

September, 2009

Bangladesh Economic Update



*Economic Policy and Poverty Team
South Asia Region*

The World Bank

Summary

- **Overall, the macroeconomic indicators for FY09² suggest that Bangladesh has weathered the global economic crisis well so far.** Low integration with the world economy helped cushion Bangladesh from the negative effects of the crisis. Annual GDP growth dipped slightly to reach a still healthy 5.9 percent in FY09.³ Lower international food and oil prices, combined with a bumper rice crop, helped bring down inflation. The external current account recorded a large surplus of US\$2.5 billion because of strong remittance inflows, double-digit export growth and a declining import bill. The nominal exchange rate was kept stable through interventions by Bangladesh Bank to absorb the large influx of dollars from remittances. As a result, the official foreign exchange reserves reached a record high of nearly US\$7.5 billion at end-June 2009. Meanwhile, the budget deficit and its domestic financing were largely contained in FY09.
- **Despite robust annual growth, the second half of FY09 saw flagging growth in exports and remittances.** While total exports (year-on-year) grew by an average of 20 percent in the first part of FY09, their growth fell to only 2.6 percent in the second half. Moreover, the overall export data masks the diverging performance of ready-made garment (RMG) exports and the non-RMG exports – with the latter registering negative growth in FY09. Remittances also show a similar pattern, with growth decelerating from 30.9 percent in the first half of FY09 to 15.7 percent during the second half. Performance of exports and remittances in FY10 will depend on the pace of recovery of the global economy.
- **Looking ahead, there are other short-term risks to growth and poverty reduction in FY10.** Inflationary pressures may re-emerge – with disproportionate impact on the poor – if the liquidity overhang in the domestic banking system continues and international commodity prices rise. Controls on lending rates and direction of credit to some sectors could potentially lead to misallocation of resources, and growing commercial bank engagement in the capital markets poses a risk to their capital in the event of a decline in the market. On the fiscal side, the underutilization of the Annual Development Program (ADP) budget hampers growth and poverty reduction. Meanwhile, energy shortages continue to choke private sector investment.
- **Bangladesh’s medium-term prospects depend on a continuation of macroeconomic stability and deepening of structural reforms.** The reform agenda entails maintaining macroeconomic stability and deepening financial sector and external trade reforms. It is also essential to rebalance the policy focus towards structural areas that have received insufficient attention. These include economic governance, urban management, infrastructure (especially power, ports and transportation), market-oriented vocational skills and quality secondary and tertiary education.⁴

¹ The report was put together by Zahid Hussain and Lalita Moorthy, with the inputs of Sanjana Zaman, Diepak Elmer, Md. Abul Basher, Mehnaz Reza, and A.K.M. Abdullah, and was done under the guidance of Sanjay Kathuria.

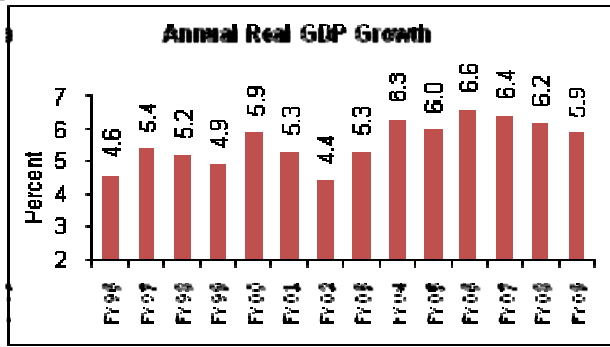
² Fiscal Year 2009 spans the period from July 2008 to June 2009.

³ “Annual” growth rates refer to change over previous fiscal years (e.g., FY09 over FY08). Unless otherwise stated, all other growth rates in this brief refer to “year-on-year” rates i.e., growth in a month in 2009 over the corresponding month in 2008 (e.g., July 2009 over July 2008).

⁴ See World Bank (2007). “*Bangladesh: Strategy for Sustained Growth.*”

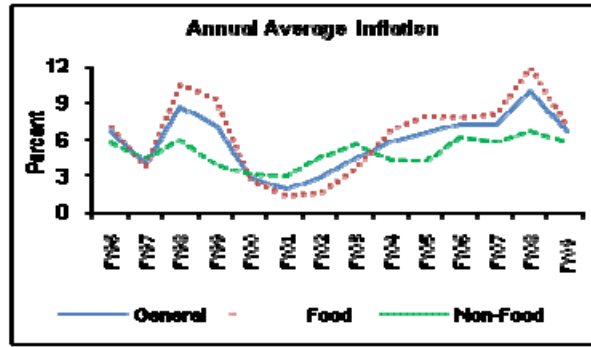
A Chart-Summary of Recent Economic Developments and Short-Term Risks

In FY09, real GDP growth dipped slightly to a still healthy 5.9 percent ...



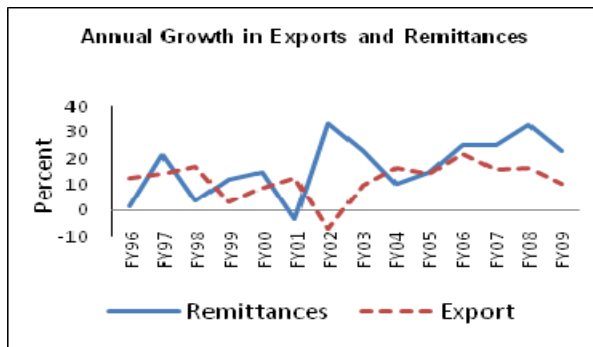
Source: Bangladesh Bureau of Statistics

... and domestic inflation stayed low ...



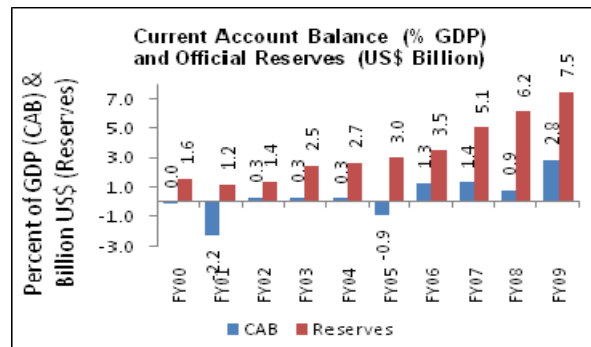
Source: Bangladesh Bureau of Statistics

... while exports and remittances continued to grow...



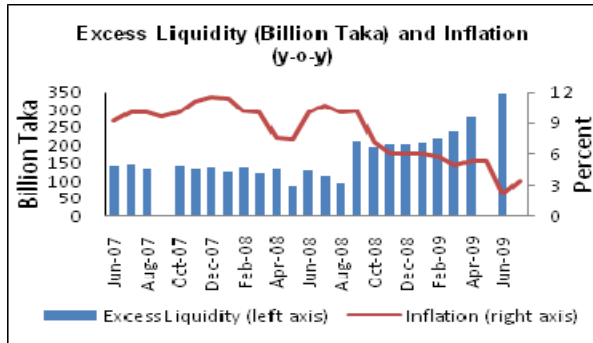
Source: Bangladesh Bank

... leading to record high external current account surplus and reserves.



Source: Bangladesh Bank

Looking ahead, excess liquidity, combined with potential supply-side shocks in agriculture, may lead to inflationary pressures...



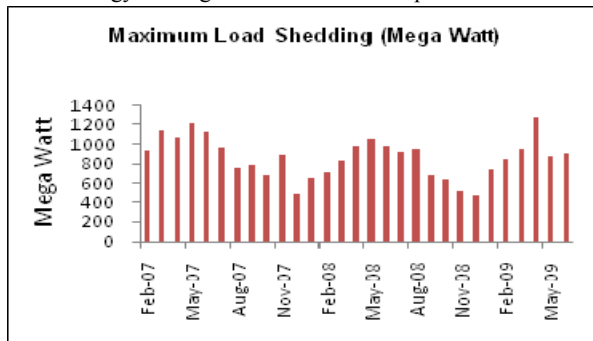
Source: Bangladesh Bank and Bangladesh Bureau of Statistics

...export orders of ready-made garments remain sluggish...



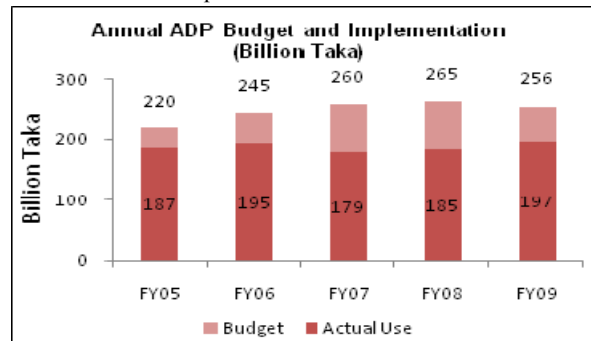
Source: Export Promotion Bureau, BGMEA & BKMEA

... and energy shortages continue to choke private investment...



Source: Power Division, GoB

... and slow ADP implementation remains an issue.



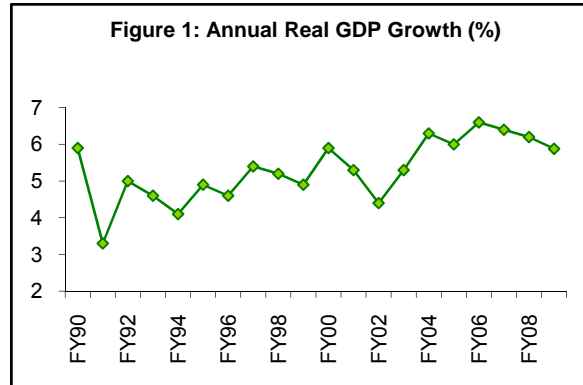
Source: Implementation Monitoring & Evaluation Division, GoB

Recent Economic Developments

Real Sector Developments

Annual GDP growth in Bangladesh remained strong in FY09 despite the global economic crisis.

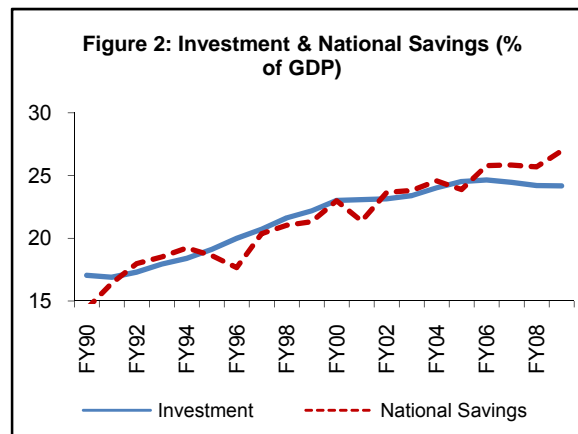
Limited integration with the world economy shielded Bangladesh from the adverse effects of the global economic crisis. Growth decelerated slightly from 6.2 percent in FY08 to a still healthy 5.9 percent in FY09 (Figure 1). *Agricultural* production grew by 4.6 percent (rebounding from 3.2 percent in FY08) driven mainly by strong growth in crops and horticulture. In contrast, *industrial* growth slowed from 6.8 percent in FY08 to 5.9 percent in FY09 mainly because of a slowdown in large-and-medium-scale manufacturing geared towards exports. *Services* managed to grow at 6.3 percent, slightly below the growth rate in FY08.



Source: Bangladesh Bureau of Statistics

While there was growth in real capital formation, it was below average for the decade. Annual real capital formation grew by around 5.7 percent in FY09, which is a sharp increase from 1.8 percent in FY08 but much lower than the average of 8.2 percent in the past decade. The investment-GDP ratio, measured in current prices, remained nearly flat at 24.2 percent due to declining rate of public investment. Private investment maintained its gradually increasing trend since FY06. About three-quarters of total investment is construction, which in nominal terms grew by 14.2 percent in FY09 compared with 16.9 percent growth in FY08. Investment in plant and machinery grew by 6.2 percent, compared with 1.8 percent nominal growth in FY08.

Gross national savings exceeded domestic investment. It accounted for 27 percent of GDP in FY09, up by a percentage point from a year earlier.⁵ This was because of a strong growth in net factor income and net current transfers. Meanwhile, the gross domestic savings, expressed as a percentage of GDP, fell slightly to 20 percent in FY09, reflecting an increase in the private consumption growth rate while GDP growth declined. This fall was more than offset by strong growth in remittances, leading to an excess of gross national saving over gross domestic investment by around 2.8 percent of GDP (Figure 2).



Source: Bangladesh Bureau of Statistics

⁵ This differs from the officially reported gross national saving rate because the latter includes statistical discrepancy.

Looking ahead, growth may moderate further in FY10 because of a possible decline in key components of aggregate demand:

a) *Private consumption*, accounting for around 75 percent of GDP, may decline because of lower agricultural growth and a slowdown in remittances. While remittances depend on global developments, agricultural performance remains subject to the vagaries of nature. Farmers have reportedly missed the target of planting 58 million acres of Aman (compared with 55 million acres last year) by about 30 percent because of drought. Having missed the planting window (mid-July to mid-August), farmers responded by planting local varieties which have lower yields. The government has emphasized ensuring timely and adequate availability of agriculture inputs at subsidized prices, particularly in the Boro (the largest rice crop) season in the second half of FY10. Even if these efforts succeed, growth in crop and animal farming production will likely be lower in FY10 because of the base effect of last year's bumper production.

b) *Private investment* outlook is mixed: (i) Over three quarters of gross fixed capital formation comes from the construction sector, where high prices of materials in FY08 and the first half of FY09 kept the annual average real growth at 5.7 percent for the two years, which is much below the average annual rate of 8 percent for the previous 5 years. The outlook is now improving, as indicated by a positive 3-month seasonally-adjusted and annualized rate of growth of steel imports since February, 2009. Although the rate of growth dropped in May 2009, data on letter-of-credit (LC) opening for steel imports suggests a likely turnaround. (ii) Imports of capital machinery – accounting for 14 percent of total capital formation in FY09 – are declining. Annualized growth in the seasonally adjusted 3-month moving average of import of capital machinery remained negative since March 2008. LC opening for import of capital machinery in July 2009 declined by 5.7 percent in nominal dollar terms relative to July 2008. (iii) While the annual FDI inflows increased by 46 percent in FY09, because of a \$430 million buyout of domestic investment by foreign investors in a telecommunication company, this surge is not likely to be sustained. Continued energy shortages, high start-up costs of business, transportation bottlenecks, and slow institutional reforms suggest a pessimistic near-term outlook for private investment.

c) *Export* growth is likely to slow further. There continues to be a global softening of aggregate demand amidst fears of a double-dip recession. Demand in the US and European markets may not soon return to previous levels as households continue deleveraging. As such, export growth may remain weak, particularly in the first half of FY10.

Monetary Sector Developments

In FY09, broad money grew by 20 percent while reserve money grew by 31.4 percent (Figure 3).⁶ Although growth in credit to the private sector declined from nearly 25 percent at the beginning of FY09 to 14.6 percent towards the end because of lower demand for imports, it still made the largest contribution (11.2 percentage points) to monetary expansion in FY09. Growth of credit to the public sector

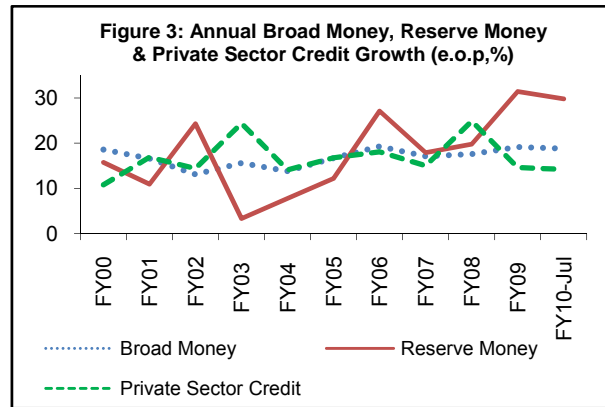
⁶ Bangladesh Bank's (BB) annual monetary program adopts reserve money (RM) as the operating target while broad money (M2) is used as the intermediate target. The underlying assumption is that the growth of monetary aggregates (such as M2) has a direct impact on the domestic price level. By controlling the growth of monetary aggregates, BB aims to achieve price stability. In practice, BB sets the growth rate of RM that is deemed consistent with targeted inflation, with the expectation that this RM growth will in turn lead to a growth rate of M2 that is consistent with target inflation and adequate liquidity in the economy. A recent BB analysis of the dynamic relationship (based on impulse response and variance decomposition) among the components of RM, however, shows that net foreign assets and net government borrowing – mostly beyond the control of BB – have greater influence on RM changes, thus limiting BB's control over RM or M2.

contributed 4.8 percentage points and accumulation of net foreign assets contributed 4.1 percentage points.

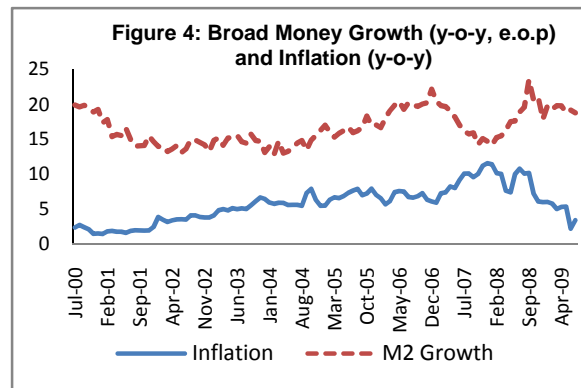
Liquidity in the banking system increased during FY09. The Bangladesh Bank (BB) transacts with the authorized dealers in the inter-bank market to keep the nominal exchange rate stable. Slowdown in import growth, together with strong remittance inflows and double-digit export growth, kept the interbank market highly liquid in FY09 - a year in which BB's net purchase of US\$ amounted to US\$1.48 billion. In the absence of sterilization, liquidity increased, which the banks deposited in their current accounts with BB. The deposits held with BB by the commercial banks increased from Tk18.6 billion at end-June, 2008 to Tk128 billion at end-June, 2009 - a growth of 75 percent in FY09 compared with only 12.1 percent growth in FY08.

Combined with increasing international commodity prices, a prolonged liquidity overhang in the banking system may create further pressure on prices. As such, the decline in inflation in FY09 to 6.7 percent (from 9.9 in FY08) cannot be taken for granted. The fall in overall inflation in FY09 was driven mainly by a drop in food inflation from 12.3 percent in FY08 to 7.2 percent because of a good harvest and fall in international rice prices. Non-food inflation at the end of FY09 remained quite high at 5.9 percent, though lower than 6.3 percent in FY08. Meanwhile, international commodity prices have started rising recently while domestic monetary expansion continues to be high. This can create further pressure on prices. It must be noted that while monetary growth and inflation appear to move in tandem in Bangladesh (Figure 4), there has been significant divergence between the two since January 2008 because of increased recourse to administered prices since the onset of the global food crisis. The correlation, however, has not broken down entirely. Also, non-food inflation is more influenced by monetary conditions.

The BB adopted an expansionary monetary policy for July to December 2009 to deal with the global economic crisis but questions remain. BB's monetary policy seeks to accommodate the central government's expansionary fiscal stance for FY10 to mitigate the impact of the global economic crisis. The target growth rate of broad money is 15.5 percent in FY10 to accommodate 6.0 percent real GDP growth and 6.5 percent inflation. Private sector credit growth is projected at 16.7 percent, while public sector credit is forecast to grow at 25.3 percent.⁷



Source: Bangladesh Bank

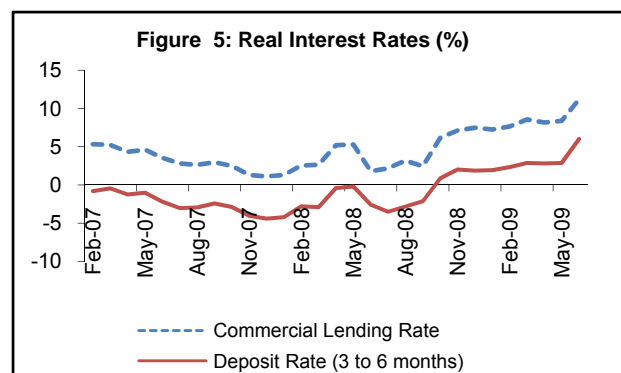


Source: Bangladesh Bank & Bangladesh Bureau of Statistics

⁷ Monetary outcomes in July 2009 have generally not been in line with the Monetary Policy Statement. Broad money growth declined to 18.8 percent compared to the same month last year as private credit growth declined further to 14.2 percent. But net foreign assets increased by 32.7 percent.

A ceiling on lending rate has been imposed.

Real interest rates have continued to increase (Figure 5). In order to reduce the excess liquidity and to induce private sector investors to borrow from the financial system, starting from the second quarter of 2009, BB imposed lending rate cap at 13 percent which has eventually been translated into deposit rate cap of 8.5 percent for term deposits and around 6 percent for savings deposits. The deposit rate barely covers the inflation rate posing disincentive for the people to save. The cap on the lending rate is based on the assumption that nominal commercial banking lending rate is downwardly rigid. An analysis (Box 1) shows that the rates on national savings certificates set a floor for the commercial bank lending rate.



Source: Bangladesh Bank

In addition, BB has initiated a number of other measures. These include targeted lending programs, for listed commercial banks, starting from second quarter of 2009. These are: (1) extending 5 percent of the loanable fund to agriculture sector at 2 percent nominal rate of interest; (2) rescheduling of loan installments receivable till September 30, 2009 for major export sectors, affected by global recession; and (3) establishing 3 rural branches for each new urban bank branch.

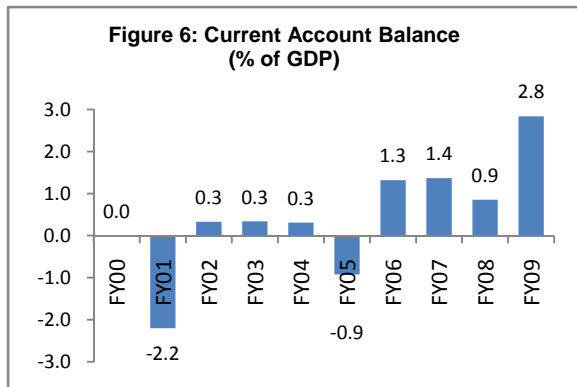
Directed credit to “priority sectors” may not have the desired effects. The BB in its Monetary Policy Statement reiterated the need to channel credit to priority sectors like SMEs and agriculture, this time through ‘mandatory’ rather than ‘advisory’ approaches. Lending for agriculture has been made compulsory for all commercial banks, with incentives in the form of refinance facilities, and ceilings on lending rates and charges/fees for priority sectors. These approaches do not have a history of much success, and it remains to be seen as to how much additional credit flows to the priority sectors. More promising avenues are the fostering of strong competition in lending, and also nurturing of specialized institutions to deal with issues of access to finance for rural and small borrowers.⁸

External Sector Developments

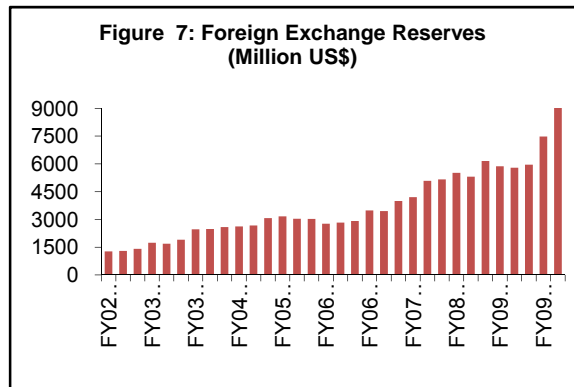
Bangladesh’s balance of payments situation remained sound in FY09 despite the impact of the global economic crisis. The external current account has recorded a large surplus US\$2.5 billion in FY09 (equivalent to 2.8 percent of GDP) because of strong remittance inflows and double-digit export growth (Figure 6). FY09 ended with a stock of US\$7.5 billion official foreign exchange reserves – nearly 22 percent higher than end-June 2008. Official reserves increased further in mid-September after IMF released US\$ 630 million as part of the Special Drawing Rights (SDR) allocation made to all IMF members (Figure 7).⁹

⁸ BB does allow for the possibility of banks to lend indirectly to priority sectors through locally active financial institutions.

⁹ The IMF will provide another \$105 million shortly as part of its stepped up efforts to inject liquidity in the central banks across the globe.



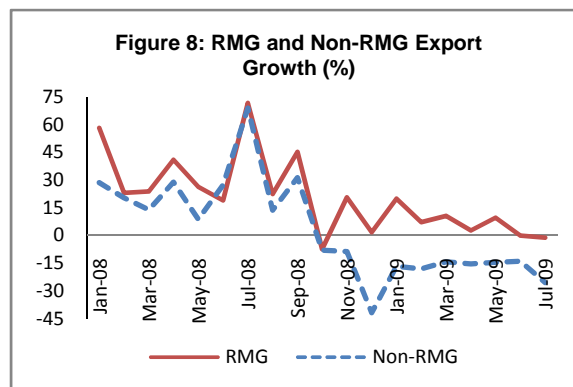
Source: Bangladesh Bank



Source: Bangladesh Bank

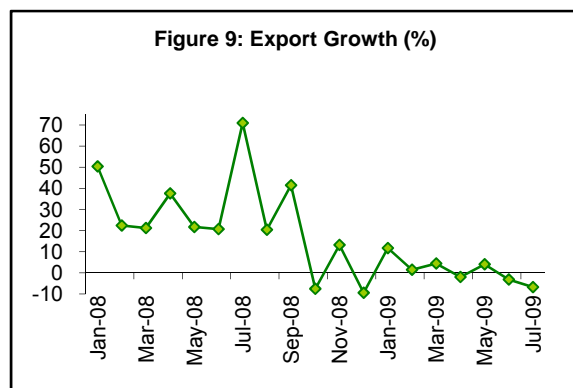
Exports continued to grow in FY09, especially in the first half of the year. Exports reached US\$15.6 billion in FY09 compared to US\$14.1 billion in FY08, registering an annual growth of 10.3 percent. However, export performance deteriorated in the second half of FY09 in the wake of the global economic crisis. While total exports grew (year-on-year) at an average of around 20 percent in the first half of FY09, the growth rate dropped to 2.6 percent in the second half. In fact, the fiscal year ended with a year-on-year decline of total exports in June of 3.2 percent.

Of total exports, the ready-made garments (RMG) sector did better than the non-RMG sector in FY09. The RMG sector displayed a strong growth performance in FY09 while exports declined in all other major export categories (Figure 8). Knitwear and woven garments grew annually by 16.2 percent and 14.5 percent respectively. RMG exports, which account for 21 percent of total exports, declined by 6 percent. However, some non-RMG sectors – like pharmaceuticals did see positive growth (see below). In addition to reduced demand, both RMG and non-RMG items have also witnessed downward pressure on prices.



Source: Bangladesh Export Promotion Bureau

Export orders began declining in the last quarter of FY09 and its impact is beginning to show in recent export shipments. FY10 began with a year-on-year decline in exports by around 6.8 percent in July 2009 (Figure 9). The decline, in part, reflects the base effect of a 71 percent increase in exports in July 2008. However, the top 25 out of a total 35 export items declined, including woven garments which dropped by 4.7 percent. Knitwear grew by only 1.8 percent, year-on-year, while frozen food slumped 50 percent. Export prices of manufactured items dropped nearly 5 percent, the sharpest fall in more than a year. According to the Bangladesh Garment Manufacturers and Exporters' Association (BGMEA), prices of woven garments have shrunk by



Source: Bangladesh Export Promotion Bureau

20-25 percent, over 100 factories have already shut down, laying off nearly 50,000 workers, and many of those in business are incurring losses.

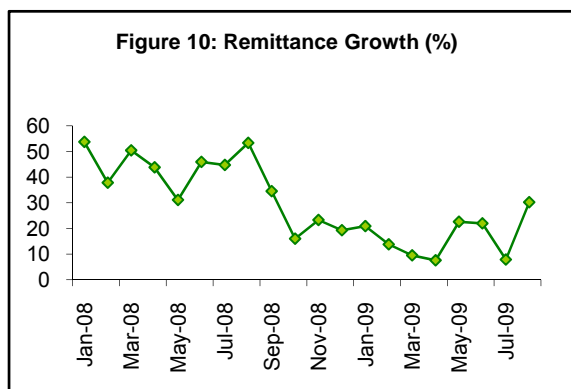
There are signs of optimism that point to a possible recovery of exports later in the year (see Box 2, page 20). The optimism hinges on the prospects of recovery in external demand as well as the resolution of several domestic constraints including the shortages of gas and power supplies. On the non-RMG export side, there are some positive developments as well. In response to the decline of exports of finished leather products, Bangladeshi manufacturers have started developing their expertise in footwear and leather bags and purses, as these items continued to grow by 10 percent and 90 percent respectively in the past fiscal year.¹⁰ According to industry insiders, the declining global demand for fashionable and costly leather products is seen as an opportunity for Bangladesh to produce ordinary but essential items. The cost of production is lower in Bangladesh than in China and India, which has resulted in increased orders from European markets. The pharmaceutical sector also grew at an annual rate of 6.2 percent in FY09.

Import payments and demand decreased in FY09, reflecting falling commodity prices and weak business confidence. The annual growth of total imports in nominal dollar terms declined to 4.1 percent in FY09, a significant fall compared to the average annual growth rate of 17.6 percent during the preceding five years. The fall in commodity prices in the world market, although rebounding recently, and the decrease in the quantity of imports of some goods (food in particular) contributed to the sluggish growth of imports in FY09:

- a) The global price of main imports, such as wheat, oil and oil seeds, petroleum, raw cotton and plastics declined by 2-36 percent.
- b) The price of rice increased by about 20 percent (mainly due to the sharp increase in the first half of FY09) but the overall quantity of rice imports declined by more than 81 percent because of the bumper harvest of the *boro* crop.
- c) The price of capital goods and machineries increased by about 33 percent and quantity of imports decreased by 43 percent, yielding a decline in the total import bill.
- d) The price of petroleum declined by about 25 percent, which contributed to a decline in the total oil imports by more than 10 percent. The rate of growth of imports by export-processing zones (EPZs) in FY09 was less than 1 percent, whereas the rate in FY08 was 13.1 percent.

Reduced import of capital goods and machineries may affect the export sector even with the global recovery. Concern about the volatile global economic and financial situation and a availability of gas and electricity may have restrained exporters from building capacity during FY09. This may affect the ability of the sector to respond to a possible rise in external demand in the near future as the global recovery gains steam.

Remittances from abroad continue to be strong despite the global economic recession. The first

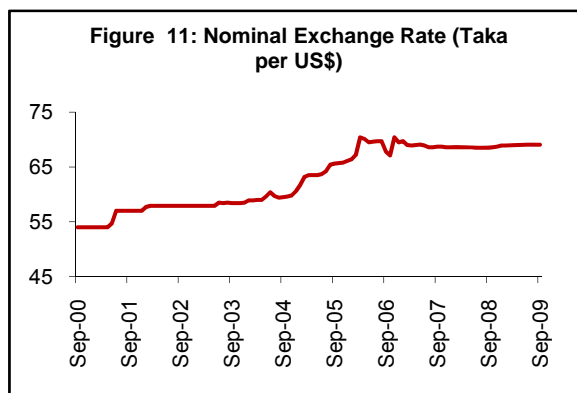


Source: Bangladesh Bank

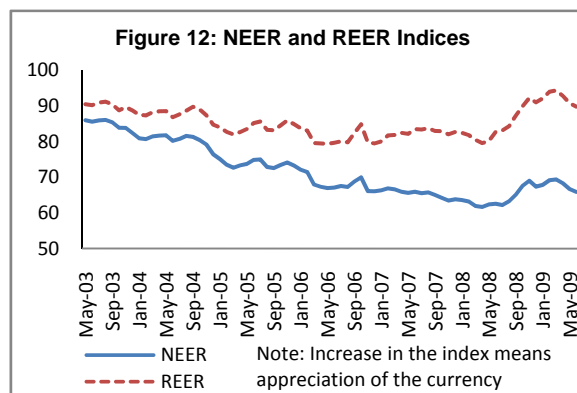
¹⁰ Troubled leather makers realign export focus, The Daily Star, 10 August 2009.

two months of FY10 registered US\$1.8 billion inflow of remittances, corresponding to a growth of 18 percent over the same period last year (Figure 10). This builds upon the strong performance in FY09, when remittances to Bangladesh reached a record US\$9.7 billion (equivalent to 10.8 percent of GDP), up by 22.4 percent over FY08.

While the nominal exchange rate has been stable, there are growing concerns about competitiveness. Despite some recent depreciation, the real effective exchange rate (REER) has gradually appreciated compared to its mid-2008 level, given the unchanged value of the taka-dollar nominal exchange rate (Figures 11 and 12). While Bangladesh has an edge over its competitors in terms of labor costs, exporters are negatively affected by several other aspects of the investment climate, including lack of reliable power supply. As global export prices for garments and other goods are coming under downward pressure, the appreciating REER would have put further pressure on the profitability of exporters from Bangladesh.

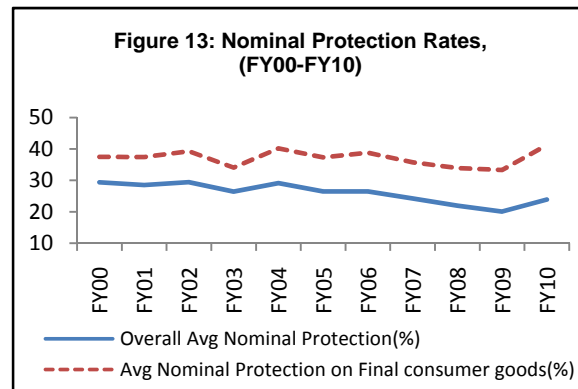


Source: Bangladesh Bank



Source: IMF

On the trade policy side, the main developments pertain to the increase in nominal protection rates in the FY10 budget. After steady progress made in the past few years, trade liberalization faced a reversal in FY10. The average nominal protection in FY10 rose to 23.9 percent, up from 20.1 percent in FY09 (Figure 13) with the wider application of supplementary duty (imposed on 144 additional tariff lines) and regulatory duty (imposed on 2683 tariff lines) along with reduction of custom duty (on 965 tariff lines). The wider application of supplementary duty and the introduction of regulatory duty on all items subject to the highest CD rate of 25 percent (which include mainly final consumer goods) have contributed to significant tariff escalation with movement along the stages of production. This has increased effective protection of import substitutes and may also have hurt the exporting sector.

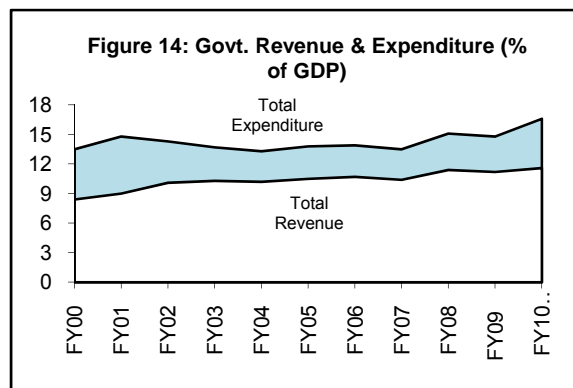


Source: National Board of Revenue

Fiscal Developments

The overall fiscal deficit was contained in FY09.

It has remained below 4 percent of GDP for the past six years. The expansionary fiscal stance in FY09 was muted by ADP implementation shortfall, and savings from provisions made for fuel and fertilizer subsidies. These helped contain the overall budget deficit to 3.6 percent of GDP, compared with the FY09 revised budget target of 4.1 percent and the actual 3.7 percent deficit in FY08. The overall budget deficit is projected to increase to 5 percent in FY10 (Figure 14). Some noteworthy points for FY09 are:



Source: Ministry of Finance

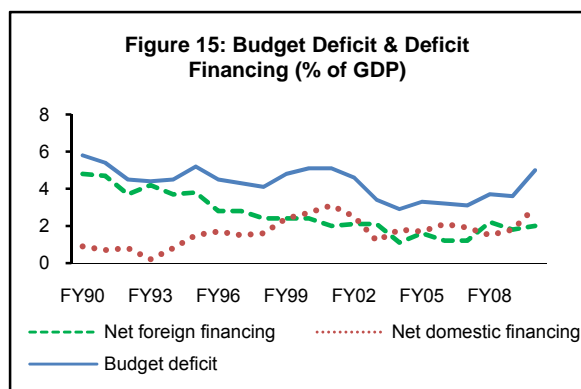
a) *Revenue collection*, particularly tax revenue, underperformed in FY09. FY09 National Board of Revenue (NBR) revenue collection is estimated to be 3.6 percent lower than the original target. Growth (cumulative) in tax revenue slowed from 27.6 percent in July 2008 to 10.7 percent by June 2009. This is largely because of a reduction in international commodity prices and domestic economic slowdown that reduced imports and thus import-based taxes. Growth (cumulative) in import-based tax slowed from 51 percent in July 2008 to 5.1 percent by June 2009. Domestic taxes grew by 12.7 percent and income tax by 18.3 percent in FY09.¹¹

b) *Public expenditure* in recent years has increased from 13.3 percent of GDP in FY04 to 14.8 percent in FY09. The increase were driven by a 4.2 percent rise in subsidies and transfers in FY09 (almost doubling since FY04). The budget also took on board the losses incurred by Bangladesh Petroleum Corporation, Bangladesh Chemical Industries Corporation, and Bangladesh Power Development Board because of lack of pass through of increases in international prices to domestic prices. A second feature of recent public expenditure trends is the secular decline in ADP spending to 3.2 percent of GDP in FY09 (down from 5.4 percent in FY02). The utilization rate has tended to decline as budgeted ADP size grew bigger.

c) A *stimulus package* worth Tk.34.24 billion was disbursed in FY09 to ward off the second-round impact of the financial crisis. The package consisted of additional Tk.25.5 billion for power, fertilizer, and export (jute, leather, and frozen foods) subsidy, Tk.5 billion for recapitalization of state owned lenders, and Tk.3.74 billion for expanding social safety net programs.

¹¹ The declining trend in revenue growth continued in July when the National Board of Revenue's collection declined by 2.5 percent relative to July 2008. A sharp fall of 19.7 percent in import-based taxes is mainly responsible for this decline. In July, domestic taxes grew by 16.4 percent and income tax by 15.2 percent. July revenue collection constituted 6 percent of total FY10 NBR revenue target, compared with 7 percent last year.

The deficit is likely to be financed mainly through domestic borrowing. The government's financing strategy has been to finance as much of the deficit as possible from external grants and concessional credits. However, external financing has been declining in recent years with the exception of FY08 when it increased due to the emergency assistance to cope with the impact of natural disasters. External financing is projected to increase to 2 percent of GDP in FY10, compared with an estimated 1.8 percent in FY09. Domestic borrowing is projected at 3 percent of GDP in FY10, compared with 1.8 percent in FY09, relying largely on borrowing from the banking system (see Figure 15 for long-term trends).



Source: Ministry of Finance

Total public debt to GDP is falling, but some issues call for attention. First, domestic debt has been increasing, although total public debt as a percent of GDP has been declining since reaching a peak in FY94. Second, interest payment constitutes the second largest item in the FY10 budget (13.9 percent of total expenditure). Third, while debt financing is not yet a concern, the composition of foreign financing is shifting towards shorter maturity and higher interest loans, calling for stricter surveillance. Finally, there is also the issue of contingent liabilities, as losses incurred by state-owned enterprises continue.

Bangladesh's debt indicators improved significantly in the period FY02-09, due to fiscal adjustment, rising GDP growth, higher inflation tax and real exchange rate appreciation (Table 1). Total debt-GDP ratio steadily declined from 52.9 percent of GDP in FY02 to 43.8 percent of GDP in FY09. Prudent expenditure management and improvements in revenue mobilization reduced the primary deficit from 3 percent of GDP in FY02 to 1.4 percent in FY09. On average, the primary deficit has declined by 1.6 percent of GDP during this period. Strong growth effects, averaging 2.6 percent of GDP, and inflation tax averaging 0.95 percent of GDP reinforced the effect of primary deficit reduction on total debt. In addition, appreciation of the real exchange rate eroded the real value of foreign debt by about 0.9 percent of GDP per year. Reliance on seigniorage (printing of money) for debt reduction has increased significantly in the last few years, averaging 1.4 percent of GDP per year. The reduction in debt was partly offset by an increase in interest payments, averaging 1.9 percent of GDP per year. A significant part of the change in debt, however, remains unexplained by the debt dynamics model.

Moving forward, the fiscal policy stance for FY10 is appropriately expansionary in intent (see Box 3, page 21). Its successful implementation requires much stronger revenue mobilization than has been achieved historically and a higher rate and quality of expenditure, especially on the Annual Development Program. There is also a Tk.50 billion stimulus package and competing demands from various groups – exporters in particular – for support from this package. These will have to be managed carefully. Last but not the least, the institutional preparation for implementing the Public Private Partnership initiative, unveiled in the FY10 budget, needs to be accelerated.

Table 1: Debt Dynamics in Bangladesh (Percent of GDP)									
	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Total Debt	52.9	51.1	49.1	47.5	46.9	46.5	44.4	43.8	44.4
Change in Debt	2.1	-1.8	-2.0	-1.6	-0.6	-0.4	-2.1	-0.6	0.6
A. Sum of Standard Items	2.9 3.	1	2.3 2.	5 1.	5	1.7 2.	0 0.	9	5.1
Interest Payments	1.7 1.	9	1.6 1.	7 1.	8	1.9 2.	2 2.	2	2.3
Primary Balance	-3.0 -1	.5	-1.2 -1	.7 -1	.6	-1.2 -1	.5 -1	.4	-2.7
Seigniorage	1.7 0.	3	0.6 0.	9 1.	9	1.4 1.	6 2.	7	-0.1
B. Sum of Extra Items	-3.1 -4	.4	-4.0 -3	.5 -2	.7	-6.0 -6	.3 -4	.8	-4.6
Growth Effect	-2.1 -2	.5	-2.9 -2	.6 -2	.8	-2.7 -2	.5 -2	.3	-2.2
Inflation Effect	-0.5 -0	.8	-0.7 -0	.9 -0	.9	-1.2 -1	.5 -1	.1	-1.0
Revaluation Effect	-0.5 -1	.1	-0.3	0.0	1.0	-2.2 -2	.4 -1	.4	-1.4
Memo Items									
Actual Change in Debt	2.1	-1.8	-2.0 -1	.6 -0	.6	-0.4 -2	.1 -0	.6	0.6
Predicted Change in Debt	-0.1 -1	.3	-1.7 -1	.0 -1	.2	-4.3 -4	.3 -3	.9	0.5
Residual	2.3 -	0.5	-0.3	-0.6 0.	6	3.9	2.2	3.3	0.1
Std. Budget Deficit	4.6 3.	4	2.9 3.	4 3.	4	3.1 3.	6 3.	6	5.0

Source: World Bank Staff estimates

Short-Term Risks and Outlook

Vulnerabilities and Risks

Bangladesh continues to face several risks that affect its short-term prospects for growth and poverty reduction. Chief among these are the risk of deepening of the global economic crisis, rising inflation, power bottlenecks, slow implementation of the Annual Development Program (ADP) and risks in the financial sector:

a) If the global economic conditions continue to worsen, it could have a negative impact on exports and remittances from Bangladesh. Recent gains in production, leading indicators and trade provide reasons to believe that a bottom to the global recession has been reached. China, along with a number of East Asian countries appears to be leading the way into recovery, while leading indicators and renewed gains in export orders have underpinned prospects of an incipient revival in OECD economies. However, the risk to the external outlook is still tilted towards the downside. Difficulties in banking across key OECD countries continue despite strong support from monetary authorities worldwide. Rising unemployment and fragility in the stability of the financial sector can renew downward pressure on asset

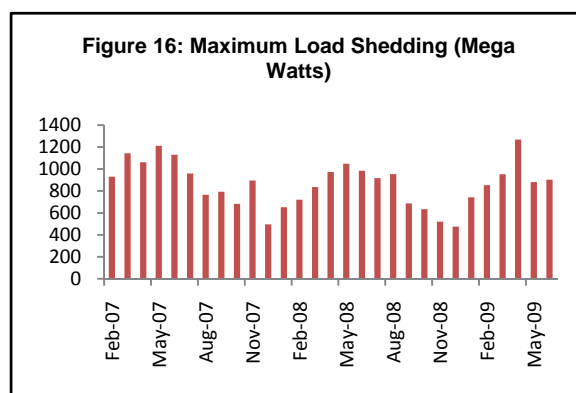
prices and trigger a deflationary environment. There are also questions about the sustainability of public debt in some countries that could add to upward pressure on bond yields, thus threatening recovery in the housing market. Falling home prices could further undermine confidence in bank capital bases. If higher unemployment and social discontent prompt governments to expand trade restrictions and restrict immigration, countries like Bangladesh will suffer.

b) Inflation also poses a short-term risk. If the liquidity overhang persists in the banking system and the global commodity prices increase, it could put upward pressure on prices. Inflation disproportionately affects the poor, who are least able to bear the consequences.

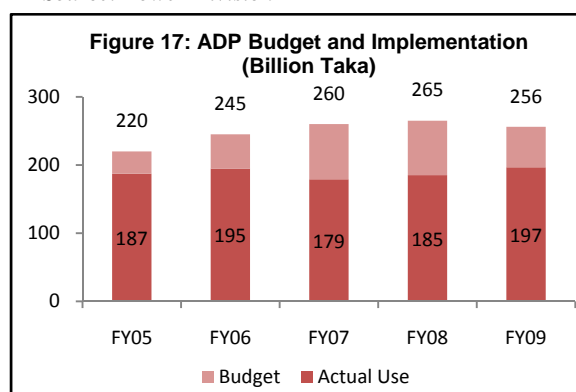
c) Meanwhile, power shortages continue to choke the private sector. Power shortages (Figure 16) are the most serious and immediate of the infrastructure constraints, with damaging impact on productivity and investment.¹²

d) Slow ADP implementation will hurt both growth and poverty reduction. The government has proposed an ambitious ADP increase of 32 percent for FY10 over the FY09 revised budget etc. However, experience has shown that the ADP utilization has been slow and has never exceeded Tk.200 billion in the past (Figure 17). It remains to be seen if ADP implementation speeds up in FY10.

e) Several sources of vulnerability remain in the financial sector. Chief among these is the rapid growth in non-traditional banking activities in recent years that is generating new risks, underlining the importance of strengthening the regulatory perimeter. Banks are rapidly increasing their engagement in capital market activity, directly or through merchant bank and brokerage subsidiaries. Risks to capital from a fall in the market could be large for some banks. Also, significant traditional risks remain within the banking system. Loan classification and provisioning remain uneven. Non-prudential government interventions, such as interest rate ceilings and government orders to direct credit and ease debt service for some sectors raises risks, increases inefficiency and reduces transparency.



Source: Power Division



Source: Implementation Monitoring & Evaluation Division

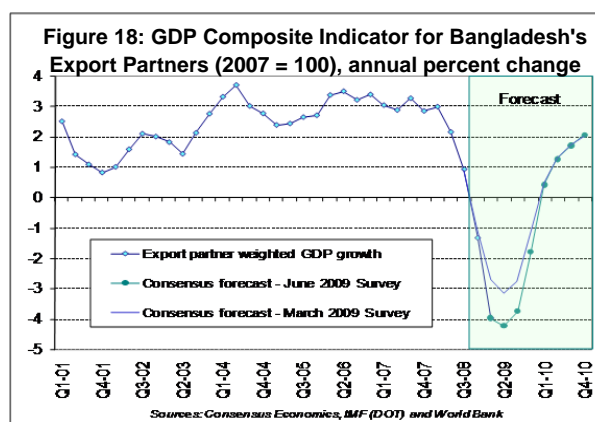
Near-Term Economic Outlook

The near-term outlook depends on how the risks outlined above play out in FY10. Clearly, the global economic outlook plays an important role in how events in Bangladesh unfold going forward. Economic conditions in the US, Europe and the Gulf Cooperation Council countries will need to be

¹² See World Bank (2007). "Bangladesh: Strategy for Sustained Growth."

monitored closely (Figure 18) because they provide the markets for exports from Bangladesh and destinations for migration. Apart from this, as outlined above, Bangladesh's own macroeconomic policies, domestic supply conditions, particularly weather and energy supplies will also play a crucial role.

The near-term outlook for Bangladesh's export sector hinges on the performance of the RMG exports, which constituted 79 percent of total export earnings in FY09, against the backdrop of the global economic downturn. An analysis shows that the US RMG market conditions (January 2008-May 2009) shows that Bangladesh's RMG exports to US were resilient in face of the industry-wide downturn. Trends in US import, during this period, also reveal that US RMG imports have been less affected by the financial crisis compared to total US imports as well as US manufacturing imports (from all countries). It remains to be seen if these trends hold up in FY10.



Source: Consensus Economics, IMF & WB

Remittances will also play a major role. Despite an annual increase of 22 percent in remittances in FY09, the pace of growth started to decelerate in the second half of the fiscal year. The outflow of migrant workers from Bangladesh has slowed and the number of returnee migrants has increased. These risks notwithstanding, remittances to Bangladesh are expected to grow in FY10, albeit at a slower rate than in FY09 (Box 4). Remittances are expected to grow at 10 percent in the base-case scenario, 12 percent in the high-case scenario and at 8 percent in the low-case scenario.

Three scenarios for FY10 are possible (Table 2). In the *base-case scenario*, real household consumption growth is assumed to slow to 5.8 percent, compared with 6 percent in FY09 and growth in real exports are assumed to slow to 9 percent, compared with 12 percent achieved in FY09. With investment growth of around 5.7 percent, which is low by Bangladesh's historic standards, Bangladesh is likely to grow at 5.5 percent in FY10. If sustained global recovery leads to strong export performance and if the performance of the energy sector improves,¹³ investment growth could be stronger, taking GDP growth to around 6 percent in the *high-case scenario*. If the energy deficit stagnates or deteriorates and global recovery falters then export growth cannot be sustained at FY09 levels and real investment growth could decline further. In this *low-case scenario*, GDP growth could be as low as 4.5 percent.

The medium-term outlook depends on the quality and pace of policy and structural reforms. While managing near-term risks is important, the government must also begin systematically to address the medium-term development issues. The reform agenda entails maintaining macroeconomic stability and deepening financial sector and external trade reforms. It is also essential to rebalance the policy focus towards structural areas that have received insufficient attention. These include economic governance, urban management, infrastructure (especially power, ports, and transportation), market-oriented vocational skills and quality secondary and tertiary education.¹⁴

¹³ The government unveiled on August 30 the first stage of their strategy to alleviate the power crisis. The government will reportedly invite bids by September 10 for the installation of 17 diesel and furnace oil-run plants to generate 1,330 megawatts of electricity on a fast-track basis. The initiative to fast track solutions to the crisis is welcome, but an over-reliance on rental power solutions will ultimately prove to be costly. There are significant opportunities in replacing the old government owned power plants in Bangladesh. Also, the National Coal Policy needs to be finalized as soon as possible. Bangladesh's long-term energy policy must rely on rapid and efficient extraction of domestic coal reserves. Five good qualities coal deposits, with proven reserves of more than 2.5bn MT have been discovered in Bangladesh.

¹⁴ See World Bank (2007). "Bangladesh: Strategy for Sustained Growth."

Table 2: FY10 Growth Scenarios				
<i>(Percent Change)</i>				
	FY09			
	Actual	Base Case	High Case	Low Case
Consumption				
Private	6.0	5.8	5.8	5.0
Public	4.0	6.0	6.0	6.0
Gross Fixed Investment	5.7	5.7	7.3	3.9
Export (GNFS)	12.2	9.0	12.2	7.0
Import (GNFS)	15.2	10.0	11.0	8.0
GDP Growth	5.9	5.5	6.0	4.5

Source: Bangladesh Bureau of Statistics and WB Staff Estimates

Poverty and Distributional Impact of the Global Economic Crisis on Bangladesh¹⁵

The welfare impact of the global economic crisis is computed using a micro-simulation model. A micro simulation model linking macro projections with household data from past years provides rough assessment of the welfare impact of the financial crisis. The following assumptions were made: (i) due to the impact of the crisis, if we assume that GDP growth is 0.8 percentage point lower in FY09; and (ii) 1.4 percentage point lower in FY10, compared to a scenario without the crisis.

Overall, the impact of crisis on employment and income is estimated to be small. Given the nature of the macroeconomic impacts, the welfare impact of the crisis is felt most by households employed outside agriculture and/or receiving remittances from abroad. The aggregate impact on employment is estimated to be low – the crisis added about 0.2 to 0.5 million to the number of adults (of age 15-64 years) who are not employed. There was some shift in employment from industry to the other sectors – the share of industry in total employment declined by an estimated 1.3 percentage points due to the crisis. The impacts on earnings, employment and remittances resulted in 0.8 percent lower labor income and 1.6 percent lower non-labor income in FY09. In FY10, labor income is projected to be 2.2 percent lower and non-labor income 5 percent lower, compared to the scenario without crisis.¹⁶ As a result, average household income is likely to have been 0.9 percent lower in FY09 and is projected to be 3 percent lower in FY10, compared to the no-crisis scenario.

Commensurate with the impacts on household income, the impact on poverty measures is low overall, but more significant in 2010 than in 2009. In 2009, poverty rate (share of population below the upper poverty line) and extreme poverty rate (share below the lower poverty line) are estimated to be 0.5 and 0.4 percentage points higher, respectively, as a result of the crisis. In 2010, poverty and extreme poverty rates are projected to be 1.6 and 1.1 percentage point higher, respectively. The impact on the poverty gap is also projected to be larger in 2010 than in 2009, while the impact on overall inequality is

¹⁵ Based on “Assessing Ex Ante the Poverty and Distributional Impact of the Global Crisis in a Developing Country,” PRMPR, World Bank (Mimeo). Updated version of the full paper will be available shortly.

¹⁶ The significantly larger non-labor income loss in 2010 is attributable to a 9 percent loss in remittance income in 2010 compared to a 3 percent loss in 2009.

negligible for both years. Instead of a decline of nearly 11 percentage points between 2005 and 2010 in the absence of the crisis, the poverty rate is now projected to fall by about 9 percentage points. This would translate to around 2.4 million additional poor individuals in 2010 due to the crisis. The crisis is projected to raise the poverty rate by similar levels in rural and urban areas, compared to the no-crisis scenario for both years. However, in relative terms, the impact on urban poverty is higher than on rural poverty.

The estimated impact is also uneven between different regions of the country, with the more industrialized and integrated regions likely to be affected more by the crisis. The eastern part of the country (Dhaka, Chittagong and Sylhet divisions) had far outpaced the west (Rajshahi, Barisal and Khulna) in poverty reduction between 2000 and 2005. The crisis is, however, expected to have a greater impact in the east than the west because the east has a much higher concentration of industry and external remittances than the west. For both 2009 and 2010, the average loss in household income due to the crisis is found to be the largest for Chittagong and Sylhet (that have the highest incidence of remittances) followed by Dhaka, and then the other divisions. The impact on poverty, relative to the no-crisis poverty rates, shows a similar pattern: in 2010 for example, the crisis is projected to raise poverty rate by 17 percent in Sylhet, 14 percent in Chittagong, 6 percent in Dhaka and 5 percent or less for the others.

The poverty impacts, however, do not fully capture the extent of the welfare impact of the crisis. The projections also suggest that the income or consumption impact would be higher for the middle and upper ranges of the distribution than for the poorest groups, who are the least likely to receive remittances or work in industry even in the absence of the crisis. The moderately poor and near-poor or lower middle-class in urban areas are affected more than the similar group in the rural areas, because they depend more on income from the industry and services sectors than is the case for their counterparts in rural areas.

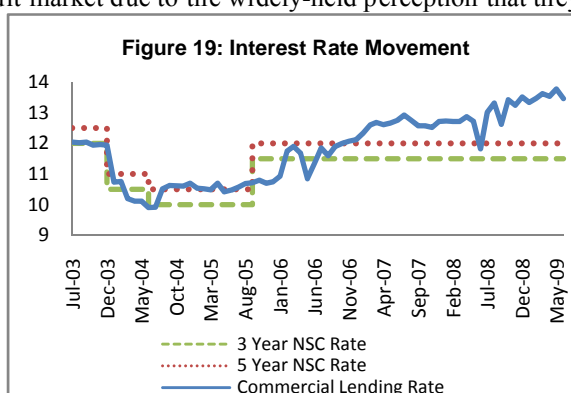
These projections are subject to a number of important caveats that are typical for simulations based on extrapolations from past growth, employment, income and poverty trends. Most significantly, the simulations cannot take into account structural changes that may have occurred in the Bangladeshi economy due to the crisis, which may lead to poverty and distributional impacts different from what is projected here. The impact on poverty is also sensitive to price movements, particularly in food prices. The above results are based on current estimates of expected inflation and food price inflation. A departure from these estimates can yield significantly different outcomes. If food prices were to fall significantly, for example, poverty in 2010 would be much lower than what is estimated here. ■

Box 1: Why nominal lending rates are high - and are they really sticky downwards?

The lending rate has remained relatively high in Bangladesh making it difficult to support private investment and employment. The interest rate spread is another area of concern, which has remained relatively high with the real deposit rate turning negative until recently. With no clear guidelines to set the nominal interest rate structure prior to the financial sector reforms in the 1990s, the complexity and rigidity of the administered lending and deposit rates significantly undermined domestic savings mobilization and efficient credit allocation.

Several factors seem to contribute to the observed large spread between deposit and lending rates in Bangladesh. The financial system is dominated by a few large banks that allegedly have some degree of market power to raise lending rates and lower deposit rates. Moreover, the banks have a preference to hold low risk assets (such as government bonds, including National Savings Certificates (NSC)) and a bias toward trading and commercial lending over production and investment activities, especially in the small scale and rural sectors. These borrowers are required to pay high risk premiums in the formal credit market due to the widely-held perception that they are high risk borrowers.

Given the choice between holding off government securities with high, relatively risk free rates of return vis-à-vis extending 'risky' loans to private sector producers with potentially high transaction costs, the banking sector tends to prefer the former. The average asset portfolio of the country's banking sector in recent years shows that the banking sector holds nearly one-fifth of the amount that it extends in loans and advances in the form of government bills and bonds. In other words, with appropriate measures, the banking sector can significantly increase its current level of lending to support domestic investment and employment.



Source: Bangladesh Bank

One of those “appropriate” measures could be a lowering of the rates on NSCs. Both the three-year and five-year NSC rates appear to set a floor for the commercial bank lending rate (Figure 19). There is strong correlation of 0.7 between commercial bank lending rates and the two NSC rates, the presumption being that NSC rates affect the commercial banking lending rates and not vice-versa. This appears to explain why nominal lending rates tend to be high. As figure 19 shows, nominal lending rates do decline when NSC rates decline. When NSC rates increase, the lending rates catch up and tend to stay well above the NSC rates.

Box 2: RMG Export Performance and Prospects

The RMG sector has shown resilience, but export orders are declining. There are two main reasons for the resilience of the RMG sector. The first is the “Wal-Mart” effect, where consumers substitute more expensive products for cheaper ones such as those from Bangladesh. The second reason is that buyers are shifting production from China to Bangladesh, as the latter may have become the world’s lowest-cost producer. The RMG growth momentum could not be sustained however. While RMG exports grew at an impressive 24.2 percent (year-on-year, average) in the first half of FY09, the growth rate came down to 8.1 percent in the second half of FY09.

Both the Bangladesh Garment Manufacturers and Exporters Association (BGMEA) and the Bangladesh Knitwear Manufacturers and Exporters Association (BKMEA) have reported a slowdown in export orders since December 2008. Orders were negative for the BGMEA in December, January, February and April. The BKMEA experienced declining orders for every month in 2009, except February. Given the time lag between orders and shipments of around 4 months for woven garments, and 2-3 months for knitwear, the slowdown in growth of RMG exports has become evident in Q4 of FY09. Moreover, rebates of 10-20 percent on already-placed orders are being negotiated.

According to the Bangladesh sourcing head of a top European retailer, major markets have bottomed out and orders are expected to increase again (Financial Express, May 2009). Positive export orders for BGMEA in both May (15.4 percent) and June (19.4 percent) provide some evidence of a possible recovery of retail markets in the US and Europe. This assessment is also supported by recent data from the US and EU showing Bangladesh as the main beneficiary in apparel imports. Bangladeshi apparel imports to the US grew by 12.2 percent in dollar terms between January-May 2009 (Source: Office of Textiles and Apparel). During the same period, overall clothing imports to the US declined by 6.2 percent in value and 4.8 percent in volume. While apparel imports from Vietnam grew at double digit too (10.1 percent), shipments from China increased by only 3.9 percent. Imports from India and Sri Lanka declined by 6.3 and 6.4 percent respectively. Data for the EU paints a similar picture. Apparel imports from Bangladesh increased by 20.3 percent in the first four months of 2009 (Jan-Apr) (Source: Eurostat).

But some risks remain. According to the BGMEA, prices of woven garments have shrunk by 20-25 percent, over 100 factories have already shut down, laying off nearly 50,000 workers, and many businesses are incurring losses.

Box 3: The FY10 Budget

The FY10 budget has surpassed the size of all previous budgets in Bangladesh’s history. *Total expenditure* is projected at 16.6 percent of GDP. About 61 percent of the FY10 budget comprises of recurrent expenditures, the same proportion as in the original FY09 budget. A number of spending initiatives that have been funded in the FY10 budget will affect expenditure allocations in FY10-12. For the first time, the FY10 budget formally introduced the concept of Public Private Partnership (PPP) as a vehicle for infrastructure investment and Tk. 25 billion has been allocated for this. Other initiatives include a fiscal stimulus package (Tk 50 billion), implementation of Pay Commission recommendations (Tk 35 billion), implementation of an urgent three-year program to increase electricity generation (Tk 35.7 billion), and construction of a 6 km bridge across the Padma river (Tk 15 billion). The existing safety net programs have been strengthened while a few new programs have been introduced in the budget.

The FY10 *revenue* target is high by historic standards, but achievable as demonstrated in FY08 (27 percent growth). Revenue is slated to grow by 15.7 percent relative to FY09 estimated revenue collection. Tax-GDP ratio is projected to increase from 9.0 percent in FY09 to 9.3 percent in FY10 and the revenue-GDP ratio is projected to increase from 11.2 percent in FY09 to 11.6 percent in FY10. NBR alone will have to generate 78.8 percent of total incremental revenue. NBR taxes, which account for over 95 percent of total tax collections, are projected to grow by 16.1 percent. Achievement of revenue target would require strengthened administrative efforts to avoid leakages and bring in more eligible people within the tax net as well as energize the revenue-sensitive sectors of the domestic economy. Bangladesh has around 2.3 million registered income taxpayers of whom only 0.75 million pay taxes on a regular basis. However, about 0.15 million government employees later get tax refund.

The proposed increase in the *FY10 ADP* is ambitious when considered in the context of the annual nominal growth of actual ADP during last decade at a rate of 5.1 percent per annum. The size of ADP has been fixed at Tk -305 billion in FY10 which is a 56 percent increase over the FY09 actual ADP spending. The shares of internal and external resources in the proposed ADP are 46 and 54 percent respectively. To implement the proposed ADP, the internal resources will have to grow by 20 percent and external resources will have to double relative to the FY09 actual ADP. Implementation of ADP and PPP, therefore, will be key challenges in this fiscal year.

Box 4: Outlook for Remittances

Global and regional remittance flows are projected to decline in 2009 and a recovery is expected in 2010 and 2011. Due to the weak economic and employment situation in migrant-destination countries in the first half of CY09, global remittance flows are expected to decline by 7.3-10.1 percent (World Bank, July 2009, Outlook for Remittance flows 2009-2011). For South Asia, the expected reduction is a more modest 3.6-6.4 percent. Remittances are an important driver of economic growth and poverty reduction in Bangladesh. In the past, global remittance flows have been stable even during an economic downturn in the recipient country, and resilient in the face of a slowdown in the source country. In fact, remittances to Bangladesh in FY09 increased by 22 percent over FY08. However, the current global economic crisis is affecting both developed and developing countries at the same time, which will most likely affect future remittance flows.

The outflow of migrant workers in Bangladesh has slowed down significantly. In July 2010, the outflow dropped by 57 percent compared to the same month last year. The impact of the global economic recession started to become evident in the second half of FY09, when the outflow of migrant workers declined by 47 percent. For the whole of FY09, the number of migrant workers finding employment abroad has declined by 33 percent, when 650 thousand migrant workers found employment abroad compared to 969 thousand in the same period last year.

The number of returnee migrants has also likely increased. One of the reasons for migrants returning are the unscrupulous practices of some outsourcing companies, that often engage in overtrading of employment visas, which leads to migration of workers in excess of the legal employment opportunities available in the destination countries. However, migrants are also returning as a consequence of the global recession. According to newspaper reports, 12,000 workers returned from Malaysia between January-July 2009 (The Daily Star, August 2009). Migrant workers have also suffered from the collapse in Dubai's construction boom, as a consequence of which, many have lost their jobs or have been sent home on long-term vacation. Several thousand Bangladeshis employed in the readymade garment and textile industries in Mauritius are being sent back as well (The Daily Star, July 2009).

The economic outlook in GCC countries will be decisive for Bangladesh. The GCC countries together accounted for 63 percent of total flows in FY09. Saudi Arabia was by far the largest source of remittances (US\$2.9 billion), followed by the UAE (US\$1.8 billion). The outflow of Bangladeshi workers to GCC member countries has been affected in the wake of the global financial crisis. In FY09, 461 thousand workers emigrated to the Gulf countries compared to 657 thousand in FY08, corresponding to a 30 percent decline. The recent increase in oil prices to around US\$70 a barrel should, however, reduce the risk of a fall in remittances from Bangladeshi workers in GCC countries.

A regression exercise shows that the key determinants of changes in the level of remittance inflow are the number of workers finding employment abroad every year, the oil price, the exchange rate, and the GDP growth rate. The results show that: (i) an additional migrant worker brings in US\$816 in remittances annually; (ii) a dollar increase in oil price increases annual remittances by nearly US\$15 million; (iii) depreciation of exchange rate by one taka increases annual remittance by US\$18 million; and (iv). Remittances are higher during periods of low economic growth.

Assuming oil prices at around US\$70 per barrel, GDP growth at 5.5 percent, and an exchange rate of Tk 68.8 per US\$, three FY10 scenarios result from the regression exercise: Remittances will increase by 12.3 percent in the high case scenario, 10.1 percent in the base case scenario, and 8.4 percent in the low case scenario (Table 3). The main reason for the resilience of remittance flows to Bangladesh is that the overall stock of migrants continues to increase despite the global economic recession.

Table 3: FY10 Remittances Growth Projection			
	Base Case	High Case	Low Case
Overseas Employment	350,000	610,000	150,000
Remittances Growth (%)	10.1	12.3	8.4