Bangladesh Development Update

Poverty Reduction and Economic Management, South Asia Region

The World Bank
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Summary

Economic performance has remained resilient to global headwinds and disruptive politics

1. GDP growth in FY13 decelerated, for the second year in a row, to 6 percent. Disruptions caused by political strife, deepening political tensions relating to the impending political transition and the inadequacies of improvements in the provision of power, gas and infrastructure were the key factors in the growth slowdown. These contributed to weakening investor confidence leading to a 1.2 percent decline in the private investment rate. Recovery in remittance growth contributed to sustaining private consumption growth which combined with a significant rise in public investment and robust increases in exports helped maintain GDP growth above the average 5 percent growth in developing countries in 2013. Growth declined in both the agriculture and service sectors while industrial growth increased slightly.

2. Inflation decelerated but remained high. Annual average inflation declined from 8.7 percent in FY12 to 6.8 percent in FY13 reflecting a decline in both food and non-food prices. Softer international prices helped reduce food inflation. Increased production, declining demand from large importers, and increasing food stocks in international markets exerted downward pressures on international prices. The conduct of monetary policy improved remarkably in FY13, which helped reduce non-food price increases. Given that year-on-year inflation in August was still high at 7.4 percent, Bangladesh Bank’s (BB) decision to stay the course on monetary discipline in FY14 despite the forthcoming elections is a step in the right direction.

3. External balances have improved further. The external trade deficit decreased significantly due primarily to an increase in export growth over FY12 and flat import payments. The surplus in current and financial accounts also improved remarkably. As a result, foreign exchange reserves continued to set historic records. The current reserve level at 4.9 months of GNFS imports is adequate, but not excessive. BB interventions helped keep the interbank average nominal exchange rate stable, but the premium on curb market rate has been increasing since April, 2013. This apparent divergence in the behavior of the formal and informal market exchange rates is attributable to a rise in demand for informal market dollars, perhaps due to capital flight.

4. The banking system remains under stress and capital market activities have been weak. Several financial scams and resultant loan defaults in the state-owned commercial banks (SCBs) moved them into a position of insolvency, which needs to be urgently addressed. Capital market activities remained generally weak throughout FY13. Low investor confidence persisted and securities trading went through occasional ups and downs within a low band of activities in terms of volume and price movements.

5. Fiscal policy is on track, but a host of domestic challenges remain. The conduct of fiscal policy in FY13 has been broadly in line with the original budget. The overall fiscal deficit (excluding grants) at 4.3 percent of GDP has been below the budget target of 5 percent. The FY14 budget targets a modest deficit of 4.6 percent of GDP and a domestic financing target of 2.9 percent, as the authorities confront a host of domestic challenges ranging from a rising incidence of road traffic congestions, shortages of power, water and gas, to the need for higher welfare spending to protect the poor and the vulnerable.
The most pressing challenges lie in maintaining economic and financial reforms, rebuilding the image of the garment sector, and removing supply bottlenecks

6. **Some structural reforms have moved forward.** The IMF’s Extended Credit Facility is on track with significant progress in strengthening macroeconomic conditions and structural policies under the ECF arrangement. The new VAT law has moved firmly into the implementation phase; the National Board of Revenue has introduced an online tax registration system; amendments to the Banking Companies Act have been passed and progress is being made in identifying critical weaknesses in the state-owned commercial banks in step toward strengthening their governance and financial position; the FY14 budget introduced revenue reforms such as increasing the corporate profit tax rate on cigarette manufacturing companies and reducing the nominal protection rate to 28.1 percent in FY14 from 28.9 percent in FY13.

7. **Rebuilding the garment industry’s image and addressing supply bottlenecks is critical.** Following the devastating collapse in April of a multi-story building housing garment factories, the government has pledged to work with the International Labor Organization to improve worker safety in the country. At the same time, supply-side bottlenecks have to be addressed. Ongoing political uncertainty, frequent general strikes and associated hostilities have added to the existing negative pressure caused by longstanding energy and infrastructure deficits that continue to dampen the investment climate.

**Traditional risks remain while newer challenges mount**

8. **Bangladesh’s near and medium-term macroeconomic outlook hinges on internal stability and structural reforms.** The outlook is subject to several vulnerabilities—further growth slowdown due to internal strife, the prospect of resurgent inflation due to intensified supply disruptions and wage push factors, slowing of exports and remittance, fiscal expansion due to increased recurrent expenditures in response to political pressures, and failure of financial intermediation. Overall, the Bangladesh economy is moving into a more volatile phase. The risks stemming from the impending political transition have grown significantly while new risks and challenges have gained prominence, including notably the risks associated with the damaged image of Bangladesh’s major manufacturing success story—the garments industry.

**Garment industry at the crossroads**

9. **Deadly incidents of fire and building collapse over the last year have exposed the parlous state of physical and social compliance in the garment industry placing the country’s primary foreign exchange generator at a historic cross road.** The sector has the potential to become a US$36 to 42 billion industry by 2020 if it can prevent a recurrence of the tragedies seen with the Tazreens Fashions fire and the Rana Plaza building collapse. On the other hand, it could fall into a decline by continuing to neglect workers’ rights and safety, thereby prompting buyers to reduce their dependence on Bangladesh or abandon the country altogether, in order to protect their reputation with consumers.

10. **The industrial accidents have revived concerns over compliance in labor standards and worker safety, putting Bangladesh’s competitiveness in ready-made garments (RMG) at risk.** Due to the recent industrial disasters, the international community has placed the Bangladesh garment industry under serious scrutiny. Attention to low worker wages, poor working condition and the violation of workers’ rights has become more pronounced. These issues combined have raised questions about the sustainability and competitiveness of the country’s entire RMG industry.

11. **Noncompliance in worker safety is a collective failure of the manufacturers, the buyers, and the government.** Buyers have demanded quality at low prices without much regard of the working
environment. Manufacturers have cut costs by failing to invest in improving safety and labor standards. These failures have been aided and abetted by lax enforcement and regulatory capture.

12. **The time to act is now.** Experience shows that while incremental progress tends to be made after a disaster, many of the announced steps are not ultimately implemented. When another disaster happens, a flurry of actions is announced again, but implementation remains incomplete and history repeats itself. Bangladesh can hardly afford another such incident. The most immediate priority for the government, therefore, is to ensure enforcement of the steps suggested by foreign buyers, international agencies and domestic regulatory bodies. Coordination between the various stakeholders is essential to avoid wasteful multiplication of reform efforts and to maintain coherence and effective implementation. All the stakeholders need to work together to ensure a healthy and safe workplace. Without this it will be difficult for the sector to recover and continue to grow.

13. **The cost of inaction could be high.** Removing Bangladesh’s favored access to the United States market under the Generalized System of Preferences (GSP) program may not hurt Bangladesh’s garment industry unduly, as the benefits to the industry were non-existent, but if the EU were to suspend Bangladesh’s favored access to its markets, Bangladesh could see its total exports fall by as much as 4.1 to 8 percent.
I. Recent Economic Developments

14. **GDP growth in FY13 decelerated for the second successive year.** Disruptions caused by political strife, deepening political tensions over the impending political transition and inadequate improvements in the provision of power, gas and infrastructures were key factors in the growth slowdown. These combined to weakening investor confidence leading to decline in the private investment rate. However, robust increases in exports and remittances helped maintain a healthy GDP growth rate. Monetary policy restraint and favorable global commodity prices decelerated inflation. A large increase in the overall balance of payment surplus boosted official foreign exchange reserves as the Bangladesh Bank intervened to prevent a large appreciation in the nominal exchange rate. While weak corporate governance and regulatory lapses have stressed the financial system, fiscal performance complemented macroeconomic stabilization with a modest overall budget deficit, underpinned by better expenditure control and improved composition of deficit financing.

Weaker agriculture growth as well as disruptions of services have underpinned growth deceleration on the supply side

15. **Growth in Bangladesh has accelerated steadily over the past decades with only occasional year to year deviations from the rising trend.** FY13 was one such deviant year with GDP growth declining from the previous year. The Bangladesh Bureau of Statistics (BBS) estimated the real growth rate to be 6.03 percent in FY13 (Figure 1).\(^1\) While this is still healthy compared with the average 5 percent growth in developing countries in 2013, it was the second consecutive year of growth decline. Slower growth reflects decline in both agricultural and service sector growth. Growth came largely from construction and manufacturing while services also made significant, though lower than last year, contribution (Table-1).

16. **Agricultural output growth weakened to 2.2 percent in FY13 from 3.1 percent in FY12,** primarily because of stagnant cereal crop production coupled with a drop in profitability due to lower output prices and increased production costs for farmers in the first half of FY13. Total food grain production in FY13 was 34.89 million metric tons—almost the same as last year. Boro (the largest rice crop) production increased marginally over that of last year despite reduced acreage and damage caused by cyclone Mahasen. Adequate supply of water at the maturity stages, spread of recently introduced rice seed varieties, and good weather conditions helped increase boro yield.

17. **Services growth declined from 6.3 percent in FY12 to 6.06 percent in FY13.** Services suffer most from the direct impact of strikes and political violence because they just cannot do business and even if they keep their outfits open, it is hard for the customers to come to get the services. It is therefore no surprise that land transport, wholesale and retail trade and health and social work registered the largest decline in growth within the services sector. The disruptions in transportation and normal pace of activities inflicted a large toll on services. Domestic retail and wholesale trade was impacted by a sharp fall in consumer demand for durable and non-durable purchases.

\(^{1}\) Bangladesh Bureau of Statistics has finalized rebasing the GDP series to 2005/06. The level of nominal GDP in the new series is 13 percent higher relative to the 1995/96- based GDP series. Real GDP growth rates differ as well, but the trends are similar to the old series.
### Table 1: Contribution to Growth

*(Percentage Point)*

<table>
<thead>
<tr>
<th>Sectors</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
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<td><strong>5.7</strong></td>
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<td><strong>6.7</strong></td>
<td><strong>6.2</strong></td>
<td><strong>6.0</strong></td>
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</table>

*Note: Contribution will not necessarily add up to the growth numbers as statistical discrepancy in the expenditure side and import duty in the sector side has not been presented.*

*Source: WB staff calculation from BBS data.*

**Aggregate demand remained resilient despite declining private investment**

18. The level of real private investment has declined by 1.2 percent. Capital accumulation through investment has been the primary driver of real GDP growth in Bangladesh in decades. The deceleration of GDP growth came with a one percentage point of GDP decrease in private investment (Figure 2), which had stagnated at around 19.5 percent of GDP for several years, and higher national saving rates (Figure 3). The magnitude of the decline in the private investment rate is the greatest ever in a single fiscal year in Bangladesh’s history, though not very large by regional standards. Almost all private investment related indicators corroborate the decline. Capital machinery import fell significantly for most manufacturing industries and private sector credit growth plummeted to 11.04 percent in FY13 from 19.7 percent in FY12. Investors appear to have been discouraged by political turmoil and uncertainty surrounding the impending political transition, labor unrest in the RMG sector, banking scams, and a lack luster global economy.\(^2\)

\(^2\) According to the Real Estate Housing Association of Bangladesh (REHAB), there is currently an excess supply of 25,000 apartments in Dhaka and Chittagong.
19. **Increased public investment drove up the total investment rate.** Following an increase to 26.5 percent of GDP in FY12, total investment increased further to 26.8 percent in FY13 entirely because of a near 27 percent increase in public investment in real terms. Consequently, public investment as a percent of GDP increased to 7.9 in FY13 from 6.5 in FY12—the highest in Bangladesh’s history. The increase in public investment reflects improvements in Annual Development Plan (ADP) utilization and an increase in public investment outside the ADP.

20. **Private investment needs to rise significantly to further boost GDP growth.** Raising private investment was given high priority in the Sixth Five Year Plan, but progress during the first three years fell well short of expectation. The expectations were not realistic to begin with because the investment climate was overcast by infrastructural problems including in electric power supply, land use, and the road network and economic fallout due to confrontational politics which led to the stagnation of private domestic investment. The general investment climate and competitiveness of the economy leaves a lot to be desired. Inadequate supply of infrastructure, corruption, access to finance and an inefficient government bureaucracy are the most problematic obstacles to doing business in Bangladesh. While many countries have improved their respective processes contract enforcement, Bangladesh has not made any significant globally-benchmarked reforms in this regard. With contract enforcement taking on average more than 1400 days, Bangladesh is slowest among its comparator countries and ranked at 182nd out of 183 countries surveyed in 2012. It was ranked 110th in the Global Competitiveness Index 2013-14 out of 148 countries, regaining the ten places it lost in the 2012-13 ranking. Yet, in terms of infrastructure and institutions Bangladesh continued to rank poorly (131st and 132nd respectively).

21. **Exports gained momentum notwithstanding recession in the euro area and internal strife.** After a slow start in July and August 2012, total exports increased by 11.2 percent in FY13, compared with 5.9 percent growth in FY12. Growth came from a steady increase in RMG exports. This performance is impressive given the recessionary economic environment in the EU, which is the most important export market for Bangladeshi products (Figure 4), internal disruptions due to hartals (strikes), and the image crisis of the garment industry due to the Tazreen fire and Rana Plaza collapse which together killed nearly 1250 workers. RMG exports increased by 12.7 percent in FY13, compared with only 6.6 percent growth in FY12. In addition to RMG products, a number of other items such as ICT, jute goods, leather, footwear also registered respectable growth.

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4 IFC, Doing Business 2012.
22. The value of Bangladeshi exports to the EU region increased because of higher volume growth. All other comparator countries, except Pakistan, experienced significant decline in RMG exports to the EU region in FY13. Bangladesh’s success in RMG exports to those countries has been maintained over the last several years and gained momentum from FY12 because of change to the rules of origin in favor of Bangladesh. Under the new rules, domestic value addition for industrial products was reduced from 70 percent to 30 percent so that a product is now still considered have as originated in Bangladesh even if 70 percent of its components are from elsewhere. This decision helped growth of especially woven garment exports to the EU market. Reflecting these positive developments, Bangladesh’s market share in the EU market has increased steadily from 8.9 percent in FY10 to 17.4 percent in FY13 (July-March). Bangladesh has been successful in capturing the market share lost by China in the EU. The growth in Bangladesh’s RMG exports to the US market is similar, though not as robust as in the EU market. Inflation has decelerated, but the level is still high

23. Inbound remittances grew by 12.6 percent to US$14.45 billion in FY13 compared to US$12.84 billion in the previous year (Figure 5). Remittance grew by 10.2 percent in FY12. The higher remittance growth through most of FY13 was associated with sharply higher number of workers going abroad. The numbers rose sharply between FY11Q4 and FY12Q4. Several studies provide evidence that remittance significantly boost household consumption and contribute to improved housing and living conditions.6

Inflation has decelerated, but the level is still high

24. The behavior of inflation has been somewhat erratic.9 Inflation started decelerating from the second half of FY12.10 The overall inflation rate (measured by the new CPI) on a point-to-point basis peaked at 12.7 percent in September 2011. Since then the overall inflation rate declined steadily to 5 percent in September 2012, primarily due to falling food prices which counteracted the rise in nonfood prices during a large part of the same period. Inflation rose back to 8.4 percent in April 2013, driven initially by a rising non-food price index and subsequently by rising food prices, before declining to 7.4 percent in August. The recent decline in inflation reflects drops in both food and nonfood prices.

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6 Pakistan recently gained preferential market access to EU.
7 The positive effect of large number of workers going abroad is generally reflected in remittance inflows with a lag of 6 months to one year.
8 Barai, Munim K., Development Dynamics of Remittances in Bangladesh, SAGE, Open 2012.
9 In January, the Bangladesh Bureau of Statistics (BBS) changed the way it computes the consumer price index (CPI), introducing a new CPI series, effective from July 2013, using 2005-06 as its base year. This replaced the 1995-96-based series. This made inflation in FY12 considerably lower than had been calculated in the older series, leading some to question the BBS’s motivation for introducing the changes. Changes in how the CPI is computed are made periodically in virtually all countries, both to improve coverage and to take into account changing consumption patterns and demographics. The observed drop in Bangladesh’s inflation in FY12 is in fact an exception: in five of the past six years, the new series yields higher inflation rates than those based on the older 1995-96-based series. The BBS made three main changes in the new CPI calculation: (i) improved coverage by increasing the total number of consumption items covered; (ii) modified weights associated with the various items to reflect their share in total consumption based on the 2005-06 Household Income and Expenditure Survey findings; and (iii) changed urban/rural weights for computing the national CPI. While inflation rates at the national level for 2012-13 based on the new and old CPI are virtually identical (8.1 vs. 8.0 percent), the divergence between the two is greater over the six-year period (8.4 vs. 7.9 percent).
10 Inflation rate overshot budgetary targets for FY11 and FY12 by significant margins.
Although the deceleration has brought some relief to policy makers, the level of inflation is still high compared to other developing countries (Figure 6).

25. **Softer international prices helped moderate domestic food price increases.** Prices of internationally-traded food declined for the third consecutive quarter since their historical peak in August 2012.\(^\text{11}\) Increased global supplies and large stocks and declining demand from large importers exerted downward pressures on international prices. The prices of major commodities for which Bangladesh is highly import-dependent, softened with the appreciation of taka against US dollars as well as Indian rupees. A falling rice price during February-December 2012 was a major driver of the fall in food prices, but from December to end-June 2013 the rice price has risen by 17 percent.

26. **Monetary policy played an important role in controlling nonfood price rises, reducing pressures on the balance of payments, and stabilizing the exchange rate.** The conduct of monetary policy improved remarkably in FY13. The Bangladesh Bank (BB) started effective implementation of tightening measures from January 2012 and broadly achieved the monetary targets for FY12 and FY13. During FY10-11, broad money (M2) expansion exceeded the targets set under the BB’s Monetary Policy Statement (MPS) by significant margins, thus helping fuel the inflationary pressure in the economy. But after the adoption of a tighter monetary policy stance at the beginning of 2012, liquidity expansion started to decelerate and was essentially limited to levels targeted under the MPS announced by the BB. Broad money growth in FY13 declined to 16.7 percent, compared to 17.4 percent growth in FY12 (Figure 7). Private sector credit growth shrank to 11 percent, well below the 17.7 percent target, and public sector credit grew 22.6 percent, slightly higher than the 20.3 percent target.

27. **Bangladesh Bank has signaled its decision to stay the course on monetary discipline in FY14, despite the forthcoming elections.** The BB’s MPS for July-December 2013 envisaged targeting a monetary growth path to curb inflationary pressures “while ensuring that credit growth is sufficient to stimulate inclusive growth”.\(^\text{12}\) It sought to keep broad money growth at around 17 percent while raising domestic credit growth to 17.2 percent and private-sector credit growth to 16.5 percent. These are consistent with sustaining GDP growth at around 6 percent and lowering inflation to 6.5 percent (2005/06 base) while meeting private-sector credit demand and providing financing for the FY14 budget. However, a 6.5 percent inflation target is high relative to the 1-2 percent inflation rate in most of Bangladesh’s major trading partners, except India.\(^\text{13}\) This gap may complicate exchange rate management by appreciating the taka over the medium term.

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\(^{11}\) World Bank, Food Price Watch, Year 4, Issue 14, July 2013.

\(^{12}\) Bangladesh Bank, Monetary Policy Statement, July-December 2013.

External balances have improved, although the underlying drivers send mixed signals

28. The external trade deficit decreased significantly, due primarily to increased export growth relative to FY12 and flat import payments. The overall trade deficit fell to US$7 billion in FY13 from US$9.3 billion the previous year. The reduction underpinned the strong overall BOP position in FY13. Combined with continued strong inflow of workers’ remittances, this led to a strong rebound in the external current account position. After recording a US$447 million deficit in FY12, the current account recorded a surplus of more than US$2.5 billion in FY13 (Figure 8).

29. The financial account surplus also improved remarkably to US$2.8 billion in FY13 from US$1.4 billion in FY12. This reflected a steady pickup in foreign direct investment (FDI) and a large increase in multilateral and other long-term loans. FDI increased by 9.2 percent while disbursement of multilateral loans increased by 38.7 percent. Despite a large inflow in other long-term credit due to private-sector borrowing from the international financial market for investment in approved projects and working capital loans, there was only a US$321 million combined surplus in other long-term and short-term loans, suggesting there have been large private outflows as well.14

30. Foreign exchange reserves continue to set historic highs. The combination of a strong current account position and a large financial account surplus contributed to a sharp improvement in the BOP position to an overall surplus of US$5.1 billion in FY13 from a US$494 million surplus in FY12. Consequently, foreign exchange reserves held by the Bangladesh Bank increased by almost US$5 billion to US$15.3 billion by end-June 2013 and over US$16 billion by end-September, equivalent to nearly five months of imports of goods and non-factor services. The ongoing currency volatility in India, Indonesia, Brazil, and Turkey has again demonstrated the importance of holding adequate reserves as part of a country’s defenses against shocks, while working on structural vulnerabilities in a credible manner.

Box 1: Assessing the Adequacy of Foreign Exchange Reserves

Most countries—regardless of region—have accumulated more reserves in recent years than standard rules of thumb suggest. The median coverage ratios among emerging markets amount to about six months of imports, 200 percent of short-term debt, and 30 percent of broad money. For most low-income countries, the median coverage ratios amount to about 4.7 months of imports, 55 percent of broad money, and 20 percent of GDP. Accumulation has been faster for countries with fixed exchange rates. Global reserves more than doubled to about 14 percent of world GDP and more than six months of imports by 2010. Bangladesh’s current reserve level constitutes 4.6 months of import cover, 11.8 percent of GDP, and 20.1 percent of broad money.

Low-income countries’ vulnerabilities stem from lack of economic diversification, and weak policy and institutional frameworks. In the absence of economic reforms to address these issues directly, reserves are used to provide temporary and partial solutions to vulnerabilities. Some countries actively deploy their reserves to reduce volatility of foreign exchange markets or to provide foreign currency liquidity to the banking sector, while others take a more cautious approach to using reserves out of concern that depleting those reserves may signal weakness in the external sector, triggering further pressure on their currencies.

International evidence suggests that reserves have provided an effective cushion against external shocks. Countries with reserves covering more than three months of imports have been better able to smooth consumption and absorption than those with lower coverage. These findings are borne out for other types of shocks routinely faced by low-income countries. International evidence also points to the importance of country characteristics and vulnerabilities in assessing reserve adequacy: the shock-mitigation effect of reserves is particularly pronounced, for instance, in highly-indebted economies, small islands, commodity exporters, and countries with fixed exchange rate regimes.

Reserves proved useful in cushioning the impact of the global financial crisis. While financial channels were largely muted because of limited market access, those low-income countries entering the crisis with higher reserve coverage were better able to buffer domestic absorption against spillovers from advanced economies—reflected in external demand shocks and drops in external financing flows. They were also more able to protect investment to help offset the effects of the crisis, whereas low levels of reserves were associated with a sharper contraction in real per-capita investment. In general, reserve accumulation reflects the existence of large shocks and the absence or imperfections of international insurance markets. Central banks weigh the cost of holding reserves against the benefits associated with massive disruptions in their economies during crises. Recent financial crises in both emerging and advanced economies show the increasing fragility of financial markets and institutions over the last three decades. Without a global lender of last resort, the limited ability to borrow both internationally and domestically makes countries like Bangladesh vulnerable to sudden shocks to the current and capital account, against which they feel a compelling need to self-insure. The resilience of the high-reserve economies during the subprime crisis validates the self-insurance motivation.

To assess the adequacy of reserves one has to consider a broad set of risks. Sources of risk for a country like Bangladesh would include external liabilities as well as current account variables and some measure of potential capital flight. Export earnings reflect the potential loss that could arise from a drop in external demand or terms of trade shock. Imports are a more familiar current account variable to use here, but do not capture risks of external demand collapse. In practical terms, the choice between exports and imports does not make a major difference, as the two are usually of comparable size. The separate external liability stocks—short-term debt (at remaining maturity) and medium- and long-term debt and equity liabilities—account for additional different observed drains. For capital flight risk, broad money is used to represent the stock of liquid domestic assets that could be sold and transferred into foreign assets during a crisis. Calibrated optimal reserves for different country groups vary from less than two months to over 12 months of imports depending on country characteristics, fundamentals, and the cost of holding reserves. For a non-commodity exporter such as Bangladesh, optimal reserves appear to be in the range of 4.7-5.1 months of GNFS imports (IMF, WP/11/249).

Recent exchange market volatility in emerging markets show that reserves can deplete as fast as they can accumulate. Central banks in the developing world have lost US$81 billion of emergency reserves through capital outflows and exchange market interventions since early May, 2013.
31. The rapid increase in reserves in recent months raises the question of whether this accumulation has been excessive. The significant costs attached to reserve holdings make it important to understand what constitutes an adequate level of coverage. Ideally, decisions on reserves should be governed by an analysis weighing the benefits of reserves against their cost. But in practice there is huge uncertainty about both the utility and cost functions that would inform such an analysis (see Box 1 for further discussions on the adequacy of reserves). The composition of reserves is important as well. About 70 percent of Bangladesh’s foreign exchange reserves are held in US dollars and about 20 percent in euros. Gold accounts for about 6 percent. In FY13, the Bangladesh Bank reportedly incurred large losses with significant appreciation of the taka against the dollar and decreases in the prices of gold and silver.

32. The nominal exchange rate has been stable, but the premium on the curb market rate has increased. After depreciating against all major currencies, the exchange rate entered a phase of creeping appreciation from November, 2012. By end-August 2013 the taka had appreciated nearly 5 percent (Figure 9), despite the Bangladesh Bank’s intervention.\(^{15}\) However, the average curb market rate moved counter to the average interbank exchange rate, depreciating by about 1.6 percent since February 2013. As a result, the curb market premium has more than trebled, to 4.2 percent by end-August from 1.2 percent in February. This apparent divergence in the behavior of the formal and informal market exchange rates has been generally attributed to capital flight. Media reports provide anecdotal evidence that an increasing number of Bangladeshi businessmen and professionals are investing in real estate in Kuala Lumpur, Toronto, Bangkok, London, and Singapore, possibly prompted by political uncertainties. The situation appeared to have been serious enough to compel the Bangladesh Bank to issue a circular on August 22, reminding investors that moving funds out of the country to invest in real estate abroad is illegal and a punishable offense under the Foreign Exchange Regulation Act 1947.\(^{16}\)

The banking system remains under stress and capital market activities have been weak

33. A series of financial scams and resultant loan defaults in the state-owned commercial banks (SCBs) moved them into a position of insolvency. The top management collaborated with some fraudulent borrowers to swindle large amounts of money in the form of borrowing under different instruments. In most cases neither the management nor the boards of these banks have yet been held accountable by the government for these large-scale frauds. As a result these banks, which are substantially outside the control of the Bangladesh Bank, are now technically insolvent. Yet they continue to operate because of liquidity drawn from government accounts, surplus balances of state-owned corporations,

\(^{15}\) The BB purchased US$3.9 billion in FY13 and another US$850 million up to August 27 this fiscal year.

authorities and agencies and, critically, the public that believes their deposits are fully guaranteed by virtue of state ownership.

34. **The overall performance of the banking sector has been declining since 2009, particularly the SCB category.** Capital to risk-weighted assets is on the decline while the share of NPL to total loans increased to 11.9 percent by end-June 2013 from 6.1 percent at end-2011, with the largest increases concentrated in the SCBs (Figure 10). Similarly, returns on assets and equity have sharply declined. NPLs in the state-owned commercial banks are the highest of all categories of banks in Bangladesh. The spurt in losses from the loan books is due mainly to the financial malpractices that have recently been unearthed in these banks. For example, two major business groups have embezzled large amounts of money from the SCBs. Action against such frauds has unfortunately been slow and, in some cases, ineffective. High NPLs have pushed the interest rates upwards as banks try to protect profitability by charging higher rates on good loans. Apart from weak monitoring and supervision of loans, the reason for high NPLs is also linked to poor governance in the banks.

35. **The insolvency of the SCBs needs to be addressed.** This would involve injecting fresh capital into the SCBs to make up for their loan losses plus the additional amounts needed to bring their capital up to at least the required 10 percent of risk-weighted assets, as per BB regulation. Although the exact figure for capitalization is still being calculated by the BB, it could be in the order of US$2.2 billion. However, capitalization without conducting deep reforms to strengthen corporate governance in the SCBs and bring them out of political capture may not be effective. Concerted efforts by the government to undertake structural and governance reforms, including management by professional bankers and commercial operation, as has been attempted by neighboring countries, may enhance the sustainability of the banking system.

36. **Capital market activities remained generally weak throughout FY13.** Low investor confidence following the stock market crash in January 2011 persisted, and securities trading experienced occasional ups and downs within a low band of activities, in both volume and price movement. The shaky investor confidence combined with accumulated brokerage house loan balances discouraged small and individual investors from making new investments. A new market index, the DSEX, has been operationalized in order to reflect market movements more accurately. The DSEX is expected to rectify the volume bias of the previous index, DSEGEN, that was skewed by large trading volumes of a few big companies with large market capitalization. Political uncertainty and violence prevented the institutional investors from making any long term commitment to the market, despite the fact that some stock prices had fallen to five-year lows. With approval of the Demutualization Act by the government, the two stock exchanges submitted their demutualization plans laying out the timelines and other parameters for separation of ownership from day-to-day management of their stock market affairs. The regulations, if implemented properly, will reduce conflict of interest and increase transparency in the capital market. The government recently approved a low-interest loan scheme for small investors to be administered through the Investment Corporation of Bangladesh (ICB), the state-owned investment bank. While this is a significant step, its success will depend on the extent to which it boosts investor confidence and leverages capabilities of the ICB and other institutional investors.

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17 Tighter loan classification and provisioning standards introduced in 2012 contributed to half of the increase, with the remainder due to slower economic activity and lending fraud.
Fiscal policy has been on track, but challenges lie ahead

37. The conduct of fiscal policy in FY13 has been broadly in line with the original budget. The overall fiscal deficit (excluding grants), at 4.3 percent of GDP, has been below the budget target of 5 percent. Better cash-flow management through increased utilization of foreign financing for project implementation improved the composition of deficit financing. Domestic financing of the budget declined to 2.5 percent of GDP in FY13, compared with 3.3 percent in FY12. External financing improved to 1.8 percent of GDP, compared with 0.8 percent the preceding year (Figure 12).

38. Revenue collection was reasonably effective given the growth slowdown and disruptions due to political conflicts. The government had set an ambitious NBR revenue growth target of 18.79 percent over the collection level of FY12. The revenue collected in FY13 fell short of target by Tk 35.6 billion (0.5 percent of GDP), due primarily to lower import-based taxes and on the domestic supplementary duty collections. However, collection of income tax and domestic VAT remained strong. Economic activity, in particular, was negatively impacted by the disruptive political action programs and resultant hostilities during the final quarter of the fiscal year, and this hampered NBR revenue collection by limiting the expansion of the tax base and making collection more difficult.

39. Government expenditure stayed within the budgetary limit despite pressures of subsidy payments. In line with growth of revenue (0.57 percentage points of GDP), growth in budgetary expenditures were also limited by 0.5 percentage points, to 17.1 percent of GDP in FY13. Current expenditures exceeded the budget target by 0.3 percentage points primarily because of increased payments associated with subsidies, part of which were to clear arrears from FY12 (Figure 11).

40. The burden of subsidy increased rapidly after FY10, with growing fuel and electricity subsidy payments adding to continued high subsidies for agricultural inputs. As a result, the total budgetary subsidy bill, which was around 1.5 percent of GDP in FY10, steadily increased to 3.6 percent of GDP in FY13. Rapid growth in fuel, agriculture inputs, and electricity subsidies contributed to this unsustainable situation. Total subsidy in the revised budget increased to Tk 373.89 billion, against the original target of Tk 345.33 billion. While the adjustment in the electricity tariff helped reduce the Bangladesh Power Development Board (BPDB)'s subsidy bill, the allocations for the Bangladesh

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Petroleum Corporation (BPC) and agriculture sector increased. The fertilizer subsidy provided by the government to agriculture doubled in the revised budget from Tk 60 billion to Tk 120 billion.

41. **Improved implementation of the Annual Development Programme (ADP) continued in FY13.** However, political disturbances slowed project implementation in the final quarter, keeping ADP expenditure 4.5 percent below the revised budget target of Tk 523.7 billion. The ADP utilization rate improved substantially in the early part of FY13, with 49.5 percent of the budget utilized by March 2013, which was 4.7 percentage points higher than the corresponding period the previous fiscal year. However, implementation slowed in the final quarter of FY13 as contractors faced difficulties because of political agitation. The implementation rate declined to 91 percent of the original FY13 ADP size (Figure 13).

42. **The overall FY14 fiscal stance is prudent.** The FY14 budget targets a modest deficit of 4.6 percent of GDP and a domestic financing target of 2.9 percent of GDP, as the authorities confront a host of domestic challenges ranging from growing traffic congestions, shortages of power, water, and gas to a need for higher welfare spending. The budget envisages an ambitious 20 percent revenue growth target and a not-so-ambitious 17.5 percent expenditure growth target.

- Tax collections are likely to continue to suffer from strike-related disruptions and slower imports in the first half of FY14 in particular. The budget does not include measures that could strengthen revenues in the near term through further removal of exemptions and phasing out of truncated bases for VAT.
- As usual, sectoral shares in total expenditures are in line with policy priorities and the economic composition of expenditures is slated to improve with the share of recurrent expenditures projected to decline to 57 percent in FY14 from 60 percent in FY13.
- Subsidies are projected to decline to 2.9 percent of GDP, although the budget does not make any specific commitments to cost-containment measures for fuel and electricity subsidies.
- The share of construction & works and asset acquisition in total “capital” expenditure is projected to rise to 52 percent in FY14 from 38 percent in FY13.
- The FY14 ADP remains plagued by the usual problems of too many projects to implement and too many with inadequate allocations. ADP implementation will need special administrative attention this year because of the impending political transition. Recent reviews suggest that strengthening the capacity to manage public investments may have a significant positive impact on development outcomes.

43. **The ratio of public debt to GDP has continued to decline, but contingent liabilities have grown.** From 42.9 percent of GDP in FY10, public debt declined to 40.3 percent in FY13, driven primarily by the contribution from higher GDP growth relative to the interest rate on public debt. The real exchange rate (which measures the cost of foreign goods relative to domestic goods) appreciation also contributed to the decline of debt/GDP ratio in FY13 relative to FY12. The interest cost of public debt remained low, at 2.3 percent of GDP, in FY13. However, contingent liabilities originating from guarantees given by the government primarily favoring state-owned enterprises have grown rapidly to Tk 591 billion (5.7 percent of GDP) in June 2013 from Tk 291 billion (4.2 percent of GDP) in June 2010. The bulk of the contingent liabilities (nearly 65 percent) stems from the Bangladesh Petroleum
Corporation (43.4 percent), Bangladesh Agricultural Development Corporation (10.3 percent), Rajshahi Krishi Unnayan Bank (4.3 percent), Bangladesh Power Development Board (3.9 percent), and Bangladesh Telephone and Telegraph Board (3.03 percent).

II. Policies and Short- and Medium-Term Development Challenges

Structural reforms have progressed slowly, although some are regressive

44. The IMF’s Extended Credit Facility (ECF) is on track. Bangladesh has made significant progress in strengthening macroeconomic conditions and structural policies under the ECF arrangement. With current international reserves at levels almost double the lows of 2011; the country is now better placed to withstand adverse external shocks. The new VAT law has moved firmly into the implementation phase, amendments to the Banking Companies Act have been passed (see below), and progress is being made to diagnose critical weaknesses in the state-owned commercial banks as an initial step toward strengthening their governance and financial positions.

45. The National Board of Revenue has introduced an online tax registration system. Under this new system, tax identification numbers (TIN) are issued online after validation of taxpayer information on a real-time basis in conjunction with the National ID database and Registrar of the Joint Stock Companies (RJSC) database for individuals and businesses respectively. The current database contains 3.7 million TIN holders of which only 1.8 million are active with accurate data. The new system will help clean up the existing database and enable improved tax governance and oversight. It will also reduce the time and cost for taxpayers since they are able to register online without cost, whereas the old system took nine days and required a US$13 payment as advance income tax. This automation, supported by the IFC, is a primary step towards an automated and efficient tax administration. The online registration has started successfully, with 1,11,318 individuals and firms re-registering and a further 42,261 individuals and firms newly registered in the first two months of the new TIN system.19

46. The FY14 budget introduced revenue reforms. These included an increase in the income tax exemption limit from Tk 2,00,000 per annum to Tk 2,20,000, an extension of the existing tax holidays to the end of FY15, a reduction in tax from Tk 3,000 to Tk 2,000 for people living in Pourashava areas, and from Tk 3,000 to Tk 1,000 for people living in Upazilla and other areas. New revenue generation measures included an increase in the tax rate for publicly traded and non-traded cigarette manufacturing companies by 5 percent and 2.5 percent respectively, the imposition of 10 percent and 15 percent surcharges on individuals with assets between Tk 20-100 million and more than Tk 100 million respectively, and an increase in the income tax rate for publicly traded mobile companies from 35 percent to 45 percent. In addition, the provision for whitening undisclosed wealth by paying a 10 percent fine plus normal taxes will continue in FY14. The government also provided the opportunity to invest undisclosed money in the real estate sector by paying taxes between Tk 750 and Tk 7,000 per square meter, depending on location and size.

19 NBR, August 29, 2013.
47. **The nominal protection rate fell.** The average nominal protection rate declined, from 28.9 percent in FY13 to 28.1 percent in FY14. This decline was due mainly to the reduction of custom duty slabs from 3 percent and 12 percent to 2 percent and 10 percent respectively. The decrease in customs duty primarily impacted the nominal protection of capital goods and intermediate goods—the average nominal protection for capital goods decreased by 0.9 percentage points while for intermediate goods the decline was 1.0 percentage point. The average protection on raw materials is unchanged and there was an increase in the average protection rate for consumer goods. Although the average para tariff declined from 15.1 percent in FY13 to 14.9 percent in FY14, the share of para tariffs in nominal protection increased from 52.1 percent to 53 percent (Figure 14).

48. **Parliament passed the Road Maintenance Fund Board Bill 2013.** This bill will allow development of a self-financed Road Fund, under a 13 member board headed by the Secretary of the Road Division. Funds will be raised from road taxes, motor vehicle taxes, motor fitness, route permit, registration and license fees, road cutting and utility fees, and road penalties. There is also provision for collecting funds from government and development partners. The resources from the proposed fund will be used for regular repairs, operations and maintenance of all roads, bridges, culverts, and pavements under the Roads and Highways Division’s road network.

49. **The price of urea fertilizer decreased.** The government cut the price of urea by 20 percent, from Tk 20 per kg to Tk 16 per kg on August 24, 2013. The requirement of urea varies between 2.5 million to 3.3 million metric tons of which around 1.7 million tons is imported. This price reduction will increase the subsidy bill for urea by Tk 6.4 billion to 6.8 billion, with government providing a subsidy of around Tk 18 per kg of urea. In FY14, the total subsidy for urea is projected to be Tk 35 billion.20

50. **Parliament passed the Bank Company (Amendment) Bill, 2013.** This amendment was a structural benchmark under the ECF program. The amendment limits the maximum number of directors to 20, including three independent directors in each bank. The bank authority has to receive permission from the Securities and Exchange Commission (SEC) to appoint an independent director. No person can be the director of more than one financial institution at a time and two members of a family are not allowed to be appointed directors of the same bank. The amendment strengthens the Bangladesh Bank’s (BB) authority by empowering the BB to remove managing directors of state-owned banks and inspect the cooperative societies collecting funds from non-members. Furthermore, the amendment changed individual bank’s capital market exposure from 10 percent of total liabilities to 25 percent of its regulatory capital (the sum of total paid-up capital and reserves) and provides for fining to a maximum of Tk 2 million for failure to maintain this exposure.

51. **The Labor Law was amended.** After the three successive devastating industrial accidents, the government reformed the Labor Law. The new law contains 87 amendments. Among these is the elimination of the obligation to provide employers with the names of union leaders at the time of registration of a trade union, permitting workers to call on outside experts for advice during collective bargaining, and allowing workers to elect 10 percent of their enterprise officers from outside the workplace in the public sector; these steps are expected to improve the labor rights situation. The increase of the number of trade unions allowed in a factory from two to five has also been welcomed. The amendments also include several measures to improve worker safety and welfare, and provide for the formation of a central fund for employees of 100 percent export-oriented foreign-owned companies, mandatory deposition of 5 percent of net profit in provident and welfare funds, and group insurance provisions for workers in case of accidents. In addition, the Labor Inspectorate has new responsibilities to inspect safety and health conditions of workplaces and conduct on-the-spot inspections, and factory

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owners are not allowed to change a factory layout without permission of the inspectors, nor are they permitted to lock exits.

52. **Government rolled out 3G telecom licenses by auction.** After a long delay because of tax-related disputes with telecom operators, the government conducted the 3G auction in September. Four telecom operators acquired 25 megahertz of spectrum at a total price of US$525 million before VAT (5 percent). The operators are required to pay 60 percent of the purchase price within 30 days and the rest within 180 days. The state-owned Teletalk (which has already launched services) will have to pay US$210 million as well. Fifteen megahertz of spectrum remained unsold. In order to spread improved Internet services all over the country, the license requires the operators to introduce 3G services in the divisional cities within the next nine months. Operators will not be limited to providing only 3G services, but can use the spectrum (existing and newly acquired) to also provide 4G services. Some consolidation in the sector is likely with the possible acquisition or merger of Citycell in a few months, which would mean the industry will have five operators instead of the existing six. It is expected that the operators will be able to provide 3G services in the capital city within this calendar year. The challenge now is to help the government mobilize the monies collected into the social obligation fund for demand-side initiatives in the mobile broadband ecosystem.

53. **Restoring the image of the garment industry is the most immediate challenge.** The government has pledged to work with the International Labor Organization to improve worker safety in the country. The tragedy has placed Bangladesh’s RMG sector in the world spotlight and has bound all players in the global garment value chain to be accountable for their roles, responsibilities, commitments, and pledges with regard to the victims of the Rana Plaza disaster and workers of all Bangladeshi factories in general. Past experience has shown that while some incremental progress tends to be made after a disaster, many of the announced steps remain unimplemented. Once another disaster happens, a flurry of actions is announced again and history keeps repeating itself. Bangladesh can hardly afford another such incident. The most immediate priority for the government, therefore, is to ensure enforcement of the steps suggested by foreign buyers, international agencies, and domestic regulatory bodies.

54. **Supply-side bottlenecks have to be addressed.** Growing uncertainty on the election front is undermining business confidence and stifling economic activity. The ongoing political uncertainty, together with frequent general strikes and associated hostilities, have added to the longstanding energy and infrastructure deficits in dampening the investment climate, posing a nontrivial threat to the sustainability of the average 6 percent growth achieved in recent years, let alone raising it to 7 percent in the near future. For growth to return to pre-crisis rates and be sustained, much more attention will need to be paid to policies that tackle supply-side bottlenecks such as weak and poorly enforced regulations, corruption, inadequate and irregular provision of electricity and gas, growing road congestion, and inadequate investments to improve educational and health outcomes. The government is likely to make progress on meeting the conditions of the Extended Credit Facility with the IMF. In the past, governments have been slow to implement long-term infrastructure plans, with incoming administrations sometimes rescinding agreements made by their predecessors. Maintaining policy continuity in an election year will also be a challenge.

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III. Outlook and Risks

Global risks have receded

55. Evidence is emerging that the global economy is slowly recovering, albeit with hesitancy and unevenness. Since the onset of the crisis in 2008, expectations of a firming of growth have ended in disappointment on more than one occasion. The current conjuncture is no different, with forward-looking indicators, including business surveys, strengthening over the past six months only to weaken again recently. Activity in high-income countries has been under considerable pressure from fiscal and banking sector consolidation and related uncertainties. These pressures are expected to remain in the near- and medium-terms, though the drag they are exerting on growth is projected to diminish, in part because much of the necessary adjustments have already been made. In the US, overall, GDP growth for the year is projected to slow somewhat, compared to 2012, to about 2.0 percent in 2013, before strengthening to 2.8 percent in 2014 and 3.0 in 2015. GDP rose by 0.3 percent in the euro area during the second quarter of 2013, compared with the previous quarter. Growth in Japan rebounded; expanding at a 4.1 percent annualized pace, with consumer demand rather than investment a major driver.

56. Growth in developing countries projected to gain strength. Overall, developing-country GDP is expected to firm somewhat in 2013, growing by 5.1 percent and gradually rising to 5.6 percent in 2014 and 5.7 percent in 2015. However, there exist considerable regional and country-level variations. Many countries in East Asia and Sub-Saharan Africa are growing rapidly and are already close to or above potential, and therefore at risk of overheating; countries that appear to be running up against capacity constraints at growth rates well below those of the pre-crisis period, including several large and economically important middle-income countries; countries with considerable slack in their economies, whether because of the severity of the post-crisis downturn (developing Europe), or because of social and political disruptions to economic activity (Middle East and North Africa); and finally developing countries where recovery from the crisis appears complete, and there are no outward signs of overheating.

Risks stemming from internal environment now predominate

57. Bangladesh's near and medium-term macroeconomic outlook is subject to several vulnerabilities—a possible resurgence in inflation due to intensified supply disruptions and wage push factors, export slowdown, fiscal expansion due to increased recurrent expenditures in response to political pressures, and failure of financial intermediation. Global economic issues and a variety of domestic economic and political issues have led to an “extreme deterioration” in consumer confidence among Bangladeshi consumers in their overall outlook for the months ahead.

58. The impact of the recent rupee depreciation is uncertain. The Indian rupee has depreciated from 53.7 per dollar on May 2 to around 62 per dollar on September 15. Similar large depreciation has occurred in Indonesian and Turkish currencies as well. The currency turbulence is linked to external factors such as the expected tapering of quantitative easing in the US and domestic factors such as high current account and fiscal deficits. India, Indonesia and Turkey compete with Bangladesh in the export markets. Such large depreciation of their currencies is likely to toughen competition for Bangladesh. The impact will depend on the permanence of the currency depreciation, the impact of the policy response in these countries, the feedback effects on their inflation rates, and the impact on the cost of intermediate input and raw material imports in Bangladesh. If the foreign exchange markets have over-reacted to the US Federal Reserve Bank’s signal then clearly a reversal is likely, and early signs suggest that such a

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22 Discussion in this section is based on Global Economic Prospects, World Bank, June, 2013.
process is underway;\textsuperscript{24} the reversal may be expedited if the policy tightening measures already announced in these countries begin to have the desired effects on market sentiment. These countries will also lose the competitiveness gained from currency depreciation if the latter stokes inflation. Bangladesh is a large importer of raw materials and intermediate inputs from India. About 34.7 percent of the total imports of cotton and cotton fabrics came from India in FY12. Depreciation of the rupee has made these imports a lot cheaper which will reduce the cost of producing Bangladesh's exports and thus mute the loss of competitiveness. There may also be some re-sourcing of intermediate input imports from other sources to India, which will further reduce cost of producing Bangladeshi exports.\textsuperscript{25} Moreover, Bangladesh exports mainly low-end garments while India concentrates on high-end value fashion items. It cannot therefore be assumed that the impact of rupee depreciation will be necessarily negative, large, or long lasting.

59. **The growth outlook hinges primarily on internal stability and policy reforms.** Real GDP growth in FY14 may slow to 5.7 percent, reflecting the negative impact of the recent strikes on sentiment towards Bangladesh on the part of foreign investors and a hiatus in policymaking as the parliamentary election approaches. Policymaking is expected to improve if the transition to a new government in 2014 happens peacefully. This should help boost investor sentiment. Increases in private consumption will continue to support growth. Private consumption growth in turn will depend on growth of the agricultural sector as well as remittances from Bangladeshis working abroad. Gross fixed investment may rise with the dissipation of political uncertainties. This component of GDP accounts for 71 percent of fixed investment in Bangladesh. The pace of private investment is also likely to be boosted by the efforts to attract greater flows of foreign direct investment from India, China, and Russia, as well as from members of the Bangladeshi diaspora in OECD countries. With improvements in capacity utilization and revival of investment momentum, the external trade deficit is likely to widen in the medium term because of heavy reliance on imports for raw materials, intermediate inputs, capital machinery, and fuel to meet the bulk of Bangladesh’s domestic needs. Maintaining strong remittance inflows, improving FDI and increasing utilization of concessional aid will be important for ensuring the adequacy of financing the wider trade deficit. Although agriculture’s share in GDP will continue to decline from the current 17.2 percent, it will remain the country’s largest employer and the main source of income for around one half of the working population. On the supply side, GDP growth will continue to be driven by services and industry.

60. **Several macro vulnerabilities loom large.** Overall, the Bangladesh economy is moving into a more volatile phase. The extreme risks stemming from the impending political transition have enhanced significantly while new risks and challenges have gained prominence.

- **Inflation could rise.** Production and supply-chain disruptions due to intensified political violence in the run-up to elections are a major near-term inflation risk. In addition, with large wage increases expected across all sectors of the economy, including the RMG and public sectors, wage-push inflationary pressures may build. The strengthening of the taka against both the US dollar and Indian rupee may dampen import price inflation somewhat. However, there remain significant upside risks. Food prices could increase faster than expected if inclement weather reduces the size of harvests in Bangladesh or elsewhere in the world. Local food costs will also be influenced by global energy prices, particularly gas, as most farmers in Bangladesh will continue to rely on chemical fertilizer to maximize their crop yields. If rainfall is close to normal and supply disruptions minimal, the rate of a food price increase may decelerate. Events in the Middle East may trigger a global oil price shock leading to pressure on the external and fiscal balances. The Bangladesh Bank's efforts to maintain a balance between growth in monetary aggregates and

\textsuperscript{24} The rupee had already risen back to around 63 per dollar by September 11.

\textsuperscript{25} Bangladesh imports cotton mostly from Central Asia Countries, Pakistan, India, USA, Australia, and Brazil. The country imports cotton for the woven industry from India, Pakistan, and China. It also imports woven fabrics and some high-end fabrics from China.
the developments in the real sectors would require sizable sterilization operations to counter the monetary impact of growing foreign exchange reserve levels supported by continued restraint on the monetization of fiscal deficit.

- **Fiscal policy implementation may be stressed.** The NBR’s revenue collection grew by 12 percent in July-August relative to the same period the previous year—well below the 20 percent target for FY14. Achieving the FY14 revenue growth target will be challenging if economic growth slows further and imports do not recover. A new government is expected to take charge during the second half of the fiscal year. It may revisit the fiscal framework when preparing the revised FY14 budget. Besides, the continued increase in the budgetary subsidy bill remains a threat to sound fiscal management and this may be exacerbated in the run-up to elections. Reducing the subsidy bill, as projected in the FY14 budget, will depend on external factors such as petroleum and fertilizer prices in the international market and adjustments in domestic energy and agricultural input prices.

- **Fragile corporate governance in the financial sector poses systemic risk.** Recent stock market volatilities and financial scams have weakened the fundamentals of the banking sector significantly. The scams exposed the vulnerabilities of the SCBs and the risks they pose to the soundness and stability of the financial system, which are compounded by inherent weaknesses of the banking sector. SCBs have to be properly managed by professional bankers and run along commercial lines.

- **Remittance growth may weaken as manpower exports decline.** Remittance declined by 5.6 percent in July-August, compared to a 16.3 percent growth in the same period in 2012. Remittance inflows have become vulnerable with the recent sharp decline in the number of workers going abroad (Figure 15).\(^\text{26}\) Reviving the momentum in labor exports will require intensive economic diplomacy with the labor-importing countries. Current instability in the Middle East and North Africa may have negative consequences for Bangladeshis living and working in those regions, hampering their ability to earn and remit money home.

- **Sustainability of RMG exports under threat.** Exports grew by 14.6 percent in July-August, driven by 17.2 percent growth in woven garments and 17 percent growth in knitwear. While this is a good beginning for FY14, managing the RMG sector safety, working condition and labor rights issues will be critical for sustaining export growth. With a structural transformation where large, modern manufacturers either take over or impose safety controls over the many small subcontractors and the combination of low wages, large work force and the right skills, Bangladesh’s garment industry has the potential to expand rapidly in the long run if it can avoid catastrophic accidents such as Rana Plaza. Near-term risk is on the downside additionally because

\[^{26}\text{Only 65,046 workers left for work abroad in FY14 (July-August), compared with 1,06,486 in FY13 (July-August).}\]
of the prospect of disruptive political situation which may have an adverse impact on all exports, not just garments.27

IV. Garment Industry at the Crossroads28

61. The sunny picture of the ready-made garment (RMG) industry has changed as a result of several deadly but avoidable industrial accidents. RMG has been the main driver of Bangladeshi exports in the past two decades. The share of garments in total exports increased from 53 percent in FY95 to 79.6 percent in FY13, reaching a historic high of US$21.5 billion in exports. A McKinsey report in 2011 said Bangladesh has the potential to replace China as the biggest apparel sourcing hotspot centered on price advantage via low-cost labor and satisfactory quality levels. However, since November 2012, five deadly fire and building collapse incidents exposed the dreadful state of physical and social compliance. Now the industry is at a historic crossroad from where it can either rise to become a US$36–42 billion industry by 2020 with improved labor and safety standards, or fall by continuing to neglect these critical compliance issues.

62. The garment industry has seen volume-driven growth concentrated mostly in the EU and US markets. Currently, woven and knitwear products have about even shares of the total RMG exports. While the average unit price was declining in the early 2000s, since 2010 the prices of both knitwear and woven garments have risen, reflecting a gradual product diversification. Relaxation of the rules of origin at different times under the GSP facility boosted exports to EU. However, the slow recovery from the recession in the EU and US, combined with active policy support from the Bangladesh government, encouraging garment exporters to explore nontraditional markets such as China, Japan, South Africa, Russia, and India, which has seen significant increases in the market shares in those countries. Low cost, high capacity and strong capability has placed Bangladesh’s garment industry at an advantageous position relative to competitor countries.

63. The recent industrial disasters have exacerbated the concern over working conditions, worker rights, and wages. The Rana Plaza collapse in April, 2013, the worst industrial disaster in

27 Recent research has shown that an increase in supply-chain uncertainty reduces imports from locations with high delivery-time uncertainty. An increase in order costs reduces a firm's shipping frequency and increases average inventory holding cost for the firm's base inventory stock. As a result, firms import less from locations with high ordering costs to reduce average inventory holding costs. A 10 percent increase in supply-chain uncertainty lowers imports by as much as 4.2 percent. This is evidence that delivery uncertainty imposes a cost on imports. A 1.0 percent increase in ordering costs lowers imports by as much as 1.2 percent. See Supply Chain Uncertainty as a Trade Barrier by Don Clark, Valentina Kozlova and Georg Schaur, University of Tennessee, May 5, 2013.

28 Annex A provides a much more detailed discussion of the post-Rana Plaza state of the garment industry and the challenges it is currently facing.
Bangladesh and one of the worst in manufacturing worldwide (Figure 16), has revived the debate over whether the low-cost advantage of Bangladesh’s garment industry is based on unfair treatment and abuse of workers. The rapid expansion of the industry has led to the conversion of many buildings, built for other purposes, into factories, often without the required permits. This resulted in widespread safety problems which the government lacks the capacity to monitor. Apart from lax enforcement of safety standards, the absence of proper trade unions has inhibited workers’ ability to effectively bargain for safer working environments. Low wage rates have also come under scrutiny.

64. **Sustainability of the competitiveness of Bangladesh’s RMG industry is at risk.** Apparel manufacturers are reporting 30-35 percent reductions in orders due to the recent compliance failures. Global fashion houses are starting to look for new sourcing countries such as Vietnam, Cambodia, and Indonesia, for fear of reputational risk in dealing with Bangladesh. Bangladesh’s failure to adhere to international standards for workers’ rights and safety in the RMG industry led to suspension of the GSP facility provided by the US. Although this cancellation will not have a major impact on Bangladeshi exports, since RMG did not have GSP in the US to begin with, it further taints Bangladesh’s image. Moreover, other industries that have benefited from the GSP facility (for instance, agro products, ceramics, and plastics) will experience a negative impact in both exports and labor welfare. The losses may be equivalent to 4.1 percent of total exports—or even as high as 8.1 percent of total exports (upper tail risk)—if the EU were to suspend its GSP.

65. **Noncompliance in worker safety is a collective failure of the manufacturers, the buyers, and the regulators.** In their clamor for profitability, buyers often concentrate on getting quality products at low prices regardless of the working environment. This in turn encourages manufacturers to avoid the cost of improving safety and labor standards. Very often manufacturers subcontract orders to smaller factories with substandard compliance, sometimes without buyers’ authorization. Buyers also do not maintain enough manpower to regularly monitor the factories who are supposed to process their orders. Furthermore, overall enforcement of labor laws and building codes is lax because of a lack of regulatory capacity. Monitoring building safety standards and compliance is weak because of insufficient trained manpower. In addition, the absence of any credible threat of prosecution for violating the law makes many firms apathetic toward compliance. Failures by the governmental bodies to ensure the proper implementation of safety standards occurs also when policymakers and regulatory bodies favor particular interest groups rather than the national interests they are mandated to serve. A lack of sound infrastructure and lack of suppliers’ understanding of the rules of compliance are further inhibiting factors.

66. **European and American buyers’ consortiums have announced separate initiatives to improve compliance over the next five years.** Although the “Accord” signed by 89 mostly-European retailers and the “Alliance” formed by 20 American retailers have similar plans to inspect factory buildings of suppliers and improve labor safety, the European scheme seems to be more progressive than that of the Americans. The Accord is legally binding, allows worker representation, and forces buyers to do business and get involved financially in improving building safety, while the Alliance has none of these features. However, the Accord and the Alliance both have commitments of the biggest buyers who source from Bangladesh and they have committed to inspecting about 1,500 factories in total.

67. **The EU and Bangladesh agreed to a time-bound “Sustainability Compact”, which is broadly consistent with the action plan provided by the US.** The key commitments made by Bangladesh to improve labor standards features amendment and enforcement of the labor law to improve the fundamental rights of workers, strengthen the Department of Factories and Establishments (DIFE), implement the National Tripartite Plan of Action (NTPA) on Fire Safety and Structural Integrity in the RMG industry, and assess building and fire safety of all active export-oriented RMG units, in accordance with the established milestones and timelines.
68. **The government has taken several steps to improve labor safety and compliance.** The government and representatives of Bangladesh employers’ and workers’ organizations signed the NTPA. This directs activities such as assessing safety of factory buildings, strengthening labor inspection, building awareness about worker rights and safety, and serves as a basis for the buyers’ initiatives. The labor law was amended to provide improved protection for the fundamental rights to freedom of association and the rights to collective bargaining. The government is attempting to strengthen regulatory oversight by taking steps to upgrade the DIFE and increase its capacity. Steps have been taken to acquire 532 acres of land to establish a Garments Industrial Park near Dhaka city and to relocate the factories there. A minimum wage board has been formed to reassess the minimum wage set in 2010.

69. **Effective implementation of planned actions through coordinated efforts is the need of the hour.** Progress has been slow in implementation of the agreed measures because of bureaucratic tangles. In order to expedite the proper execution of the strategic plans, procedures should be streamlined. Regular coordination should be maintained between the government and the private sector to ensure that the policy actions are uniform and cover the whole industry comprehensively so as to achieve undisruptive and compliant production.

V. World Bank Assistance

70. **Disbursement has increased.** At the end of FY13, the World Bank’s Bangladesh portfolio had 41 projects, including 29 IDA Projects and 12 standalone Trust Funds, with a net commitment of approximately US$5.3 billion. Disbursements in FY13 reached US$764.5 million for a disbursement ratio of 24 percent. FY13 disbursement is around 27 percent higher than FY12 disbursements. It is the highest disbursements after FY08 which was US$863 million. This disbursement equates to 3.2 percent of total public expenditure, 11.5 percent of the Annual Development Program, 23.9 percent of total foreign assistance and 44 percent of total project aid (in relation to the revised FY13 budget). IDA/TF portfolio is dominated by human development programs (37 percent) and infrastructure investments (28 percent). The remaining part is divided between sustainable development activities (17 percent), private sector development engagements (11 percent) and strengthening public sector /governance systems (7 percent). At the end of July-August 2013, the portfolio has disbursed US$73.4 million.

71. **New commitments have increased as well.** Seven new IDA projects (US$1.56 billion) and six TFs (US$93 million) were approved in FY13. The approved operations are a combination of successful follow on projects as well as smaller yet innovative pilot operations. Significant recent approvals have been:

- **The US$500m Safety Net Systems for the Poorest (SNSP) program** aims to improve the equity, efficiency, and transparency of five major safety-net programs in Bangladesh by improving targeting of program resources to the poorest households to promote more pro-poor coverage (through disbursement-linked indicators); strengthening management, program information systems and monitoring capacity to ensure efficient administration; and strengthening governance and accountability measures for increased transparency.

- **The US$375m Coastal Embankment Improvement project** aims to improve the resilience of the population living in the coastal areas of Bangladesh to climate change and recurrent storm-surge-induced flooding, by increasing the area protected in 17 polders from tidal flooding and storm surges; improving agricultural production by reducing saline water intrusion in selected

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29 FY08 disbursements included US$200 million Transitional Support Credit, disbursed in a single transfer because it was budget support.
polders; and improving the government’s capacity to respond promptly and effectively to an eligible crisis or emergency.

- A US$2.58 million JSDF grant to BRAC for "Safe Migration for Bangladeshis" was signed on June 21. The project will support enhanced information flows to potential migrants and their families regarding their rights, the migration process, affordable migration financing, and cost-effective remittance management; the overall goal is to reduce their vulnerability.

72. The Bank Group is adjusting its focus to areas that need greater attention now in light of Bangladesh’s evolving circumstances by shifting the basis of its engagement from financing to analytical and technical assistance in areas where financing is relatively available, thus freeing up resources for areas where there are currently short-falls. The Bank remains a committed partner with Bangladesh, while recognizing the challenges of operating in a weak governance environment. Building on Bangladesh’s remarkable development achievements, the Bank Group will continue to work with Bangladeshis all across this historical and resilient country, to reduce poverty and bring prosperity to all Bangladeshis, the poor in particular.
Annex A

Bangladesh’s Garment Industry at the Crossroads

The garment industry in Bangladesh has come a long way from just 50 factories in the 1980s employing only a few thousand people to about 5,400 factories currently employing nearly 4 million people, mostly women. The ready-made garments (RMG) industry has been the main driver of Bangladeshi exports in the past two decades. The share of garments in total exports increased from 53 percent in FY95 to 79.6 percent in FY13. Twenty-one of the top 25 export products of Bangladesh, including the top five export items, are clothing articles. Supportive public policies that gave special dispensation to the sector, such as back-to-back Letters of Credit (L/Cs) and special bonded warehouse facilities enhanced the natural advantage that Bangladesh has in labor-intensive products. Garment exports reached a historic high of US$21.5 billion in FY13, constituting 16.7 percent of GDP. A succession of deadly fire and building collapse incidents in the last year has exposed the dreadful state of physical and social compliance and put the industry at a historic crossroads. It could rise to become a US$36-US$42 billion industry by 2020 if it can ensure that the horrors of Tazreen Fashions and Rana Plaza are never repeated, or fall by continuing to neglect workers’ rights and safety, thereby compelling buyers to reduce their reliance on, or even abandon Bangladesh altogether in order to protect their reputations.

1. **Bangladesh’s RMG export potential is far from being exhausted.** According to the McKinsey report 2011, Bangladesh has the potential to replace China as the biggest apparel sourcing hotspot. Bangladesh exports mostly basic garments, with concentration on T-shirts, trousers, shorts, shirts, jackets, jerseys, pullovers, and cardigans. Bangladesh’s garment hegemony in global markets hinges on price and capacity. Low wages and lax regulations underlie Bangladesh’s competitive advantage. There is a vast network of garment factories that can churn out clothing quickly and cheaply. Taking full advantage of cheap labor and special incentives provided by the government, Bangladesh has expanded its capacity enough to become the next China.

2. **A wake up call?** This sunny picture of the RMG industry has changed since November 2012 with five deadly incidents, of which the deadliest was the Rana Plaza building collapse in Savar which killed more than 1,100 workers in April, 2013. The accidents have exposed the fragility of the hurriedly built capacity to deliver orders in time without bothering to comply with rules, regulations and worker safety standards. The incidents drew global attention to worker safety and rights violations putting pressure on big global clothing brands and the Bangladesh government to respond by using their economic weight to bring change. After reviewing the salient features of the garment industry, this annex provides an assessment of the post-Rana Plaza developments in the RMG industry, including an analysis of the factors underlying the compliance failures and the action plans being contemplated to address the failures.

30 A letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase.


32 More than 75 percent of total garment exports are comprised of knit: (i) T-shirt, singlets and other vests, HS code 6109, (ii) jerseys, pullovers, cardigans, etc., HS code 6110, and woven: (i) men’s suits, jackets, trousers and shorts, HS code 6203, (ii) women’s suits, jackets, skirts and shorts, HS code 6204, and (iii) men’s shirts, HS code 6205.
Garment Industry at a Glance

Figure 1: Commoditywise Performance (US$Million)

Source: Export Promotion Bureau

Figure 2: Marketwise RMG Export Performance (Million US$)

Source: UNCOMTRADE

Figure 3: Number of Employment in Garment (In Million)

Source: BGMEA

Figure 4: Export per Worker (US$)

Source: WB staff calculation from BGMEA and EPB data

Figure 5: Average Employment per Firm

Source: WB staff calculation from BGMEA

Figure 6: Minimum Wage (in US$)

Source: WB staff
I. Salient Features of the Garment Industry

3. Currently, both woven and knitwear have almost even shares in total RMG exports. The share of woven garments in total RMG exports declined from 74.3 percent to 51.3 percent from FY00 to FY13 while the share of knitwear increased to 48.7 percent from 24.7 percent in the same period. This was due to the higher average growth of knitwear at 18.8 percent compared to a 10.3 percent growth of woven garment during FY00-FY13 (Figure 1). The sharp increase in the exports of knitwear resulted from changes in the Rules of Origin (ROO) in the EU market from “3-stage-processing” to “2-stage-processing” in the late 1990s. This required a double transformation from yarn to fabric and from fabric to garment, meaning that fabric had to be sourced locally. Bangladesh developed an integrated value chain in knitwear; producing 80 percent of knitwear exporters’ fabric needs while for woven 35 percent of the fabric used is locally produced. The value addition is around 35-40 percent in woven and around 70 percent in knitwear. However, since the relaxation of the ROO in the EU, effective from January 2011, woven garments have also witnessed a significant boost as the EU now permits “single-stage processing” and allows the use of non-originating materials up to 70 percent under the value added criteria, compared with maximum 49 percent previously.

4. Garment exports are concentrated in the EU and US markets. Around 79.3 percent of the total garment exports were directed to the EU and US market in calendar year 2012, with the EU and US receiving 58.1 percent and 21.2 percent respectively. Garment exports to the EU are dominated by knitwear, while woven garments are the main exports to the US market. A trend of slow market diversification is emerging as the shares of garment exports to markets other than the EU and US have grown, from 5.6 percent in 2000 to 20.7 percent in 2012. Slow recovery of the EU and US economies from the global economic crisis and active government policy support has been encouraging exporters to explore nontraditional markets such as China, Japan, South Africa, Russia, and India.

5. The growth in garment exports in recent years has been volume driven. In FY13 the export volume of knitwear and woven garment grew by 14.7 percent and 18.5 percent respectively. In the US market, from 2000 to 2012, the volume of knitwear exports increased 2.6 times while woven exports doubled. During the same period, the volume of knitwear exports increased three-fold and woven exports increased 2.3 times in the EU market. Although the average unit price showed a declining trend during the early 2000s in both markets, it has been slowly rising in recent years. During 2010 to 2012 average unit price of knitwear increased 24.6 percent and 4.5 percent while woven price increased by 32.1 percent and 22.2 percent in the EU and US market respectively. This reflects a slow product diversification happening within garment sector as Bangladesh moves up the value chain.

6. The RMG sector is the largest employer in the manufacturing sector of Bangladesh. After the migrant worker community of around 7.7 million, the RMG sector is the largest employer in Bangladesh outside agriculture. Growth in employment more than doubled since FY00 to FY12, reaching 4 million workers (Figure 3) of whom 80 percent are women. The number of RMG factories has grown steadily over the years, reaching 5,400 garment factories in FY12. At the same time the scale and size of RMG factory operations has grown, with RMG factory employment averaging 500 workers per factory in FY00 and 741 garment workers per factory in FY12 (Figure 5). Productivity, measured in terms of export per worker, has increased from US$2,700 in 2000 to nearly US$4,800 in 2012 (Figure 4). However, productivity is low in Bangladesh compared to some competing countries mainly due to lack of skill and infrastructure. In FY12, RMG productivity was US$32,331 per worker in China and US$12,560 per worker in India.

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33 Forthcoming Diagnostic Trade Integration Study (DTIS) conducted by the World Bank.
34 Government has been providing a 2 percent cash incentive to RMG exporters for exporting to markets other than the EU and US.
35 WB staff calculation from USITC Tariff and Trade Database and Eurostat.
In FY12, RMG productivity was US$32,331 per worker in China and US$12,560 per worker in Vietnam.\(^\text{36}\)

**Figure 7: Average RMG export Price in EU**

<table>
<thead>
<tr>
<th>Year</th>
<th>Knitwear</th>
<th>Woven</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>2001</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>2002</td>
<td>14</td>
<td>12</td>
</tr>
<tr>
<td>2003</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td>2004</td>
<td>18</td>
<td>16</td>
</tr>
</tbody>
</table>

**Figure 8: Average RMG Export Price in US**

<table>
<thead>
<tr>
<th>Year</th>
<th>Knitwear</th>
<th>Woven</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>20</td>
<td>22</td>
</tr>
<tr>
<td>2001</td>
<td>24</td>
<td>26</td>
</tr>
<tr>
<td>2002</td>
<td>28</td>
<td>30</td>
</tr>
<tr>
<td>2003</td>
<td>32</td>
<td>34</td>
</tr>
<tr>
<td>2004</td>
<td>36</td>
<td>38</td>
</tr>
</tbody>
</table>

**Figure 9: Export Volume of RMG in EU**

<table>
<thead>
<tr>
<th>Year</th>
<th>Knitwear</th>
<th>Woven</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>2001</td>
<td>200</td>
<td>400</td>
</tr>
<tr>
<td>2002</td>
<td>300</td>
<td>600</td>
</tr>
<tr>
<td>2003</td>
<td>400</td>
<td>800</td>
</tr>
<tr>
<td>2004</td>
<td>500</td>
<td>1,000</td>
</tr>
</tbody>
</table>

**Figure 10: Export Volume of RMG in US**

<table>
<thead>
<tr>
<th>Year</th>
<th>Knitwear</th>
<th>Woven</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>2001</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>2002</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>2003</td>
<td>30</td>
<td>60</td>
</tr>
<tr>
<td>2004</td>
<td>40</td>
<td>80</td>
</tr>
</tbody>
</table>

Source: \(\text{WB staff calculation from Eurostat and USTR Trade data base}\)

7. RMG has the potential to grow much more. Garment export can continue to grow by increasing market share. Currently China is the clear front runner with 28.5 and 38.2 percent of market share in EU and US respectively in calendar year 2012. However, China is vacating some price-competitive product segments for higher value added products. This presents opportunities for Bangladesh to improve its market share in RMG in those markets. Currently Bangladesh holds only 9.2 and 5.6 percent of the market in the EU and US respectively. Capturing 20 percent of China’s garment export would more than double Bangladesh’s total export. In addition, the nontraditional markets like Japan is actively seeking to diversify its garment import base from China to “China plus”. Even Chinese investors are seeking to source from Bangladesh as China is shifting away from basic garments and wage rates are continuing to rise.\(^\text{38}\) For instance, a Hong Kong-owned lingerie and swimwear factory in an

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\(^{36}\) Forthcoming Diagnostic Trade Integration Study( DTIS) conducted by the World Bank.

\(^{37}\) Forthcoming Diagnostic Trade Integration Study( DTIS) conducted by the World Bank.

\(^{38}\) Forthcoming Diagnostic Trade Integration Study( DTIS) conducted by the World Bank.
export processing zone 10 years ago had 3,500 workers in China. Currently, it has 2,500 workers in Bangladesh, and 200 in China.  

8. **Competitive price level is the prime reason for buyers to source from Bangladesh.** This stems from the abundance of cheap labor. The minimum wage has been adjusted twice, after 12 years and four years, since 1994 (Figure 6). Even after the 80 percent increase of minimum wage in 2010 to around US$38 per month, Bangladesh has the lowest wage among competing countries (Table 1). Wages are higher in EPZs than outside EPZs. Wage rates vary by skill level and range from US$20-22 per month for an apprentice, US$38 per month for an unskilled worker, US$45 per month for a semiskilled worker and up to US$60 per month for a skilled worker as of 2010. According to the Bangladesh Export Processing Zone Authority (BEPZA) in 2010, wage rates in Vietnam were nearly twice as high and in China nearly 10 times as high as those in Bangladesh. The prevalent low wage, in combination with the rising labor cost in China, is leading buyers to alternative sourcing destinations like Bangladesh. In the medium to long term, buyers see and feel the necessity of rising wages in Bangladesh. However, they expect a significant efficiency increase to offset this rising cost which will keep Bangladesh’s price level highly competitive in the future.

9. **Bangladesh has the capacity advantage over other countries in manufacturing large orders of basic garments.** Many countries in the world produce basic clothing (for instance T-shirts) articles. However, only a select few countries—China, Bangladesh, Vietnam, Indonesia, and to some extent Cambodia—have developed complex systems of producing and supplying high-quality and larger order sizes in the low and lower mid-market segment. In terms of capacity, Bangladesh is at an advantage compared to other supplier countries, with 5,400 factories, whereas Vietnam, Indonesia, Ethiopia, and Cambodia have 3,174; 2,600; 436 and 260 factories respectively. In addition, the 4 million labor force in Bangladesh is significantly larger than the 1.2 million of Vietnam and 0.01 million of Ethiopia.

10. **Bangladesh has developed a strong capability with three decades of experience in the RMG sector.** A formidable number of skilled workforce is required to oversee quality control, labeling, and

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**Table 1: Minimum RMG wage in selected countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Hourly Wage (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>0.21</td>
</tr>
<tr>
<td>Cambodia</td>
<td>0.24</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.35</td>
</tr>
<tr>
<td>Pakistan</td>
<td>0.37</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>0.46</td>
</tr>
<tr>
<td>Vietnam</td>
<td>0.52</td>
</tr>
<tr>
<td>India</td>
<td>0.55-0.68</td>
</tr>
<tr>
<td>El Salvador</td>
<td>0.92</td>
</tr>
<tr>
<td>China</td>
<td>0.93</td>
</tr>
<tr>
<td>Guatemala</td>
<td>1.21</td>
</tr>
</tbody>
</table>

*Source: Global Labour Rights, website: [http://www.globallabourrights.org/alerts?id=0297](http://www.globallabourrights.org/alerts?id=0297)*

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With most of Bangladesh’s labor force being women, they are socially adapted to garment-making skills such as sewing, cutting, etc. Foreign buyers have tried unsuccessfully to encourage garment-making in other countries. India and Pakistan are not well organized for large-scale production, as high-risk or structural workforce factors prevent utilization of their capacity. Africa does not have enough workers with the skills required for high-volume labeling and shipping. Latin America does not have enough workers interested in operating sewing machines. Guatemala has excellent quality, but its industry is too slow with delivery. The capability to handle large orders along with the favorable trade agreements that allow duty-free exports under the EU’s GSP umbrella has made Bangladesh an attractive sourcing destination for European companies. In addition, the reduction of GSP beneficiaries from 176 to 89 by the EU, which will be effective from January 2014, is likely to increase Bangladesh’s exports because of fewer competitors in the market. Canada will be imposing a general preferential tariff from January 2015 on 72 higher-income and trade-competitive countries. Bangladesh will not be affected by these changes because it is eligible for duty-free access under the LDC tariff.

11. **Bangladesh has begun also to move up the garment value chain.** It is attracting a growing number of retailers of fashion basics, such as Zara. Zara currently orders around 80 million units from Bangladeshi manufacturers, which might grow as local production improves. Designer brands, including Giorgio Armani, Ralph Lauren, and Hugo Boss, also have outsourced manufacturing to Bangladesh. The principal market for higher-value garments is Europe, in part because of the prominence of European designers and buyers in this market segment, but there is a growing presence in the US market as well. Mid-market brands plan to grow their share in Bangladesh by 20-25 percent in the medium term.

### II. The Impact of Industrial Accidents

Recent industrial accidents have revived concerns over compliance in labor standards and worker safety, which has put Bangladesh’s competitiveness in RMG at risk.

12. **Bangladesh’s garment industry is in the spotlight of international attention due to the recent industrial disasters.** NGOs and CSR stakeholders both at home and abroad have always been apprehensive about meeting international labor and social compliance standards in the garment industry. A series of major incidents between November, 2012 and April, 2013, which resulted in combined deaths of around 1,250 workers, has turned the apprehension into reality. These back-to-back incidents have led to a severe image crisis worldwide. The latest of these tragedies occurred on April 24, 2013 when an eight-story multi-purpose building, the Rana Plaza, collapsed, claiming more than 1,100 lives, most of whom were garment workers in the upper floors of the building in five garment factories. This was the worst industrial accident in Bangladesh and one of the worst in South Asia and in the world. The enormity of the accident renewed the concern in the world as to whether the low cost advantage of Bangladesh has begun also to move up the garment value chain. It is attracting a growing number of retailers of fashion basics, such as Zara. Zara currently orders around 80 million units from Bangladeshi manufacturers, which might grow as local production improves. Designer brands, including Giorgio Armani, Ralph Lauren, and Hugo Boss, also have outsourced manufacturing to Bangladesh. The principal market for higher-value garments is Europe, in part because of the prominence of European designers and buyers in this market segment, but there is a growing presence in the US market as well. Mid-market brands plan to grow their share in Bangladesh by 20-25 percent in the medium term.

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45 EU cuts GSP beneficiary countries to 89 from 176, New Age, November 1, 2012.
49 International media such as The Economist, The Wall Street Journal, Bloomberg, and The Telegraph report to this effect, with some describing the Rana Plaza tragedy as the worst industrial accident in South Asia since the Bhopal disaster in India in 1984.
Bangladesh in the garment industry is based on unfair treatment of workers. Unsafe working conditions, infringement of workers’ rights in the absence of freedom of association and collective bargaining, and low wage have become the key areas of concern under the social compliance framework.

13. **Attention to poor working conditions, violation of workers’ rights and low wage rates has become pronounced.** Compliance with internationally acceptable working condition, labor standards, and preservation of worker rights has gained renewed significance for buyers worldwide in their decision to source from Bangladesh. Apart from weak regulatory enforcement of safety standards, absence of formal trade union in the various RMG units is likely to have contributed to safety failures. The lack of proper trade unions has meant that workers are not able to exercise their rights to effective bargaining for safer working environments. Trade unions in many countries, have offered legitimate and effective ways to establish fair deals for workers by providing a legal foundation to stand together. Poor wage rates have also come under sharp focus. The international community has always been concerned that Bangladesh’s low-cost competitive edge reflects abundant cheap labor being used under sweatshop conditions. A recent study found that the real wage in the RMG industry in Bangladesh declined by 2 percent from 2001 to 2011. The minimum wage set in 2010 was alleged not to be equivalent to a “living wage” by workers and different international worker rights organizations and there has been a demand for another increase ever since. The workers demand gained added weight as the recent industrial setbacks also exposed the substandard working condition the workers had been exposed to. H&M, the biggest buyer of Bangladeshi RMG, advised to revise the minimum wage.

14. **The sustainability of the competitiveness of the ready-made garment industry has been put into question.** Apparel manufacturers are reporting 30-35 percent reductions in orders due to the recent compliance failures. Citing safety concerns, Walt Disney has already ceased production. H&M has been rethinking their sourcing strategy, while Wal-Mart blacklisted 250 RMG factories in Bangladesh. Global fashion houses are starting to look for new sourcing countries such as Vietnam, Cambodia, and Indonesia, for fear of reputational risk. International retail giants, such as Inditex, are also considering a zero-tolerance policy, and cutting ties with suppliers who are non-compliant (or who subcontract to non-compliant factories).

15. **The United States suspended the trade benefits of Bangladesh under the GSP program.** The GSP statute requires certain standards for workers’ rights and safety for a country to be eligible.

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50 Media reports and interviews with workers revealed that a major crack was identified in the multi-storied Rana Plaza the day before the incident happened. However, the factories remained open, despite the concern of the workers.


52 Although the current monthly minimum wage of US$38 is not considered a subsistence wage, it is currently equivalent to the US$2.3 a day (PPP) which is above the international poverty line of US$1.25 a day (PPP).

53 H&M chief calls for annual minimum pay revisions in Bangladesh, Financial times, May 15, 2013.

54 RMG owners getting 35 pc less orders this season, The Financial Express, June 23, 2013.


60 The US Congress created the GSP program in the Trade Act of 1974 to help developing countries expand their economies by allowing certain goods to be imported to the US duty-free. Under the GSP program, 127 beneficiary developing countries are eligible for duty-free exports to the US of up to 5,000 categories of products.

61 The country eligibility criteria states that a GSP beneficiary must have taken or is taking steps to afford internationally recognized worker rights, including: (1) the right of association; (2) the right to organize and bargain collectively; (3) a prohibition on the use of any form of forced or compulsory labor; (4) a minimum age
Bangladesh’s failure to adhere to international standards for workers’ rights and safety in the RMG industry led to this suspension. The US Trade Representative (USTR) office held several reviews on Bangladesh’s GSP status since 2007 on issues of worker safety and labor rights. The decision to cancel GSP facilities culminates from not only the Rana Plaza incident but also from the repeated concerns of the US government on insufficient progress on the reforms to better protect worker rights and safety in the last six years. Although this cancellation will not impact Bangladeshi exports directly since RMG did not have GSP in US to begin with and Bangladeshi exports enjoying GSP is a very small fraction (0.6 percent) of total exports to US, it sends adverse signals about domestic production condition and taints Bangladesh’s image further. Thirteen countries have been suspended from the GSP program on similar grounds previously. Although most were later reinstated, Belarus, Sudan, Syria and Myanmar have remained out of the facility. Bangladesh’s GSP status will be evaluated again in December 2013 based on the reforms to improve labor safety and standards. Legal authorization of the GSP program expired on July 31, 2013. This means that imports that were previously eligible for duty-free treatment under GSP is subject to regular, normal trade related duties for all commodities until the program is extended.

16. **The decision to promote improvement in working conditions and labor rights by suspending GSP is debatable.** Bangladesh’s GSP utilization has been very low historically as the main export item RMG does not fall under the GSP facility. In FY13, only US$33 million of exports qualified under GSP. By contrast, Bangladesh export of RMG to the US was US$5 billion in FY13 with import duties amounting to US$745 million at an average rate of 14.9 percent. So removal of GSP is unlikely to have any major impact directly on the RMG exports from Bangladesh to US as the duty structure faced by Bangladeshi garments remains the same. Agro products (mainly tobacco and tobacco products), ceramics and plastics are the dominant exports to the US from Bangladesh under GSP, covering 33.4 percent, 16.5 percent and 15.3 percent of total exports under GSP respectively in calendar year 2012. These industries are unrelated to the recent tragedies with no incidence of labor rights violation. Thus the punitive trade sanctions by the US can be termed as off target and will have a negative impact on these unrelated and well performing industries both in terms of exports and labor welfare. Rather than suspending Bangladesh from GSP, a promise to apply GSP to all Bangladesh exports contingent upon the improvement in safety records might have been a more effective policy. Reducing or eliminating the duty on apparel items would directly benefit workers in Bangladesh by increasing employment and encouraging economic growth through growth in exports. This in turn could also have improved the working environment for the labors. Favoring the carrot of GSP for everything over waving the stick of cancellation of GSP would have improved the welfare of the US consumers as well.

III. **Explaining Compliance Failures**

*Noncompliance in worker safety is a collective failure of the manufacturers, buyers, and regulators.*

17. **Global retailers are constantly trying to provide cheap clothes to consumers in order to compete in the apparel market.** This means offering lower prices to manufactures, who compete with each other by under cutting prices. To protect profits under such the so-called “race to the bottom” phenomenon, both

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62 The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) submitted a petition to remove Bangladesh from the GSP program based on the violation of workers’ rights and unsafe working conditions in the RMG industry in June 2007, April 2011 and finally in October 2012. Based on the petitions, public hearings were held to review GSP status by USTR on October 2007 and 2009, January 2012 and finally on May 2013.

buyers and manufacturers neglect compliance. Buyers concentrate on getting quality product at low price regardless of the working environment while manufacturers do not invest in improving safety and labor standards. Very often manufacturers subcontract orders to smaller factories with substandard compliance, at a price that is even lower than what the buyers offer. Hence, with a smaller profit margin, most subcontracting factories do not commit to maintain various compliance standards in order to minimize cost. Sometimes, this subcontracting happens without the authorization of the buyers. Approving a subcontracting factory can take several weeks to set up and complete. So in order to save time, manufacturers sometimes skip the disclosure. Many buyers also do not maintain enough manpower to regularly monitor the factories who are supposed to process their orders. These dynamics are reinforced by the following:

- **Lax regulatory enforcement.** Lack of regulatory oversight is a major contributor to non-compliance. The overall enforcement of labor law and building code is very low. Monitoring of building safety standards by the relevant government authorities is weak because of insufficient manpower with relevant expertise. The compliance monitoring cell within EPB, which is mandated to improve enforcement by regular monitoring, also lacks sufficient manpower. The Department of Inspection for Factories and Establishments (DIFE), who is primarily responsible to inspect industrial units, has only 46 inspectors for around 28000 factories in the formal manufacturing sector. In addition, absence of any credible threat of consequences for violating the law makes many firms apathetic to compliance. Failures by the governmental bodies to ensure the proper implementation of safety standards also occurs when policymakers or regulatory bodies favor particular interest groups rather than the national interests they are mandated to serve. Regulatory agencies such as the Ministry of Labor and RAJUK allegedly focus more on advancing the interests of special interest groups. The apparent involvement of high profile people in garments explains why there have been no convictions on any of the major disasters.

- **Land and infrastructure deficit.** Scarcity of land has led to the spread of factories in high rise buildings not suited for industrial purposes. It has also encouraged malpractice of developing multi storied buildings in unsuitable areas (for instance, in inadequately filled up marsh land) making the buildings more prone to accidents. The energy shortage (power and gas) makes it difficult for the utility authorities to install electricity and gas connections to larger sites where factories can relocate. Access to reliable power supply has been identified as one of the most important factors for garment firms to choose Dhaka city as a factory location (with the exception of EPZs), even though the buildings are not always suited for operating factories. The duration of power outages experienced by garment firms in Dhaka city, at 4.2 hours per day is below the average for Chittagong city (4.9 hours per day) and Dhaka peri-urban areas (4.5-4.8 hours per day). Due to the power outage, factories have to maintain powerful generators which increase cost and make structurally weak buildings more susceptible to cracks and collapse.

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65 After the fire in November 2012 in Tazreen Fashions, Wal-Mart girl’s shorts were discovered in the ruins. Wal-Mart explained that its authorized manufacturer subcontracted the order without their knowledge. The manufacturer was later banned by Wal-Mart.


• **Lack of knowledge in compliance issues.** Although the government of Bangladesh adopted a unified code of conduct after 2006 and enacted labor law and building code, there is a lack of knowledge among RMG owners and mid management staff about the essential components of compliance and safety in general. The situation is worse in case of smaller sub-contracting units where crucial elements like leave entitlement of workers, adequate number of fire exits, adequate work space for workers etc. are missing.  

The lack of understanding about compliance management at the owner and supervisory level is not helping the industry to improve compliance.

IV. **Stakeholders’ Response**

Different stakeholder groups have announced a variety of actions to improve the hazardous working condition and labor standards.

18. **A mostly-European consortium of 89 retailers and apparel brands has agreed to sign the “Accord on Fire and Building Safety in Bangladesh”.** This is a multi-stakeholder agreement between signatory brands and a coalition of local trade unions, global unions, labor organizations and international NGOs where the signatory brands agree to establish a fire and building safety program over a period of five years. The commitment of big brands like H&M, the biggest buyer from Bangladesh, will have a significant impact on the implementation of this accord. The accord includes independent inspections by trained safety experts and public reporting, disclosure of the names of suppliers, supplier contracts with sufficient financing and adequate pricing, mandatory safety improvements financed by brands by negotiating with the supplier through options such as joint investments, providing loans, accessing donor or government support, offering business incentives, or paying for renovations directly. The establishment of worker-represented committees in both oversight and implementation, and a binding contract to make these commitments enforceable, is a major step forward towards the improvement of the situation in the sector. The Accord also commits signatory companies to stay in Bangladesh at least for the first two years of the Accord. However, this effort will cover around 1,000 factories which is about one fifth of the total industry. The agreement is also largely limited to Tier 1 factories representing mostly large and relatively compliant firms. This might potentially leave out small non-compliant RMG units that do mainly sub-contracting of large firms who are in many instances not authorized by the buyer.

19. **A group of 20 North American retailers announced their initiative over the next five years.** The North American retailers formed the Alliance for Bangladesh Worker Safety which includes major buyer brands like Wal-Mart, Gap Inc., J.C. Penney, etc. They represent the majority of the North American imports of RMG from Bangladesh. The commitment was drawn upon discussion with

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71 This includes two of Europe’s largest brands—H&M and Inditex. Other dominant brands such as PVH, Esprit, and Benetton have also signed the accord.
72 To assume the responsibilities of funding the program activities article 24 of the Accord states “Each signatory company shall contribute funding for these activities in proportion to the annual volume of each company’s garment production in Bangladesh relative to the respective annual volumes of garment production of the other signatory companies, subject to a maximum contribution of US$500,000 per year for each year of the term of this Agreement.” As H&M is a signatory of this Accord and has the biggest order volume from Bangladesh, they would be largest contributor with an amount US$2.5 million in five years.
73 Major or long-term suppliers representing in the aggregate not less than 30 percent of a buyer’s annual production in Bangladesh by volume are defined as Tier 1 suppliers. Other long term suppliers, together with Tier 1 factories, representing in the aggregate not less than 65 percent of a buyer’s annual production in Bangladesh by volume are the Tier 2 factories. Supplier that process occasional orders or buyer’s order represents less than 10 percent of the factory’s production in Bangladesh by volume are the Tier 3 factories.
government of Bangladesh and the United States, fire and safety experts and worker representatives. The initiative was developed with the help of the Bipartisan Policy Center. It calls for inspections of 100 percent of alliance member factories within the first year; development of common safety standards; transparent sharing of inspection results; and actively supporting democratic election and operation of Worker Participation Committees (WPC) in each alliance factory. Members of the alliance are providing the funding necessary over the five-year period—currently at US$45 million and growing—to support the specific programs of the initiative, with some companies offering an additional combined total of over US$100 million in loans and access to capital to assist factory owners they work with for factory safety improvements.

20. **The North American initiative appears to be less progressive than the European one.** Although the American program has some measurable and result oriented components, it is not legally binding. It does not involve any worker representation either in oversight or planning that might make the enforcement questionable. Financing improvements only through providing loans is not going to vastly improve the working conditions in the short to medium term. Under the North American Alliance, retailers are not taking any responsibility to improve standards. Rather, any retailer can decide not to do business with a manufacturer if the manufacturer does not improve standards by themselves which is similar to the current scenario of the industry. The Alliance also has a lot of the features of private regulatory regimes that research has shown over the last 10 years is not very effective. For instance, brands and retailers control over factory inspections by approving qualified inspectors to carry out factory inspections and develop remediation plans is deemed different from the various factory audit systems that had been developed by international buyers as a part of their corporate social responsibility (CSR) programs. These systems in several occasions proved to be ineffective. In Pakistan, a garment factory named Ali Enterprises burned down claiming 262 casualties on September 2012, less than a month after it was certified by the international auditing organization Social Accountability International (SAI). Two of the factories in Rana Plaza were certified as compliant with the standards of the Business Social Compliance Initiative (BSCI), a company controlled CSR initiative with over 1,000 member companies in Europe.

21. **European Union (EU) and Bangladesh agreed to a time bound “Sustainability Compact”.** Although EU expressed their interest in staying engaged to improve labor conditions, they also warned about the potential withdrawal of EU GSP scheme if satisfactory progress is not made under the agreed compact (see Box A1 for an analysis of the impact of removing EU GSP). The key commitments made by Bangladesh to improve labor standards features amendment of the labor law aimed at improving the fundamental rights of workers by July 2013; effective implementation, enforcement, and monitoring of the amended labor law in all factories including the EPZs; upgrading the Department of Factories and Establishments (DIFE) to Directorate with a strength of 800 inspectors with 200 inspectors recruited by end of 2013; create a publicly accessible database listing all RMG units with relevant information on compliance; implementation of the National Tripartite Plan of Action on Fire Safety and Structural Integrity in the RMG industry in accordance with the established milestones and timelines; assess building and fire safety of all active export oriented RMG units by June 2014 with most populated factories assessed by 2013; and launch skills training programs for the seriously injured workers by December, 2013. ILO will monitor the progress, coordinate efforts and mobilize technical resources.

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77 GSP withdrawal must be avoided: EU, The Financial Express, July 1, 2013.
Although Bangladesh government fulfilled the pledge of amending the labor law within the stipulated deadline, the fulfillment of all the other actions within the stipulated timeframe will be very challenging.

22. **The US action plan provided to the government of Bangladesh is broadly consistent with the EU compact.** In addition to the steps mentioned in the EU compact, US action plan envisages concrete actions required under the GSP action plan, such as increasing sanctions for labor right violations sufficient to deter future misconduct, publicly reporting on the outcome of union registration applications, establishing an effective complaint mechanism for labor violations, and ending violence and harassment of labor activists and unions. Proper implementation of these actions could provide a basis for the US to reinstate the GSP trade benefits.\(^\text{78}\)

23. **The government has taken some legal and administrative steps to improve labor safety and welfare.** The government and representatives of Bangladesh employers’ and workers’ organizations signed the National Tripartite Plan of Action on Fire Safety and Structural Integrity (NTPA). This action plan was an integration of the National Tripartite Plan of Action on Fire Safety signed on March, 2013 in response to the Tazreen factory fire and the Joint Tripartite Statement adopted in May, 2013 in the wake of the Rana Plaza tragedy by the same stakeholders. The main activities identified in the integrated NTPA include assessment of the structural integrity and fire safety of RMG factory buildings, strengthening labor inspection, worker and management training, building awareness of occupational safety and health and worker rights and rehabilitation of disabled workers. The National Occupational Health and Safety (OHS) Policy are at final stage for adoption. The registration process of Trade Union in the RMG sector has been improved and 29 trade unions (Dhaka 21, Chittagong 8) have been given registration in the first six months of 2013. Steps have been taken for acquisition of 532 acres of land to establish Garments Industrial Park near Dhaka city to relocate the factories.\(^\text{79}\) Government is also trying to strengthen the monitoring of building construction by increasing manpower of the development authority of Dhaka from 1087 to 2000. In order to reassess the minimum wage, the government formed a 6 member wage board in June, 2013. Workers are proposing a monthly minimum wage of Tk 8,100\(^\text{80}\) (US$104) which is an increase of around 166 percent from the current minimum wage, while owners gave a preliminary proposal of a 20 percent wage increase to Tk 3,600 (US$46).\(^\text{81}\)

24. **Government is strengthening regulatory oversight over the industries.** Government has taken steps to upgrade the DIFE to Directorate and strengthen inspection capacity by 200 inspectors by December 2013. Proposal has been sent to Ministry of Public Administration to increase the number of manpower of the Department from 314 to 2,291 which includes new posts of 854 inspectors. DIFE has formed 23 special inspection teams to inspect the RMG factories to find out the non-registered and non-compliant factories and to take appropriate steps accordingly. Based on the findings of inspection teams, 20 factories have been shut down temporarily for the structural defects of the factory buildings. Moreover the inspection teams have visited 3,452 factories (3,169 in Dhaka and 288 in Chittagong) and 263 cases (in Dhaka 47 and in Chittagong 16) have been filed against the non-compliant factories with the Labor Court.\(^\text{82}\)

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\(^{79}\) Ministry of Labor and Employment.

\(^{80}\) RMG leaders set to propose a raft of hikes in wage board allowances, The Financial Express, August 16, 2013.


\(^{82}\) Ministry of Labor and Employment.
Bangladesh’s legislature amended the Labor Law to provide improved protection for the fundamental rights to freedom of association and the rights to collective bargaining. There were 87 amendments made in the new law. The elimination of previous obligation to send to employers the names of union leaders at the time of registration of a trade union, allowing workers to call on outside experts for advice during collective bargaining and allowing to elect 10 percent of their enterprise officers from outside the workplace in the public sector is expected to improve labor rights situation. The increase in the number of trade unions allowed in factory from two to five has also been welcomed. There are several other measures included to improve worker safety and welfare. Including provisions for formation of a central fund for employees of 100 percent export-oriented, foreign-owned companies, mandatory deposition of 5 percent of net profit in provident and welfare funds, group insurance provisions for workers in case of accidents is expected to increase worker welfare. Providing labor inspectorate new responsibilities to inspect safety and health conditions of workplaces and conduct on-the-spot inspections, barring change in factory layout and locking exits without permission of inspectors will help improve

Box A1: Likely Impact on Exports if EU GSP Goes

The EU will review the GSP status of Bangladesh at the end of FY14 on the basis of the improvements made in labor safety and standards. What may be the impact on Bangladesh’s exports if they decide to suspend GSP? A quantitative answer to this question is attempted below by estimating an augmented gravity model with a data set covering the period 1980-2011. The model includes Bangladesh’s exports to the EU (in million US$) as a dependent variable. As independent variables, traditional gravity variables such as the GDP (in million US$) of exporting (Bangladesh) and importing (EU) countries as well as a traditional variable such as Real Effective Exchange Rate (REER)\(^1\) to control for the macro environment are included. An ordinal dummy variable, \(^2\) “GSP Regime”, has been incorporated in the equation to estimate the impact of the EU GSP on Bangladesh’s exports. The equation has been estimated by an ordinary least squares (OLS) method, as the endogeneity test conducted reveals both the GDP measures are exogenous in the equation, making OLS estimates unbiased and consistent.

\[
\text{Exports to EU} = 10791.07 + 0.18 \text{ BD GDP}^{**} - 0.00 \text{ EU GDP}^{**} - 101.26 \text{ REER}^{*} + 1117.22 \text{ GSP Regime}^{**} \\
(7624.54) \quad (0.03) \quad (0.00) \quad (56.62) \quad (416.49)
\]

(Numbers in parenthesis are standard errors, ** Significant at 5 percent level, * Significant at 10 percent level)

The regression results show significant coefficient estimates for all variables at 5 percent and 10 percent levels of significance. The positive sign on Bangladesh GDP means that the larger Bangladesh economy becomes, the more it exports to EU. The negative sign on real exchange rate implies that the more Bangladeshi currency depreciates in real terms, the more it exports. Both of these results are consistent with conventional trade theory. Although the negative coefficient on EU GDP is counter-intuitive and very small, it can be explained by the so called “Wal-Mart effect” that consumers prefer cheaper products during the period of economic downturn. The variable of interest “GSP Regime” shows that the EU GSP has a positive and statistically significant impact on Bangladesh’s export to EU. A positive change in EU GSP schemes increases Bangladesh’s export by US$1.1 billion on average, but it could be as high as to US$2.16 billion. Thus, if EU decides to change GSP facilities for Bangladesh, there may be an expected export loss equivalent to 4.1 percent of total exports, but could be as high as 8.1 percent.

\(^1\) REER data has been compiled from Darvas, Z (2012) “Real Effective Exchange Rates for 178 Countries: A New Database” Working Paper 2012/1 Corvinus University of Budapest

\(^2\) The episodic changes in GSP facilities have been modeled as the variable GSP regime takes a value of 1 for the period 1980-1994, reflecting the GSP scheme with quotas and ceilings, a value 2 for 1995-1997 for duty free quota free regime for approved merchandise, 3 for the period 1998-2000 for allowing 2 stage processing for knitwear, 4 for the period of 2001-2010 for introducing Everything But Arms (EBA) scheme and 5 for 2011 for allowing single stage processing for woven garments. This ordinal measurement of reform is based on Bangladesh: Towards Accelerated, Inclusive and Sustainable Growth- Opportunities and Challenges, Report No. 67991, The World Bank, June 2012.
worker safety. However, the International Labor Organization (ILO) and other international labor rights organizations have termed this change insufficient based on the unofficial translation of the amendments. The main areas of concern includes not reducing the 30 percent minimum membership requirement to form unions and not extending freedom of association and collective bargaining rights to workers in EPZs. In addition, there is a concern that not allowing hiring of union leaders from outside the worker groups of the respective factory, requiring more than two-thirds of the union members to authorize strikes will make the freedom of association quite restrictive.  

26. The associations have taken some initiatives to ensure compliance. The garment manufacturers associations asked its members to submit soil test report and approved building designs in order to check the structural integrity of the buildings. As of July 3, 2013, only 1,819 members of the BGMEA and 353 members of the BKMEA had submitted the required documents. The BGMEA stopped providing utilization declaration (UD) certificates and other services to 180 factories who failed to provide these documents and another 160 factories for not having adequate space in the roof tops to facilitate exit in case a fire breaks. The BGMEA shut down eight factories on safety grounds while four were given deadlines to repair faults in the buildings. The BGMEA and Chittagong Development Authority (CDA) also started to conduct safety inspections of factories in Chittagong. The BGMEA announced creation of a worker database for the whole industry and initially instructed around 300 factories in Ashulia near Dhaka to develop databases of their workers.

V. Conclusions

Sustaining the success of the RMG industry by restoring its image will require swift policy decisions and effective implementation through coordinated efforts.

27. Effective implementation of the planned actions is the key to protect exports from any further damage. The EU, the main trading partner of Bangladesh, is going to closely monitor the efforts to improve labor conditions for the whole of FY14. In order to maintain the preferential access to EU, Bangladesh has to demonstrate substantial improvements in compliance. Failure to achieve the milestones agreed within the given timeline in FY14 may result in suspension of GSP by EU. This could have grave consequences for the overall export sector and the economy. Although the labor law has been reformed, implementation regulations will be needed to bring the provisions of the new amendments into practical effect. The recruitment of factory inspectors by the government is not moving fast enough because of bureaucratic complications. Only 4 inspectors have so far been appointed and 70 other were under the appointment process as of September. Although the government has filed cases against some of the non-compliant factories in the labor court, the factories are running in full swing with unsafe working conditions as the DIFE do not have the authority to shut down the factories. Database creation of RMG workers by the BGMEA is also moving very slowly. Although five government agencies have sent

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85 Ministry of Labor and Employment.
87 BGMEA suspends services to 160 factories, The Daily Star, August 14, 2013.
88 BGMEA makes list of 8 Dhaka factories shut on safety grounds, New Age, May 13, 2013.
94 Database creation for RMG workers at snail’s pace, New Age, August 27, 2013.
teams to inspect the 5,400 factories, it is estimated that it would take at least five years to complete the process. In order to expedite the proper execution of the strategic plans, both government and the private sector procedures need to be streamlined. Furthermore, development of the industrial park should be fast tracked to facilitate relocation of factories from unsuitable buildings to proper industrial buildings.

28. **Coordination between the various stakeholders is essential to maintain coherence and effectiveness of implementation.** Although the plan of action set by European and US buyers are supposed to take the NTPA of the government as a basis for inspecting factories, no unified standards of safety has been set yet. Experts deem that it is not an ideal situation to have competing initiatives between two sets of retailers. The result may be counterproductive because of uncoordinated and even conflicting efforts. Many factories have multiple clients who are either part of the European Accord or US Alliance. If there is no coordination between the initiatives, a factory building might be inspected several times, each time with a different result as there is no unified code to follow. This might lead to suspension of production for inordinately long time or non-compliant factories continuing production. For instance, a factory banned by Wal-Mart and Inditex for safety reasons was manufacturing shirts for another US based apparel retailer VF Corp. There is also disconnect between the activities of the government and the association. The BGMEA was not aware of the activities of the government in closing down 20 factories. The EU and US buyers’ initiatives may cover around 30 percent of the factories. There is also a need to ensure that the remaining factories are under the purview of the overall safety initiative. Recently, the government and the buyers initiatives agreed to develop and follow a common guideline to inspect factories. The government also created a 30 member expert panel to inspect the factories not covered by the buyers. This harmonization of activities and coordination between stakeholders should continue till the life time of the initiatives to ensure proper inspection and compliant production facilities.

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Annex B

Table B-1: Bangladesh Macroeconomic Indicators

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<th>Description</th>
<th>FY07</th>
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<td><strong>Inflation (%)</strong></td>
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* Population data is from DECPG.

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<td>Exchange Rate (Taka per Dollar)</td>
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<td>Growth of Credit to Public Sector (%)</td>
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<td>Growth of Credit to Private Sector (%)</td>
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\(^1\) Projections are based on IMF and government estimates.
\(^2\) Base year 2005/06.
\(^3\) Source of subsidy amount is Medium-Term Macroeconomic Policy Statement 2013/14 to 2017/18, Ministry of Finance.

All growth rates are year-on-year

**Sources:** Bangladesh Bank, Bangladesh Bureau of Statistics, Export Promotion Bureau, IMF, and WB staff estimates.