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Bangladesh

State of the Economy and Near- to Medium-Term Challenges

The Awami League, voted to power by Bangladesh's electorate in last December's national elections, has laid out a vision that promises to take Bangladesh to a middle-income status by 2021. According to this vision "poverty will be drastically reduced; where our citizens will be able to meet every basic need and where development will be fast track, with ever increasing rates of growth."[1] How can the new government deliver on its economic promises? What issues does it need to tackle in the immediate near-run as well as medium- to long-run to take the country forward on the growth enhancing and poverty reducing path? What steps are needed to deal with the likely impact of the still unfolding global economic crisis? This note provides a broad overview of the current state of the Bangladesh economy, the immediate challenges it faces from the ongoing global crisis and the medium-term policy priorities for accelerating growth and reducing poverty.

I. State of the economy

A. Economic growth

In recent years Bangladesh has faced natural (damaging floods and cyclone) and external (food crisis) adversities, and domestic political uncertainties that led to violence, suspension of elections and imposition of military-backed rule in January 2007. Despite all of this, economic growth in Bangladesh has been steady and strong—6 percent plus on average in the last four years with relatively low volatility. However, as is the case for almost all countries, developed and developing alike, Bangladesh now faces the risk of a serious growth slowdown due to the ongoing global economic crisis.

The long feared capitulation of consumers in developed economies has already happened. Emerging economies are suffering from the collapse of the US and European financial markets. Major export nations such as Japan, Korea, China and Taiwan are experiencing severe collapse in their trade activity. In China, by next year, the jobless population including migrant workers and college graduates is projected to reach 24 million. India's economy is expected to expand at 7 percent in FY09, the slowest in six years and below last year's 9 percent.

This crisis, which started last September in the US, has not had much of an effect yet on the Bangladesh economy, but may turn out to be like a silent tsunami that causes major damage in the coming months primarily through lowering growth of exports and remittances, the two pillars of growth in the country. Bangladesh is unlikely to remain insulated, given its heavy dependence on US and Europe for exports and on Middle-East for remittances. Bangladesh's growth in recent years has come mostly from the industrial and services sectors, while the contribution of agriculture has fluctuated widely depending largely on the vagaries of nature and the performance of the agricultural input distribution systems (see Figure 1 and Figure 2 in Annex A).[2] The following paragraphs provide information on the state of the three sectors: agriculture, industry and services.

Agriculture: Following bumper harvests of *boro* (rice), wheat, and potato earlier in FY08, the agricultural production outlook continues to look bright. *Aus* (rice) harvest is estimated to be about 1.9 million tons compared with 1.5 million tons last year. There are good prospects of achieving the

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1 *Election Manifesto 2008,* Awami League, page 6.

2 Figures are in Annex A and data on key macroeconomic indicators are summarized in Annex B.

13.6 million tons *aman* production target, which would be over 40 percent higher than last year's production. This estimate is based on the fact that monsoon this year has been good and has not caused any damage to agriculture. Crop production this year may reach new heights if the bumper *boro* production performance of last year is repeated. Animal farming and fisheries are also reported to be doing very well. The favorable weather conditions plus other factors that include supply response to higher market and government procurement prices, continued government attention to supply of inputs, credit, and extension services, prevention of Avian Flu that badly affected livestock production last year—all of these factors imply that agricultural growth in FY09 is expected to be higher than the 3.6 percent growth achieved in FY08.

Industry: Industrial growth in the country has slowed from 9.7 percent in FY06 to 6.9 percent in FY08 mainly due to lower manufacturing and construction growth. This slowdown is due to lower private investment in manufacturing and declining public investment in construction.[3] These resulted from inadequate infrastructure facilities, particularly electricity and natural gas, and uncertainties surrounding the political transition (Figure 3). While the latter has been conclusively and satisfactorily resolved with the conclusion of national elections last December, the former remains a formidable challenge. Without early remedial measures, frequent load shedding and irregular gas supply will continue to disrupt industrial production. The small- and medium-scale industries, which are the largest provider of employment outside agriculture, are most adversely affected due to energy shortfall as they can not afford to have alternative energy sources (e.g., generators). Large and quick investments in natural gas and power are a pre-requisite for putting industrial growth back on the near double-digit trajectory. Investments in improving road conditions, port operations and urban infrastructure, and services are also needed to sustain high industrial growth. In this context, the ongoing global crisis is posing new challenges as private sector financing (particularly foreign) for infrastructure projects is likely to be increasingly difficult. In light of the current global situation, a new approach to public-private partnership may be required, where significantly more public funds will be needed.

Services: Services growth has remained robust (6.7 percent this past FY08) benefiting largely from continued strong inflows of remittances. With likely higher growth in agriculture in FY09 as detailed above, the retail and wholesale sub-sectors will also get a boost. Wholesale and retail trade, transport, telecommunications and real estate and housing—all services sub-sectors have performed well in the first quarter of FY09. Continued expansion of industry is likely to have a positive impact on services growth. A rapid growth in the mobile phone market, banking, and an increasing number of healthcare providers has contributed to robust growth in service sector.

B. Inflation

Inflation in Bangladesh, particularly food inflation, was a major problem until recently. However, with the global downturn in commodity prices as well as good domestic agricultural production, this is no longer a near-term concern (Figure 4). Inflation increased steadily from 1.5 percent in FY01 to a nine-year high of 11.6 percent in December 2007 and remained in double digits until October, 2008. Since then it has declined sharply to 6 percent in December 2008. Food price inflation has dominated the increase in overall inflation since FY03. The surge in international prices of rice and wheat (key items in the Bangladesh CPI) were major contributors to the rise in food price inflation in Bangladesh. Increase in international prices of oil, raw materials and intermediate inputs; internal shocks such as poor crop harvests and natural disasters; and domestic supply distortions exacerbated the pressures on prices emanating from abroad. There was some contribution to inflation due to high monetary growth.

[3] Real investment in plant and machinery declined by 18 percent in FY08. Public investment declined from 5.5 percent of GDP in FY07 to 5 percent in FY08 mainly due to nonperformance of construction contracts.

Both food and nonfood inflation have begun to recede and this is expected to continue in the near-term, as the global crisis deepens. However, it is possible that demand side pressures will resurge. Growth in monetary aggregates has increased rapidly in recent months (Figure 9). Bangladesh Bank's (BB) recent monetary policy statement has left the door open for monetary policy actions to counter inflationary pressures, but it maintains a bias towards accommodating credit demand, particularly to key growth driving sectors. BB, however, did send a signal of its intention to fight inflation through a small preemptive increase in policy rates and daily cash reserve requirements during last three months.

C. Macroeconomic management

The new government has inherited a sustainable macroeconomic position, but further policy actions will be required to deal with possible impact of the ongoing global crisis and to further renew momentum on the reform agenda of structural policy and institutional reform.

External Sector: Bangladesh has weathered well the shocks to balance of payments due to last year's steep rises in food and fuel prices in international markets. This was possible due to surging garment exports and remittances as well as sound exchange rate management. Despite widening of the trade deficit from US$ 3.5 billion in FY07 to US$ 5.5 billion in FY08, reflecting primarily a 25.6 percent growth in import payments, the current account recorded a US$ 672 million surplus (equivalent to 0.9 percent of GDP). Continued robust growth of remittances and strong export growth helped maintain sound external balances in the first quarter of FY09. There was a significant deterioration in current account balance last October when it turned from a surplus of US$366 million in the first quarter of FY09 to a deficit of US$ 280 million in the first four months of FY09 (July-Oct) leading to a US$646 million deficit in October 2008. This was largely due to weakening of exports and remittances in October 2008. The deterioration of the current account balance did not continue as remittances grew strongly (31.2 percent) in the first half of FY09 and foreign exchange reserve position has continued to improve through end-January, staying close to $5.5 billion (2.6 months of import cover).

The Bangladesh Bank has kept the dollar exchange rate stable to guard against intensifying imported inflation pressures (Figure 6). This rigidity has not yet seriously constrained export competitiveness largely due to the depreciation of the nominal effective rate in line with the US dollar. However, this scenario is not expected to continue. Moving forward, larger flexibility in the taka-dollar rate will be needed to support policy objectives and cushion the impact of falling export prices on export profit margins. Greater flexibility will also help develop the interbank market.

Fiscal management: Aggregate fiscal discipline has been an important pillar of Bangladesh's macro economic management (see Figure 7 and Figure 8). The FY08 budget deficit outturn was 3.7 percent of GDP despite unanticipated spending on post-disaster and food crisis mitigation and increased budget coverage of escalating fuel and fertilizer subsidies. A 26.4 percent growth in revenue collections and 30 percent underutilization of the Annual Development Program (ADP) were instrumental in keeping the FY08 budget deficit below the revised budget target. Implementation problems resulted in much reduced ADP expenditure. This, together with increased foreign financing—from 1.2 percent of GDP in FY07 to 2.2 percent in FY08—helped reduce domestic financing from 1.9 percent of GDP to 1.5 percent during the same period. The FY09 budget responded to the need to address the social impact of high food prices and natural disasters while further increasing budget coverage of the losses of State-Owned Enterprises (SOEs). Under these circumstances the FY09 budget targets of an overall deficit of 5 percent of GDP and domestic financing of 2.8 percent are reasonable, though not necessarily sustainable over the medium-term.

In recent months the growth in tax revenue has begun to slow primarily on account of import based taxes. Growth (cumulative) in tax revenue has slowed from 23.1 percent in July 2008 to 20.4 percent by September to 13.2 percent by December. Growth (cumulative) in import-based tax has slowed from 50.8 percent in July 2008 to 27.7 percent by September to 11.9 percent by December. During Jul-December 2008 domestic taxes grew by 13.1 percent, and income taxes by 17.2 percent compared to the same period last year. In order to meet the Tk. 545 billion target for FY09, revenue has to grow by 17.1 percent in the last 6 months of the fiscal year relative to last 6 months of the previous fiscal year. Tax revenue grew by 28.8 percent in the last 6 months in FY08. The gains in tax compliance and the improvement in the base achieved in FY08 should allow the budget target for revenue to be met. However, falling international prices and slower imports could have a dampening effect on import-based revenues as already evident. Thus, the new government may need to put stronger emphasis on domestic resource mobilization through higher VAT and income tax collection.

Current expenditures in the first half of FY09 grew by 68 percent relative to the first half of FY08 on account of increase in pay and other allowances as a result of the two festival bonuses, implementation of the first phase of the 100-Day Employment Generation Program, the national election, and debt service payments. Total current expenditure incurred in the first half accounted for 60 percent of the FY09 budget target. FY09 budget provided Tk 131.6 billion for subsidies out of which provision for Bangladesh Petroleum Corporation alone amounts to Tk 61.1 billion, a little less than 50 percent. With the decline in international prices of oil, fertilizer and food, a significant part of this provision may not be needed despite downward adjustment in diesel and kerosene prices by Tk 11 per litre in three steps since late October 2008. Ensuring safety net programs, particularly the new 100-Day Employment Program, are well targeted and leakages are minimized, is critical for safeguarding the quality of FY09 expenditure expansion.

Implementation of the Annual Development Plan remains a perennial problem. Increased demand for revenue expenditures together with rising construction costs (that led contractors to forgo their original contracts) hindered ADP implementation in FY08. The usual slow rate in ADP implementation has remained unchanged so far. Only 24 percent of the total FY09 ADP allocation was spent during July-December 2008, compared with 21.7 percent implementation in the first half of FY07. Reaching a reasonable implementation level of about 80-85 percent by the end of the current fiscal year is likely to be a major challenge.

Monetary Management: Monetary management has generally been sound. Bangladesh Bank maintained close vigilance of the monetary aggregates in view of the global price increases in the first half of 2008 and the consequent high levels of inflation in Bangladesh. The subsequent onset of the global economic crisis has induced BB to revisit the monetary policy stance for the second half of FY09 to take account of the risk of an impending economic slow down in Bangladesh. Monetary growth has been rather high in recent months (see Figure 9). Broad money growth through November 2008 was 21 percent, compared with 15.1 percent growth in November 2007. The rise in broad money growth was driven by 24.3 percent growth in private credit and 23.3 percent growth in credit to the government.

BB faces the challenge of steering a monetary policy that is consistent with containing inflation while at the same time ensuring adequate liquidity and credit to stimulate economic activities. With a decline in economic activity in the first half of FY08, BB's position to keep interest rates and market liquidity steady was appropriate. Circumstances have changed now. There is a widely shared concern to avoid putting the brakes on private credit growth and adopt a selectively accommodative monetary policy focusing on key sectors. However, such a policy could entrench inflationary expectations that may haunt Bangladesh when the current downward price trends in international commodity markets are reversed. Moreover, credit and liquidity conditions have not tightened to a point that can justify economy wide monetary or fiscal stimulus at this stage.

II. Near- and Medium-Term Challenges

At the moment the Bangladeshi economy looks fairly stable. The new government has inherited a good economic position. Rising protectionism in developed economies, the collapse in global trade and the sizable retrenchment by global banks is likely to have an increasingly negative impact on Bangladesh. Policy preparedness and aggressive actions will be required to deal with the likely impact of global crisis that could suddenly put the domestic economy in a downward spiral of reduced exports and remittances growth leading to lower growth and higher unemployment.

A. Near-term challenges

The minimal exposure to the global financial markets owing to the underdeveloped economy and associated domestic financial markets has staved off first round effect of the ongoing global financial crisis on the Bangladesh economy. However, with every passing day, the global crisis is worsening and there is now enough evidence to suggest that the impending global recession is likely to be the deepest and the most protracted since the 1930s Great Depression[4]. As a result, the government can expect to face some daunting macro challenges emanating from external markets in the coming months. The election manifesto of Awami League has rightly indentified this as one of the priority issue and the new government needs to address it with care and urgency. Exports and remittances—the two crown jewels of Bangladesh economy—appear to be most vulnerable to the impending global recession.

(i) Impact on exports.

Exports are most vulnerable in the near- and medium-term since they depend heavily on the US and European markets. The performance of the readymade garment (RMG) industry is crucial as it accounts for over three quarters of export earnings and depends almost entirely on US and EU markets. The sector's contribution to GDP is about 10 percent, and it accounts for about 40 percent of manufacturing output and employment. In fact its impact spreads beyond that as it also supports an array of ancillary industries.

Overall exports for the first half of the fiscal year (July-December) have grown at a healthy pace of 19.4 percent as compared to the first half of the last fiscal year. During this period, total export volume increased by 15.4 percent while price increased by 4 percent. While strong export growth was witnessed for knitwear (27.1 percent) and woven garment (21 percent), the declining trend in exports of leather (31.9 percent), jute goods (17.9 percent) and raw jute (8.8 percent) continued. Pharmaceuticals exports declined by 19.8 percent and export of frozen food items declined by 4.1 percent. Export of all items declined in December 2008 relative to December 2007 with the lone exception of woven garments which recorded 6 percent growth. It appears that the impact of the ongoing global crisis has started showing on exports as indicated by the across the board weak earnings of December.

Immediate export prospects continue to look rather grim. Christmas sales in 2008 in the US and Europe were anything but encouraging. Despite huge discounts and promotions, US retail sales in December 2008 declined for the sixth consecutive month by 2.7 percent from November and by 10.8 percent relative to December 2007. Walmart, the world's biggest retailer and a major buyer of Bangladeshi garments, has so far remained relatively immune from the crisis. But even Walmart experienced 0.1 percent decline in sales at the height of the holiday season. In Europe, the retailers relied on discounts and promotions to stimulate sales. Yet sales in UK have contracted by 1 percent or at best leveled off during the holiday season, the worst in 30 years. While both France and Italy recorded declines, sales in Germany were comparable to last year's. Like the US, Europe also saw

[4] The US has been in recession since December 2007 and the recovery might not take off till 2010. The UK economy is projected to contract by 2.9 percent, the worst one year fall in GDP since 1946.

lukewarm demand for clothing and footwear. On both sides of the Atlantic demand for gift certificates were down, implying depressed post-holiday sales in January.

The Bangladesh Garment Manufacturers and Exporters Association (BGMEA) has reported a slowdown in export orders for woven garments observed since September 2008. In January, BGMEA even reported a decline in export orders of 5.5 percent after recording a decline in export orders of 7.7 percent in December 2008. Given the time lag between orders and shipments of about 4 months for woven garments, a slowdown in growth of exports should become evident in Q3 of FY09. Moreover, rebates of 2-3 percent on already placed orders are being negotiated. There is concern about the impact on export prices as well. Top buyers including Wal-Mart, Tesco, Prominent and Mercury are reportedly demanding up to two percent rebates on their existing orders. Buyers are renegotiating prices and delaying orders. There also are reports that American retailers are delaying payment for Chinese goods 90 or even 120 days after shipping, in contrast to the usual 30 to 45 days, forcing their suppliers to try to borrow more money to cover the difference. Some suppliers, who operate on thin margins, are going out of business. Bangladeshi exporters may face similar risk as well.

(ii) Impact on remittances

In the past, global remittance flows have been stable, or even counter-cyclical, during an economic downturn in the recipient country, and resilient in the face of a slowdown in the source country. However, the current crisis is affecting all countries at the same time. While remittances in Bangladesh are holding up well so far, the sharp and sustained decline in oil prices combined with the impact of the financial crisis on the banking sector is likely to adversely affect the construction boom in the Middle-Eastern economies. This would reduce the demand for additional migrant labor in the oil-rich Arab countries and could hurt Bangladesh’s remittance income.

As noted earlier, remittance inflows increased by 31.2 percent in the first six months of the fiscal year as compared to the last year. However, remittances figures for November and December 2008 (US$ 1.5 billion) could be misleading because remittances usually increase prior to *Eid* (increased inflow mainly from workers) and national election (inflow mainly from Bangladeshi Diaspora) and December was the month for both occasions. Data for January and February, when available, will be more informative of the impact of the global crisis so far, if any.

The bulk of Bangladesh's remittances, about 63 percent, come from the Middle-East, home to over 3.6 million Bangladeshi workers, and about 29 percent come from the US, UK and Germany. Therefore, for Bangladesh, economic developments in the Gulf Cooperation Council (GCC)[5] countries will be decisive. Globally the relationship between oil prices and remittances has been weak since the 1980s. For Bangladesh, however, there is strong evidence that remittances are positively correlated with oil prices.[6] Hence the recent decline in oil prices, which have fallen more than 65 percent from their peak, creates significant uncertainties for future remittance flows to Bangladesh. Kuwaiti Foreign Minister stated on January 16 that about 60 percent of development projects have either been postponed or cancelled by the six nation GCC states because of the global meltdown. In this context it is difficult not to expect a slowdown in remittance inflows to Bangladesh.

The outflow of Bangladeshi workers to GCC member countries in FY09 (July-Nov) grew by 4.8 percent, reaching almost 242 thousand compared to 231 thousand during the same period last year. However, the growth rate has declined from 11 percent in Jul-Oct to 4.8 percent in Jul-Nov. Also, growth in outflow of migrant workers to Saudi Arabia, the most important destination country, has been negative (-78 percent). The Bangladesh International Recruiting Agencies (BAIRA) has

[5] Gulf Cooperation Council (GCC) member countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia & U.A.E.

[6] Selected Issues, June 2007, International Monetary Fund.

reported a tightening of new visas by Saudi Arabia since June 2008 on the grounds of misdemeanor. Industry insiders anticipate that the impact of the global financial crisis on Saudi Arabia and other GCC countries will lead to further restrictions on foreign workers and visas.[7] A non-government group Migrant Forum in Asia has projected that migrant labor from the Philippines, Indonesia, Sri Lanka and Bangladesh will likely be worst affected by the downturn. Singapore, home to over 170,000 Bangladeshi workers, is expected to be particularly hard hit from slowing trade with the US and Europe, and there are reports that layoffs have already begun.[8]

The global recession has also brought with certain positive developments for Bangladesh. Sharp declines in international commodity prices--particularly oil, fertilizer and food—has eased pressure on import payments and helped reduce significantly the quasi-fiscal deficits. Because of sharp increases in international prices and their lack of pass-through to domestic prices, quasi-fiscal losses reached 2.5 percent of GDP in FY09. This is now projected to decline to 0.6 percent of GDP. Cumulative growth in import payments has declined from 35 percent in July-September, 2008 to 28 percent in July-November.

A need for policy preparedness

It light of the unfolding global crisis, it would therefore be prudent for policymakers to anticipate these developments and be prepared with contingency plans on possible response to protect the economy from the adverse effects of a likely slowdown in exports and remittance income in 2009. AL's manifesto emphasized forming a task force to "devise policy to save Bangladesh from global meltdown, develop a comprehensive information center, continually monitor national and global situations and provide prompt advice to help take necessary decisions." Following up, the Finance Minister on January 21 announced setting up a committee comprising of representatives from business, trade bodies and opposition parties within 15 days to assess the possible impact of global recession and recommend measures to cope with the impact.

While the outlook for 2009 is exceptionally uncertain, and the external economic environment continues to deteriorate, the latest World Economic Outlook projects a recovery by 2010, with world output growth increasing from 0.5 percent in 2009 to 3 percent in 2010, assuming that continued efforts to ease credit strains as well as expansionary fiscal and monetary policies.[9] Advanced economies are projected to experience a 2 percent output decline in 2009 before recovering to 1.1 percent increase in 2010. Growth in the Middle East is projected to slow from 6.1 percent in 2008 to 3.9 percent in 2009 followed by 4.7 percent growth in 2010.

Like natural disasters, a crisis emanating from the external environment cannot really be averted. A well crafted policy response that is well targeted and temporary can, however, make the pain bearable until recovery ensues. With credit and liquidity conditions remaining unaffected so far, Bangladesh is in a strategic position of carefully evaluating options for policy response before the crisis begins to impact exports and remittances. The following policy options, among others, may be worth considering for debate:

1. ***Managing trade issues***

[7] There are some positives as well. According to Refugee and Migratory Movement Research unit of Dhaka University, Libya has agreed to source 0.15 million workers from Bangladesh in 2009.

[8] According to media reports, overseas employment of Bangladeshi workers has halved in eighteen countries including Saudi Arabia, Kuwait, Oman, Qatar, Bahrain, Lebanon, Singapore, Malaysia and UK. The outflow of migrant workers declined sharply in December 2008 and January 2009 by 43 percent and 45 percent respectively.

[9] World Economic Outlook Update, January 28, 2009.

- Increasing exchange rate flexibility;
- Adjusting cash subsidy on exports; and
- Enhancing the Duty Drawback and Special Bonded Warehouse facilities for exports.

2. ***Remittances***

- Implementing needed legal reforms in the area of remittance transfer and utilization;
- Allowing private banks to use the network of public banks in rural areas to distribute remittances;
- Relaxing control over sending bank representatives in (migrant) destination countries and foreign exchange transfers for the salary of these representatives; and
- Removing regulatory barriers to encourage banks to offer diversified products to match the demand of different age groups of remittance receivers as well as small remitters.

3. ***Budget management***

- Using savings from the FY09 budgetary provisions for energy and urea subsidies for critical rural infrastructure and social security schemes. At current international prices, over $1 billion are projected to be saved from the FY09 budgetary provisions.

B. <u>Medium-term challenges</u>

In its election manifesto the Awami League has committed to make efforts to increase country's annual GDP growth to 8 percent by 2013 and to 10 percent by 2021. National savings in Bangladesh have consistently exceeded the domestic investment rate (Figure 10). This suggests that investment, not savings, has been the binding constraint on growth in Bangladesh.[10] The investment rate needs to rise from the current 24.2 percent of GDP to 30 percent to achieve 8 percent, and 36 percent to achieve 10 percent annual growth. Increases in domestic savings may not suffice to finance the required increases in domestic investments. Borrowing conditions in international markets have now become difficult even for well regarded emerging country borrowers. Thus, in order for the corporate sector in Bangladesh to be able to maintain investment and growth, a more hospitable environment for foreign investment is needed. A key first step towards achieving these is to reach closure on the country's poverty reduction strategy (PRS). The AL has committed to revise the just formulated PRS within six months of assuming office.

The World Bank's recent report[11] on strategic options for sustained growth in Bangladesh identified three mutually reinforcing strategies to achieve the middle-income status: (i) a shift from agriculture to industry and services while investing on increasing agricultural productivity; (ii) deepening of integration with global markets; and (iii) fostering the emergence of diverse dynamic urban centers. In turn, to enable these transitions, Bangladesh requires maintaining macroeconomic stability, improving infrastructure services, strengthening the financial sector, narrowing the skill and employment gap, and improving economic governance.

(i) Continuing sound macroeconomic management

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[10] According to the World Bank's Investment Climate assessment 2007, Bangladesh compared favorably to other countries in terms of labor regulations, customs and import/export procedures, crime, mobile telephones, micro-finance for individuals, and licensing. The country performs weaker than international peers on courts/ contract enforcement, access to land/property registration, labor skills/training, electricity, governance, access to finance (and micro-business loans), innovation /IT, and tax administration.

[11] The World Bank, Bangladesh: Strategy for Sustained Growth, July 2007.

Bangladesh's track record of macroeconomic stability must be sustained. Sharp declines in international commodity prices since October, 2008 have made it easier to keep within the macroeconomic targets of the FY09 budget. Despite significant improvements last year, increased revenue remains the pre-eminent medium-term fiscal policy goal. Bangladesh's revenue performance has been persistently below the levels of its regional peers. The pace of improvements has suffered from a complex and inefficient policy framework, widespread evasion, and poor administration. Despite the expansion of tax holidays in the FY09 budget, improvements in administration and compliance already underway can underpin continued increases in tax revenue mobilization. A complete overhaul of tax legislation and continued modernization of tax administration are, however, required to achieve the increase in the revenue-GDP ratio envisaged in the country's Medium-Term Budget Framework (MTBF).

The government's ability to increase spending on social services and infrastructure has improved with savings generated from the budgetary provision for subsidies to fuel and fertilizer due to decline in international prices. But this needs to be translated into reality by taking concrete steps to increase the rate of ADP implementation. Reconstruction of infrastructure and housing destroyed in FY08's natural disasters, investment in power and gas, education and safety nets are key expenditure priorities.

Preventing resurgence in inflation should be a major policy concern. The recent decline in inflation cannot be taken for granted. With fiscal policy focusing on sustaining revenue collection and strengthening safety nets to address the social impact of a likely decline in export and remittance growth, monetary policy needs to be geared to fighting inflation.

(ii) Easing energy and infrastructure constraints

Closing the energy and infrastructure deficit is the next biggest challenge for the medium-term. It is one that has eluded Bangladesh in recent years. Widespread and growing shortage of electricity is the most immediate constraint on growth. Power shortages alone are estimated to cost up to 2 percent of GDP on an annual basis. With an estimated US$1 billion in additional investment needed to build utility-scale plants every year that can catch up with demand, the critical issue of efficient and enabling regulation is top priority. AL's manifesto has promised a comprehensive long term policy on electricity and energy. Over the medium and longer term, addressing the lack of speed and transparency in the procurement of new power plants is a must. On the broader issue of energy security, reaching closure on the national coal policy and a detailed gas policy review is essential.

While power is the most binding constraint, there are other lacunae in infrastructure services that hinder Bangladesh's drive towards export competitiveness and rapid investment growth. These range from customs procedures in the ports to inefficient transport networks. It will be extremely important to make sure that the improvements in the management of Chittagong port achieved recently are not eroded. They need to be complemented with investments in the physical and logistical capacity of the ports. Ganges and Brahmaputra present major barriers to the connectivity of the Western Bangladesh to the main growth poles. The new government has promised to deliver the proposed bridge on the Padma River.

(iii) Deepening the financial sector

The potentially disastrous consequences of weak financial markets are now more than apparent. Financial sector reforms are one of the success stories in Bangladesh, but the job is not done yet. Bold banking reforms since the 1990s have de-emphasized the role of state-owned banks, strengthened competition, tightened prudential regulation, and enhanced regulatory quality. Further deepening of the financial system will require a more substantial change in the role of the government from an operator and arbiter to a facilitator in order to create more competition among healthier financial institutions and result in lower overall costs of financing investments.

The remaining agenda is still large. A comprehensive vision for the financial sector and stronger support for market development are now needed. Bangladesh Bank is a natural candidate for leading this effort. BB needs to build on reforms it has already made in its internal operations to ensure that they are in line with international best practice. With the recent rapid increase in private sector credit, improvement in the BB's surveillance of the financial sector has become critical. Strengthening the SCBs financial position with a view to eventual divestment is crucial to improve banking sector efficiency. Last but not least, allowing interest rates in the primary auction for government securities to be market determined will give impetus to an active secondary market, which is vital for financial deepening.

(iv) Bridging the employment and skill gaps

Bangladesh's labor could potentially power the kind of rapid transition towards prosperity that resource-poor East Asian economies have managed to attain. The labor force is growing by 2 million workers each year because of demographic changes and increase in female participation. Almost half of the labor force is still engaged in agriculture and three quarters located in rural areas. While only 4.2 percent of the labor force in 2006 were unemployed in the strict sense (i.e working zero hours, having no income, and actively looking for work), this is only the tip of the iceberg of the much bigger problem of providing gainful employment. The rate of underemployment (persons working less than 35 hours a week) was 24.5 percent overall and 77 percent for females in rural areas in 2006.

Appropriate institutions and incentives, complemented by well-developed infrastructure, are critical for an employment friendly environment. This may, however, need to be supplemented by public intervention for the promotion of employment-intensive growth. Examples of circumstances making this necessary are: periods of adjustment when private enterprise fails to absorb labor in necessary numbers; and the stimulation of growth in regions with a disproportionately high concentration of the poor, which fail to attract large enough investment under market incentives. In such cases public investment, e.g., public works programs for the development of infrastructure in poor regions, can directly contribute to an acceleration of employment-intensive growth.

Creating productive employment opportunities for the youth and educated unemployed is another major challenge. The unemployment rate is 9.3 percent for 20-24 year old males and 10.7 percent for females in the same age group. The unemployment rate increases with the education level of the labor force. There are large gaps between the skill types demanded by the market and those being supplied by the system. Studies have found that education quality has deteriorated and there is a large quality divide between urban and rural areas. A focus on improving the quality of secondary and tertiary education and market oriented vocational skills are essential not just to build on the earlier gains in primary education but also to boost productivity and international competitiveness.

(v) Improving governance

Bangladesh is widely perceived by domestic and foreign investors as an expensive and risky place to do business, notwithstanding its sizable labor cost advantage. The toughest challenges lie in the core governance areas—crime and disorder, distrust of the judiciary, corruption, and regulatory uncertainty. Recent experience has demonstrated once again that only strong political leadership supported by a constituency that demands change can make progress with reforms that cut across a wide range of institutions and inflict collateral damage to, and hence induce resistance from, powerful vested interests. The December election results unambiguously provided a resounding verdict for change. The expectations appear to be highest in the area of governance. The electorate have clearly spoken against politics as usual

ANNEX A

GROWTH

Figure 1: Real GDP Growth (%)

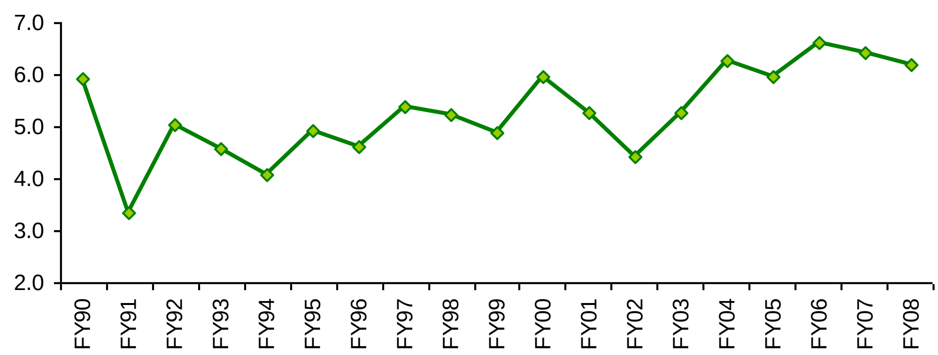


Figure 2: Sectoral Growth Rates (%)

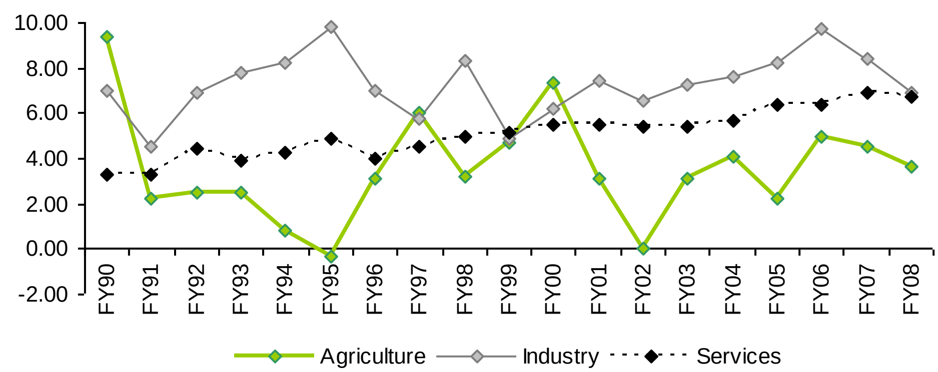
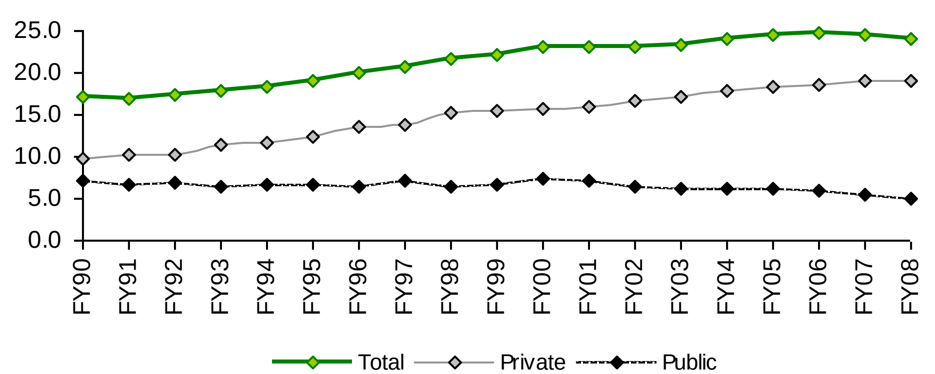
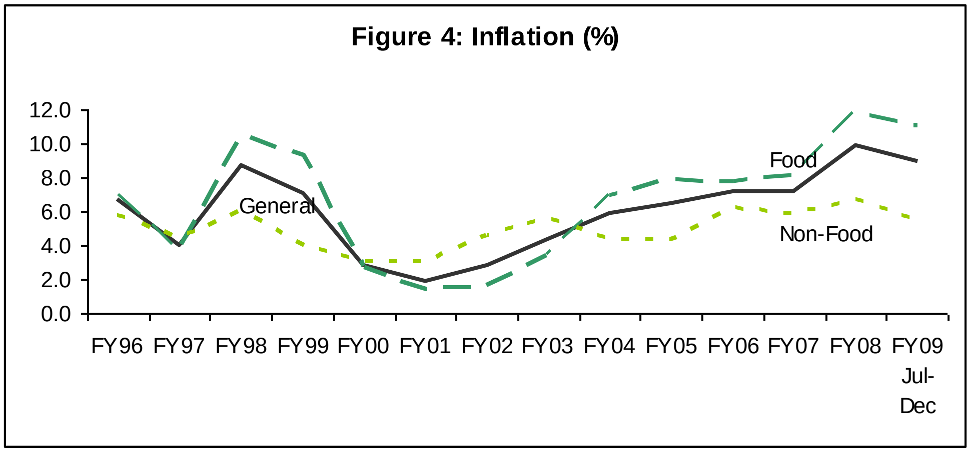


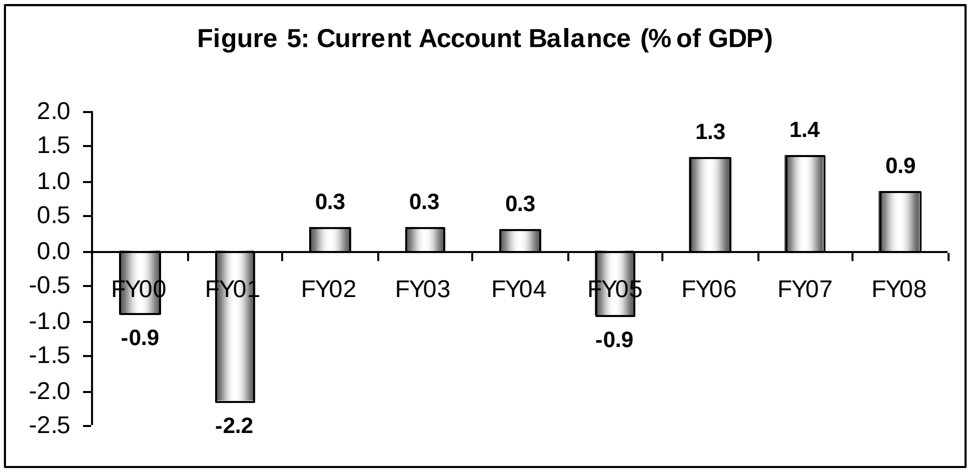
Figure 3: Investment (% of GDP)

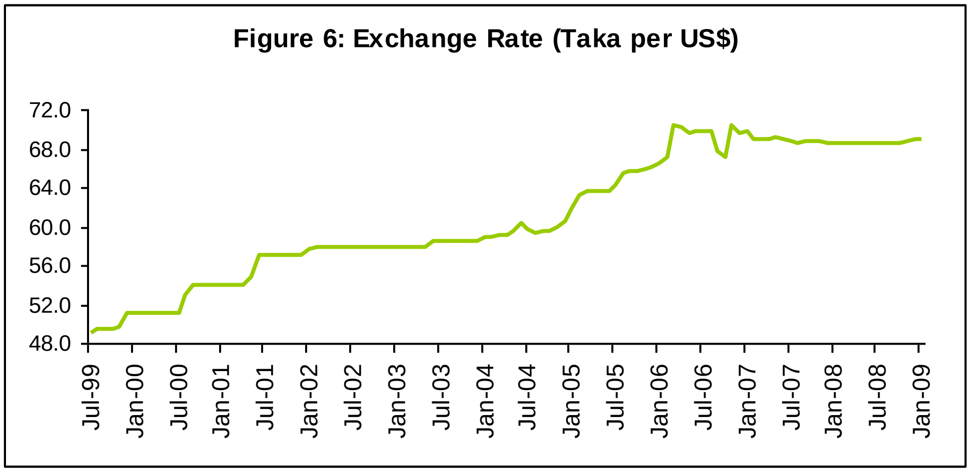


INFLATION

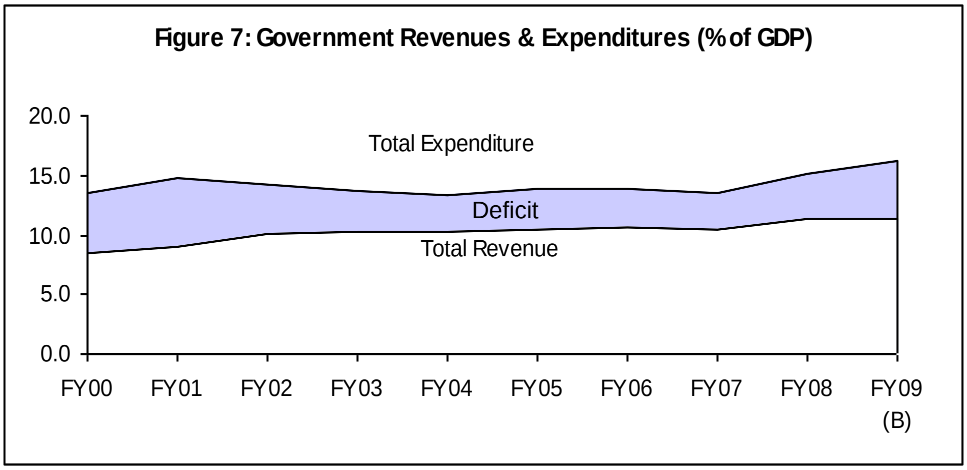


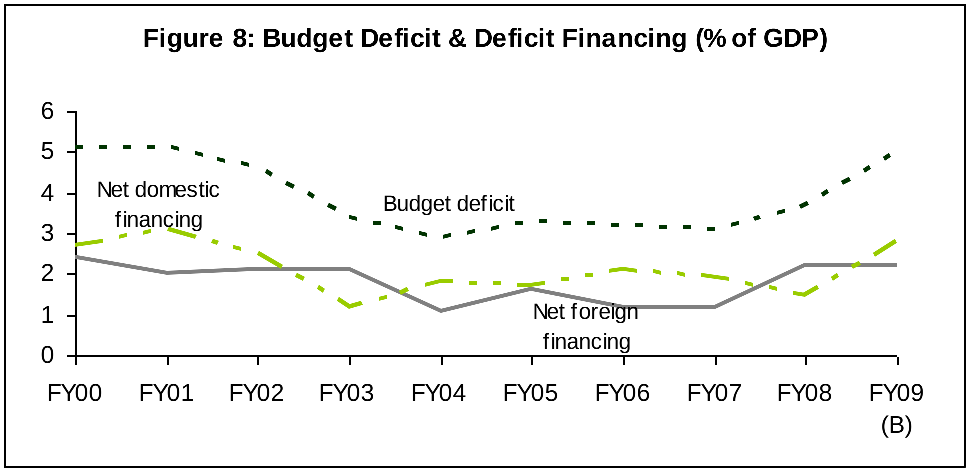
EXTERNAL SECTOR



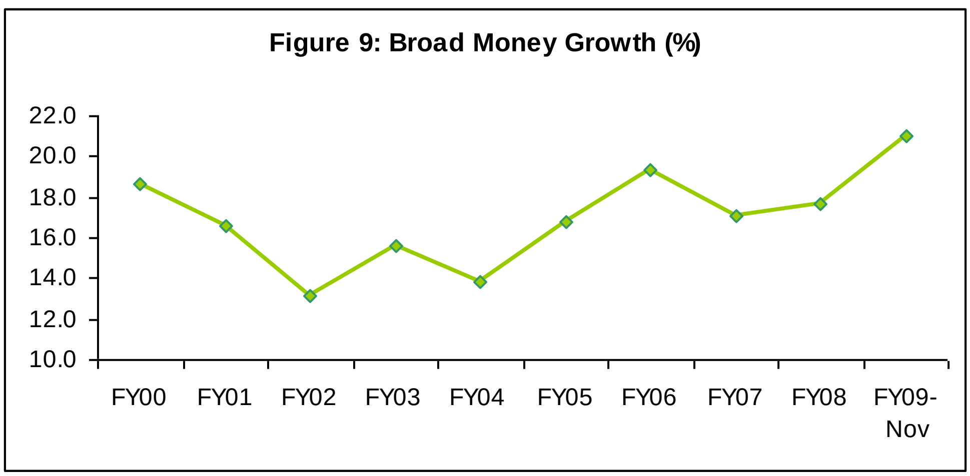


FISCAL MANAGEMENT

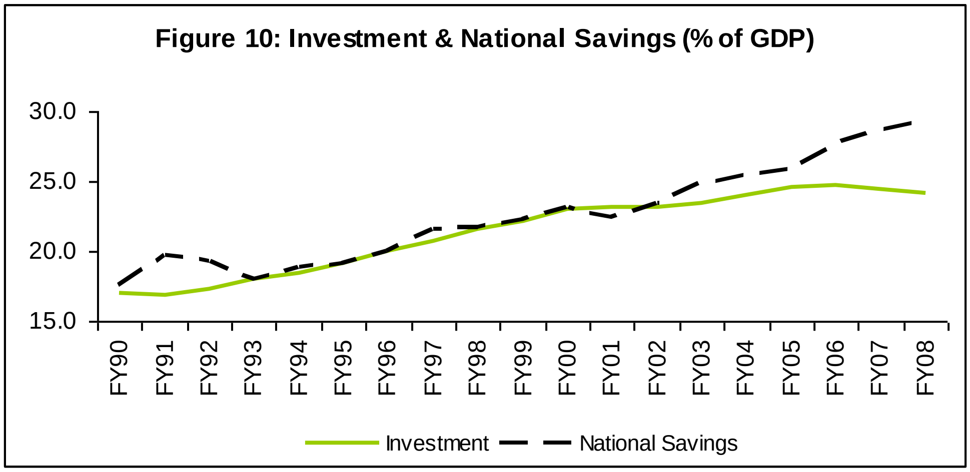




MONETARY MANAGEMENT



SAVING INVESTMENT BALANCE



ANNEX B: KEY MACROECONOMIC INDICATORS

Table 1: Key Macroeconomic Indicators

Description	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Growth Rates (%)							
GDP Growth	4.4	5.3	6.3	6.0	6.6	6.4	6.2
GDP Growth Per Capita	2.9	3.8	4.8	4.5	5.1	4.9	4.7
Saving & Investment (% of GDP)							
Gross Domestic Saving	18.2	18.6	19.5	20.0	20.2	20.4	20.1
Gross National Saving	23.4	24.9	25.4	25.8	27.7	28.7	29.2
Private Investment	16.8	17.2	17.8	18.3	18.7	19.0	19.2
Public Investment	6.4	6.2	6.2	6.2	6.0	5.4	5.0
Central Govt. Budget (% of GDP)							
Total Revenue	10.1	10.3	10.2	10.5	10.7	10.4	11.4
Total Expenditure	14.7	13.7	13.1	13.9	13.9	13.5	15.1
Overall Budget Deficit	4.6	3.4	2.9	3.5	3.4	3.1	3.7
Balance of Payments (% of GDP)							
Trade	28.6	29.3	30.7	33.9	37.9	40.3	42.3
Exports	12.4	12.5	13.3	14.2	16.6	17.6	17.7
Imports	16.1	16.8	17.4	19.7	21.3	22.7	24.7
Services & Income (net)	-1.9	-2.0	-2.2	-2.6	-2.8	-3.2	-3.2
Current Transfers	5.9	6.6	6.6	7.1	8.7	9.6	11.1
Current Account Balance (including transfers)	0.3	0.3	0.3	-0.9	1.3	1.4	0.9
External Indicators							
External Debt (US$ b.)	16.1	16.9	17.5	17.8	17.9	19.6	20.5
Ext. Debt as % of GDP	33.7	32.6	31.0	29.6	28.9	28.7	25.9
BB Gross Reserves (US$ b.) (end of period)	1.6	2.5	2.7	3.0	3.5	5.1	6.2
BB Gross Reserves (in months of imports)	2.1	2.9	2.8	2.6	2.8	3.4	3.4
External Debt Service Ratio (% of Total foreign exchange earnings)*	6.3	5.8	4.9	4.5	4.1	3.7	3.4
Money and Credit							
M2 Growth (%, year-on-year)	13.1	15.6	13.7	16.9	19.5	17.1	17.6
Net Domestic Asset Growth (%, year-on-year)	11.6	12.2	13.5	17.2	19.7	12.6	18.1
Ratio of Private Sector Credit to GDP (%)	24.7	25.8	28.4	29.9	31.5	32.2	35.1
Exchange Rate							
Nominal Period Average (TK/US$)	57.4	57.9	58.9	61.5	67.2	69.1	68.6
Nominal End of Period (TK/US$)	57.9	58.5	60.4	63.7	69.7	68.8	68.5
Real Effective Exchange Rate Index	101.5	97.0	93.4	91.7	86.9	89.7	91.0
Rate of Inflation (%) (year on year)**	**2.8**	**4.4**	**5.8**	**6.5**	**7.2**	**7.2**	**9.9**
Inflation (GDP deflator)	**3.1**	**4.4**	**4.1**	**5.1**	**5.2**	**6.8**	**8.1**
Total Public Debt (% of GDP)	**52.9**	**51.1**	**49.1**	**47.5**	**46.9**	**46.5**	**44.4**

Source: Various publications of the Bangladesh Bank, Ministry of Finance and Bangladesh Bureau of Statistics.