs discourage investment and constrain the ability of local firms to integrate into global supply chains.