Bangladesh

A strong export rebound will push up growth in FY2011, but a slowing remittance expansion will damp domestic demand. Next year could see better prospects with higher external demand. A major challenge for policy makers will be to balance the needs for taming inflation and for ensuring that credit to the private sector is not stifled. To harness the country's medium-term growth potential, removing infrastructure gaps will be essential, as will enhancing the supply of skilled human resources.

Economic performance

At 5.8% in FY2010 (ended June 2010), GDP growth was marginally higher than the 5.7% of FY2009 (Figure 3.15.1). Helped by favorable weather and continued government support, strong performance by the crop and horticulture subsector boosted agriculture's expansion. This offset a decline in industrial growth due to a fall in external demand and continued shortages of power, gas, and transport facilities. Services also grew only marginally.

On the demand side, growth was again driven by private consumption aided by higher credit flows to the private sector (supporting job creation) and by a boost to public sector wages. Total fixed investment, after remaining stagnant over the past half a decade, rose from 24.4% of GDP in FY2009 to 25.0% in FY2010. The rise in private investment provided the main impetus to performance.

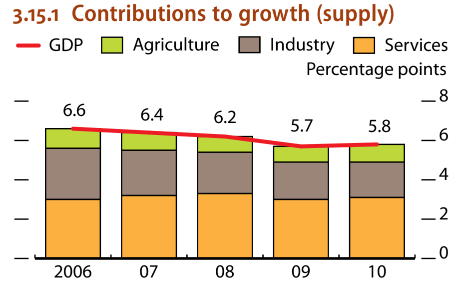
Foreign direct investment is stagnant at less than $1 billion a year. It could see a notable rise, however, if the government makes progress in awarding contracts for gas exploration and in setting up a floating liquefied natural gas terminal, as called for in its plans to address growing power and gas shortages. Foreign as well as local investment could also be lifted by the Special Economic Zone Act that Parliament passed in 2010, which aims to attract more private capital.

Annual average inflation edged up to 7.3% in FY2010 from 6.7% in FY2009 owing to a rapid rise in food prices in the first part of the year; nonfood inflation moderated. In FY2011, year-on-year inflation fell to 7.3% in July (Figure 3.15.2), from 8.7% in June but subsequently trended upward (with some volatility) to reach 9.0% in January 2011. The rise in global food and commodity prices, a continued rapid expansion in private credit, and depreciation of the taka pushed up prices.

To help the poor and vulnerable cope with higher food prices, the government stepped up food distribution operations, strengthened open-market sales of its inventories, and introduced a food-ration system for the ultra-poor.

FY2010's rapid growth in broad money continued into FY2011, reaching 21.7% in December 2010 (Figure 3.15.3), significantly above the

3.15.1 Contributions to growth (supply)



Source: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November.

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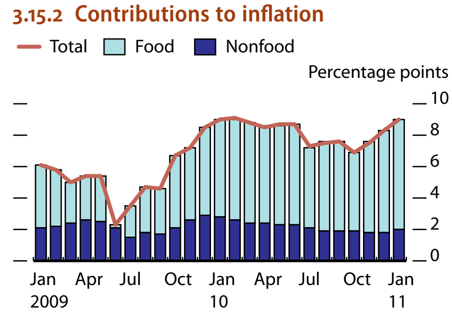
3.15.2 Contributions to inflation



Sources: Bangladesh Bureau of Statistics. *Consumer Price Index (CPI) and Inflation*. Various issues. http://www.bbs.gov.bd

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This chapter was written by Mohammad Zahid Hossain, Shamsur Rahman, and Md. Golam Mortaza of the Bangladesh Resident Mission, ADB, Dhaka.

central bank's annual program target of 15.2%. Private credit, up by 27.6% year on year in December 2010 (against the target of 16.0%) was the main contributing factor. The central bank's tightening of policy rates had little effect on credit expansion. The average lending and deposit rates also remained largely unchanged at 11.2% and 6.0%, respectively, in June–December 2010.

Revenue collection rose briskly with the revenue-to-GDP ratio climbing to 11.5% in FY2010—meeting the budget target—as domestic economic activity picked up a little and tax administration improved. Total spending jumped from 14.3% of GDP in FY2009 to 16.0% in FY2010 as the government adopted an expansionary fiscal stance to offset the impact of the global recession. Spending fell short, however, of the budget target as the annual development program remained underspent because of the lingering weak capacity in key implementing agencies. The fiscal deficit of 4.5% of GDP was well within the target of 5.0%.

After declining in the first half of FY2010, exports grew consistently year on year during the second half, posting growth of 4.2% for the full year (but still much lower than the previous year's 10.1%). Readymade garment exports moved up by only 1.2%, shaving their dominant share of total exports by 2 percentage points to 77.1% in FY2010. Exports of jute goods, petroleum by-products, and engineering products rose briskly.

Imports contracted during the first 3 quarters but reversed this trend in the fourth to show full-year growth of 5.4%, as imports of capital machinery picked up. Import bills for rice and for consumer and intermediate goods fell from their year-earlier levels. Remittance growth, robust at 22.8% in the first half of the fiscal year, decelerated sharply later, posting only 13.4% full-year growth, down from 22.4% the previous year.

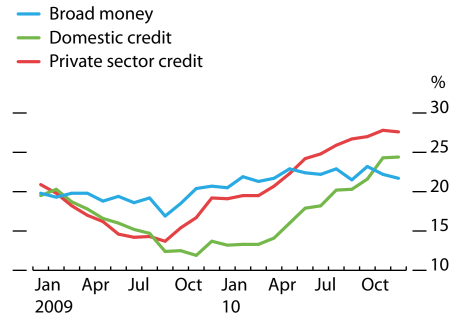
Still, the small expansion in the trade deficit was more than offset by remittance inflows, boosting the current account surplus to $3.7 billion (3.7% of GDP) from $2.4 billion (2.7%) in FY2009 (Figure 3.15.4). The improved position, alongside the lower deficit in the combined capital and financial account, pushed the overall balance-of-payments surplus to $2.9 billion and foreign exchange reserves to $10.7 billion (Figure 3.15.5) at end-June 2010, raising import cover to about 5 months. In the first half of FY2011 foreign exchange reserves showed little increase as the current account surplus largely fell away.

The nominal taka–dollar exchange rate remained stable in FY2010, but depreciated by 2.6% in the first 8 months of FY2011. Nonetheless, with domestic inflation higher than in major trading partners, the real effective exchange rate appreciated by 1.8% year on year in January 2011, implying some erosion in export competitiveness.

The Dhaka Stock Exchange general index more than doubled during FY2010 (Figure 3.15.6). The price–earnings ratio climbed from 18.4 to 24.1 and market capitalization doubled, reaching $38.6 billion (about 39% of GDP). The bullish trend in stock prices continued into the first half of FY2011 as the general index peaked on 5 December—44.0% higher than its end-June 2010 level. Then, a price correction set in, and the index fell by 41.7% by end-February as commercial and merchant banks moved to heavy selling, booking large profits. Nervous retail investors followed suit.

To stabilize the market and shore up investor confidence, the government announced measures including advising commercial and

3.15.3 Growth of monetary indicators



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org
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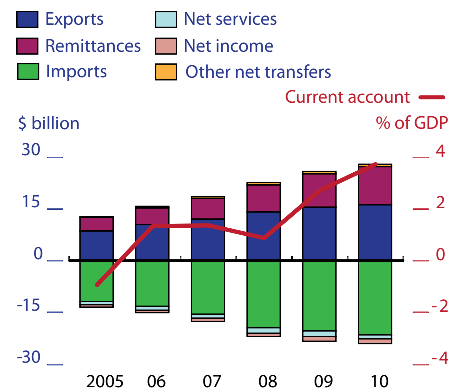
3.15.4 Components of the current account balance



Source: Bangladesh Bank. *Annual Report 2009–2010*. http://www.bangladesh-bank.org
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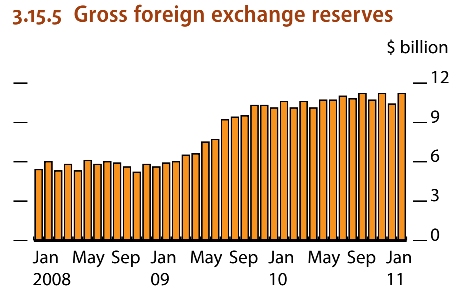
3.15.5 Gross foreign exchange reserves



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org
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merchant banks to reinvest their profits, instructing merchant banks to stop the practice of forcing margin clients to sell shares, and removing the index's circuit breaker. The state-owned Investment Corporation of Bangladesh, with seven other state-owned financial institutions, are creating a Tk50 billion (about $715 million) open-ended mutual fund (the Bangladesh Fund) to prop up the market. The government also formed a committee to investigate the causes of market instability.

Economic prospects

Economic forecasts for FY2011 and FY2012 rest on several assumptions. The policy focus on accelerating growth while strengthening efforts to tame inflation will continue, the momentum of budget revenue growth will be maintained, and it will be possible to mobilize more external financing. The government will step up initiatives to boost power generation (including commissioning rental power plants), thereby easing power supply shortages, and will take action to address gas shortfalls. A stable political environment and normal weather conditions are assumed.

GDP growth in FY2011 is projected to climb to 6.3% from 5.8% the previous year. The strong rebound in exports under way will support higher growth, offsetting the effects on domestic demand of the sharp slowdown in remittance growth. The pickup in export-linked domestic industries and tax incentives for domestic industries provided in the FY2011 budget are also expected to bolster economic activity. GDP growth in FY2012 is seen rising further, to 6.7% (Figure 3.15.7), with a continued policy focus on growth and a pickup in external demand.

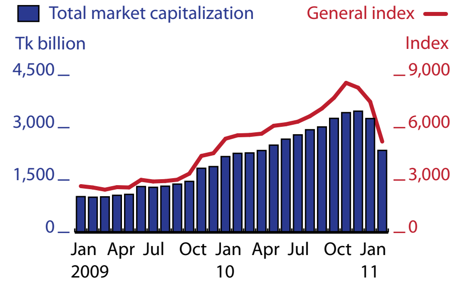
Agricultural growth in FY2011 is expected to ease to 4.1% because of lower acreage sown for the *aus* (summer crop), shrinkage in acreage and inadequate rainfall for the *aman* (monsoon crop), and the high base following the previous year's growth of 4.7%. In FY2012, the sector's growth is expected to strengthen to 4.3%, responding to higher prices following a tighter supply situation in FY2011 and continued policy support.

Industrial growth is expected to rise to 7.5% in FY2011, reflecting higher production for exports and domestic capacity expansion after the previous year's higher investment. Export performance was buoyant in the first 8 months of the fiscal year, recording 40.3% growth (Figure 3.15.8), with all major items growing strongly. Rapid growth in imports of raw materials and capital machinery also point to a better industrial performance. An improvement in the power supply and a rise in business confidence, too, are likely to boost activity. In FY2012, industry is expected to grow strongly at 7.8%, reflecting a rise in external demand and higher domestic capacity.

In FY2011, services growth is forecast to rise slightly to 6.7% from 6.4%, mainly on the strength of industrial and trade and transport activity, as the pulse of trade quickens. Sector growth will rise further to 7.2% in FY2012, reflecting industrial and agricultural strengthening.

The rise in year-on-year inflation is pushing up the 12-month average. Although the central bank's January 2011 monetary policy statement forecast 7.0% inflation for FY2011, it may well come in at 8.0%, rising

3.15.6 Dhaka stock exchange indicators



Source: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February. http://www.bangladesh-bank.org

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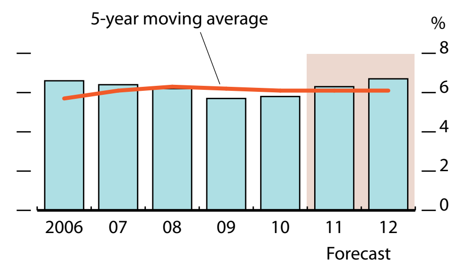
3.15.1 Selected economic indicators (%)

	2011	2012
GDP growth	6.3	6.7
Inflation	8.0	8.5
Current account balance (share of GDP)	0.2	-0.3

Source: ADB estimates.

3.15.7 GDP growth



Sources: Bangladesh Bureau of Statistics. 2010. *National Accounts Statistics*. November; ADB estimates.

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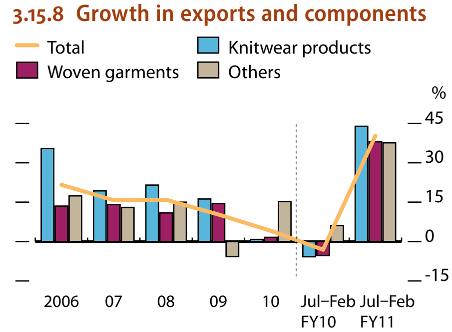
3.15.8 Growth in exports and components



Sources: Bangladesh Bank. 2011. *Major Economic Indicators: Monthly Update*. February; *Annual Report 2009–2010*. http://www.bangladesh-bank.org

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further to 8.5% in FY2012 (Figure 3.15.9). The central bank instructed commercial banks to rein in credit growth and set a deadline for cutting the credit-to-deposit ratio. The marked rise in global commodity prices, the likely further depreciation in the taka, a power tariff increase in February 2011, and expected hikes in fuel and compressed natural gas prices are all seen exerting upward supply-side pressures. Monetary policies are unlikely to fully counter them.

The slower growth in remittance inflows that began around February 2010 intensified in FY2011. Overseas workers remitted $7.5 billion during the first 8 months of FY2011, for growth of only 2.5%—a startling drop from a 19.0% gain in the year-earlier period. The decline is a concern as healthy remittance growth helps to underpin consumer spending and is a key source of domestic demand. Job placements for Bangladeshi workers, who are mostly low-skilled, declined by 10.9% in the first 8 months of FY2011 (Figure 3.15.10), continuing the declines of the previous 2 years. Remittances are likely to grow at very modest rates of 3.0% in FY2011 and 4.0% in FY2012. The latest developments in the Middle East could also affect remittances.

The continued robust performance in export earnings that started in March 2010 raised the prospect of exceeding the FY2011 annual export target of $18.5 billion. In the first 8 months of FY2011, rapid growth in readymade garment exports (woven by 38.0% and knitwear by 43.9%), representing over three-fourths of total exports, was partly due to importing countries replenishing their inventories, though it also reflected a sharp rise in wages in some other garment-exporting countries. Although industry's agreement to raise monthly wages—to about $43–$133 for garment workers—has by and large been pushed through following frequent worker unrest over the past couple of years, it hardly dented wage differentials with competitors.

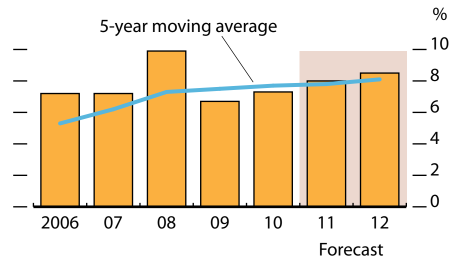
Exports of other items such as frozen foods and jute also grew strongly. Very high export growth in the first part of FY2011 is expected to moderate as inventory rebuilding comes to an end, pointing to a 21.0% expansion in exports for all FY2011. In FY2012, exports are projected to grow by 22.0%.

Exports to the European Union will benefit from relaxed rules of origin (introduced 1 January 2011) under the Generalized System of Preferences. Bangladesh readymade garments are also diversifying their export destinations to countries such as Japan, the Republic of Korea, South Africa, and Turkey.

In tandem with the rise in exports—a large part of which was based on imported raw materials—import payments rose by 40.7% in the first 7 months of FY2011. Imports of food items, industrial raw materials, and capital machinery grew rapidly. Growth in overall imports is set to moderate over the rest of the fiscal year as imports of raw materials for the readymade garment industries slow. The import bill for fuel will rise, however, reflecting volume and price increases. Imports are forecast to grow by 23.0% in FY2011 and 24.0% in FY2012.

The external current account is seen showing a smaller surplus of 0.2% of GDP in FY2011, and then turning into a deficit of 0.3% of GDP in FY2012 (Figure 3.15.11), reflecting slow remittance growth and a widening trade gap.

3.15.9 Inflation



Sources: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org; ADB estimates.
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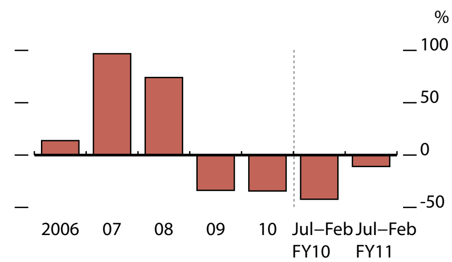
3.15.10 Growth in out-of-country employment



Source: Bangladesh Bank. 2011. *Monthly Economic Trends*. February. http://www.bangladesh-bank.org
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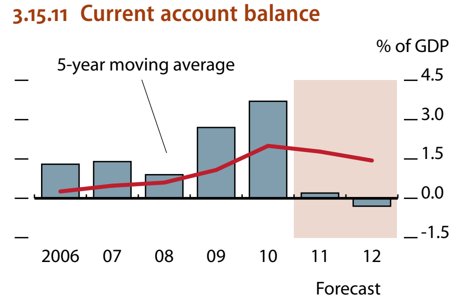
3.15.11 Current account balance



Sources: Bangladesh Bank. 2011. *Annual Report 2009–2010*. http://www.bangladesh-bank.org; ADB estimates.
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A 3-year program arrangement is expected to be finalized with the International Monetary Fund under its Extended Credit Facility, which will help Bangladesh tackle its growing balance-of-payments needs. The program is expected to catalyze financing and support policy adjustments and reforms conducive to boosting growth, while strengthening the external position (Box 3.15.1).

3.15.1 The Extended Credit Facility

Under a proposed program for a SDR640 million (about $1 billion) loan from the Extended Credit Facility of the International Monetary Fund, the government plans to undertake major reforms to put Bangladesh on a higher growth trajectory.

For raising tax revenue by around 3 percentage points as a share of GDP, it is expected to deepen tax administration reforms, including enacting value-added and income-tax laws. It aims to improve public financial management and operationalize the public–private partnership program for boosting public and private investment.

Reforms under the program are expected to improve monetary and foreign exchange operations, strengthen the finance sector and its oversight (focusing on financial conditions of state-owned commercial banks and the compliance by all banks with new capital-adequacy requirements), and promote the country's integration into the regional and global economy through a more open trade and investment regime.

For containing inflation pressure, the central bank is seen tightening monetary policy, aided by greater interest- and exchange-rate flexibility. It is also likely to work closely with the Securities and Exchange Commission to ensure appropriate actions by commercial banks and their subsidiaries to limit risks from stock market volatility.

The operating losses of the larger power and energy utilities are expected to be brought on the government budget.

Tax collection grew robustly by 28.4% during the first 7 months of FY2011 over the year-earlier period—direct taxes and domestic indirect taxes contributed most to the rise in revenue, although import-based indirect taxes also improved well. The expansion in domestic economic activity and better tax compliance, aided by reforms, are the main factors.

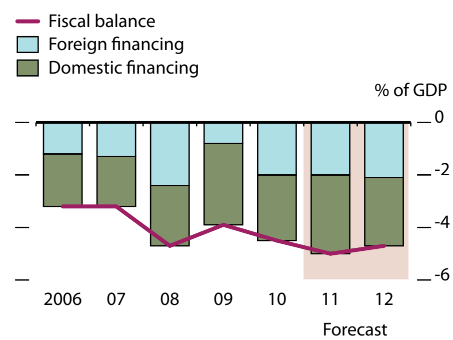
The annual development program's utilization rate in the first 8 months of FY2011 did not improve relative to the previous year, and its annual allocation is unlikely to be fully spent, despite recent government measures such as forming a task force to beef up implementation and progress monitoring.

Nor have any of the sizable resources earmarked for the Bangladesh Infrastructure Finance Fund, set up in the FY2011 budget to finance projects under the public–private partnership mechanism, been drawn on. Although budgetary allocations for food, fuel, fertilizer, and other agricultural inputs will be larger than in FY2010, the chronic underspending of investment allocations is expected to keep the fiscal deficit within its budgeted level of 5.0% of GDP (Figure 3.15.12).

The 11.0% increase in bulk power tariffs in February 2011 will help to cut Bangladesh Power Development Board's losses. The 5.0% hike in retail tariffs will improve the financial performance of power distribution companies.

The Bangladesh Petroleum Corporation (BPC) is nursing sizable losses as the government made no adjustment in domestic administered prices for fuels, even though global oil prices climbed sharply. BPC's losses will rise further as its imports are expected to soar to meet the needs of new power plants using diesel and fuel oil. BPC has arranged additional financing (of about $1.4 billion) from the Islamic Development Bank and

3.15.12 Fiscal balance



Source: Asian Development Outlook database.

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has requested assistance of $500 million from the central bank. It is also looking into additional financing from foreign commercial banks.

For the meantime, the government in the FY2011 budget made initial allocations of Tk25 billion (about $357 million) and Tk15 billion (about $214 million), as loans, to BPC and the Bangladesh Power Development Board.

Several downside risks could derail the projections. A slackening of the global recovery would likely slow export growth and heavily curtail remittances. Higher than projected domestic inflation could affect macroeconomic stability and discourage investment. Finally, inability to bring the planned short-term addition to power supply, such as the commissioning of small, private diesel and fuel-oil generators, and slippage in addressing gas shortages would also slow growth, mainly through their impact on industry.

Development challenges

Two critical challenges to exploit Bangladesh's growth potential are to upgrade infrastructure and to ensure a large, skilled workforce.

A major step in upgrading infrastructure was taken recently: three independent power producer contracts were awarded for generation. Once completed, they will add over 1 gigawatt to the grid, helping to relieve a bottleneck for industrial and employment expansion. Efforts are still needed to take advantage of the public–private partnership mechanism to create projects in infrastructure and to make the Bangladesh Infrastructure Finance Fund operational.

Bangladesh could reap a rich demographic dividend by transforming its large young population into a productive human resource through better education and health care. A balanced combination of public and private sector initiatives in delivering these services is needed.

Another issue is ensuring the availability of land for public and private sector projects. The rapidly declining land available per capita, exacerbated by poorly maintained land records, is making it increasingly difficult to buy land for infrastructure or industrial and commercial use.

A linked emerging challenge is urban congestion, in Dhaka and Chittagong especially, but also in other urban areas. Rapid urbanization is stretching too thin cities' capacity to provide urban services. For easing traffic gridlock in cities, one option is to develop mass rapid transit systems and satellite townships near the major urban areas. Rural and semi-urban areas need to be made more livable with expanded opportunities for better livelihoods.