May, 2012

Bangladesh Economic Update

Poverty Reduction and Economic Management, South Asia Region

The World Bank

Summary

GDP growth has moderated from 6.7 percent in FY11 to 6.3 percent in FY12 due to unfavorable external economics and internal supply constraints.[1] *Bangladesh has maintained the average growth of the last three years through 9.8 percent manufacturing growth and 10.4 percent growth in remittances. However, private investment has declined from19.5 percent of GDP in FY11 to 19.1 percent in FY12 and the national savings rate from 26 percent of GDP to 25.2 percent. This does not bode well for near-term growth.*

Inflationary pressures, particularly from an increase in non-food prices, have worsened. *Inflation continues to be volatile, touching double digits. Food price increases have declined from 13.8 percent in September 2011 to 8.1 percent in April 2012, good news for the poor. However, non-food price increases rose to an unprecedented 14 percent in March 2012 before declining slightly to 13.8 percent in April. Expansionary monetary and fiscal policies have driven the increases by expanding aggregate demand, which has also led to large nominal depreciation of the taka.*

High inflation disproportionately affects the poor and vulnerable non-poor households, *but mitigating factors include a 3.1 percent increase in real wages and effective safety net programs designed to address vulnerability and marginalization. Various safety net programs, particularly Vulnerable Group Development, Food for Work and Open market sales of rice are helping to cushion the impact of high inflation on poor households.*

Monetary policy remained accommodative for most of 2011 but gradual tightening is occurring. With the high fiscal deficit and domestic borrowing by Government, monetary policy is now bearing the brunt of macroeconomic policy adjustment*. The Bangladesh Bank's monetary policy statement for the second half of fiscal 2012 aims for further tightening to tame inflation, with a focus on achieving "single digit levels" of inflation. The 17.6 percent monetary growth through April 2012 is on track to achieve the overall program target for the rest of FY12.*

Close surveillance to ensure banking system stability and the flow of credit to the private sector is crucial*. There are continued liquidity shortages in the banking system, evident from the banks' persistent use of the repo window of the central bank. This has arisen from the need to pay for petroleum imports and facilitate the major increase in government borrowing. In addition, the licensing of new banks will add to competition for deposits and challenge the supervisory capacity of Bangladesh Bank.*

Growth in tax revenues continues to be robust. *NBR revenue increased by 19.2 percent during July-April, 2012 compared to 27.1 percent in the period a year earlier, with the slowdown reflecting the large increase in FY11.*

The composition of public spending and finance needs correction. *Recurrent expenditures are likely to overshoot the original 2012 budget target, driven by larger-than-budgeted growth in subsidies and transfers. The central government budget deficit increased by more than 2.5 times from July to January compared to the same period the previous year. Combined with an only 11 percent increase in the level of net foreign financing and a 59 percent decline in net non-bank borrowing, this has induced large domestic bank financing of the deficit, including monetary financing.*

[1] Bangladesh's fiscal year runs from July 1 to June 30, indicated here by the concluding year.

The balance of payments (BoP) is on a deteriorating track, with reserves falling to below three months of imports and export growth turning negative in March 2012. *The biggest reasons for a 36 percent reduction in the current account surplus in the first three quarters were the 39.2 percent rise in petroleum-product imports to feed the liquid fuel-based power plants, and a slowdown in export growth to 10.1 percent. Pressure on the BoP is likely to intensify this year if exports continue to be hit by Euro zone problems. There has been a sharp drop in knitwear export growth to only 3 percent in the first ten months, suggesting that exports were demonstrably hampered by recession in the euro zone.*

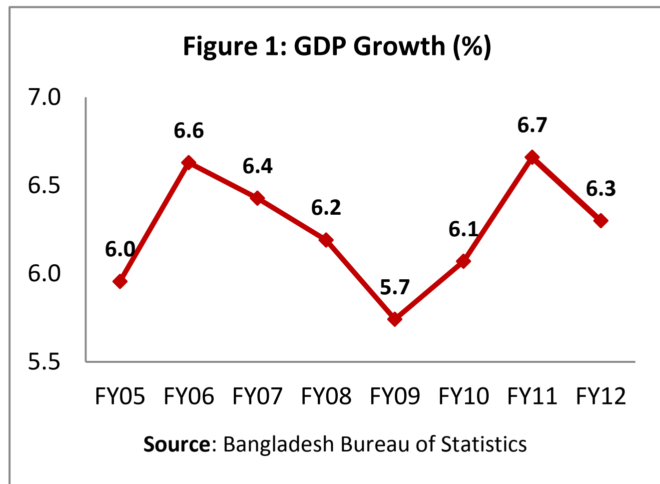
The growing central government deficit and its monetization and domestic financing, are exerting pressure on macroeconomic balances. *A coordinated policy response is required to ease macroeconomic pressures and improve growth prospects. Key actions include the need to create fiscal space, contain government borrowing to mitigate the risk of crowding out of credit to the private sector, better regulate the capital market, and stimulate investment and job growth in the export sector. Unlike in 2008, Bangladesh has insufficient policy space to avert the negative impact of a global slowdown through fiscal stimulus packages and monetary easing.*

Recent Economic Developments[2]

Economic growth in fiscal 2012 is estimated at 6.3 percent

Bangladesh's growth performance has been improving in recent years (Figure 1). Successive bumper crop harvests, strong manufacturing growth, continued recovery in construction, and sustained robust growth in services contributed to this improvement.

Growth has slowed to an estimated 6.3 percent in FY12, according to Bangladesh Bureau of Statistic's preliminary estimate**.** A slowdown in growth in FY12 had been on the cards even before the Euro debt crisis unraveled. Successive bumper harvests in the crops sector reduced room for further strong growth despite good harvests (base effects), thus reducing agricultural growth. Additional factors that led to slower growth in FY12 include recent macroeconomic policy tightening measures and financial-sector restraints that were needed to stabilize the economy and ease pressure on foreign exchange reserves; the lack of any significant improvement in the enabling environment for private investments; and an unfavorable external environment.



- *Agricultural growth has slowed from 5.1 percent in FY11 to 2.5 percent in FY12.* The slower agricultural growth was driven by a decline in crop sector growth from 5.7 percent in FY11 to 0.9 percent in FY12. Although aman production had positive growth due to good rainfall nationwide during the *aman* growing season and sunny weather during the harvest, aus production was lower and the *boro*[3] (largest rice crop) production is likely to have been marginally lower than the previous year's crop, due to slightly lower acreage. Growth in animal farming was also very sluggish at 3.4 percent in FY12, compared with 3.5 percent in FY11.
- *Manufacturing growth picked up slightly from 9.5 percent in FY11 to 9.8 percent in FY12.*This came entirely from a pick-up in small scale manufacturing from 5.8 percent in FY11 to 7.2 percent in FY12. Fiscal incentives given to the SMEs in the FY12 budget together with credit support under the Equity and Entrepreneurship Fund implemented by Bangladesh Bank appears to have helped growth in small scale manufacturing. Growth in large scale manufacturing declined from 10.9 percent in FY11 to 10.8 percent in FY12.
- *Weaker growth in large scale manufacturing is attributable largely to a significant reduction in export growth*. Bangladesh is likely to struggle to achieve the 15 percent official export-growth target because of weak demand in Europe and the deteriorating efficiency of the trade logistics infrastructure. Exports grew by 8.4 percent in July 2011-April 2012, relative to the same period the

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[2] This brief was prepared by Zahid Hussain, Sanjana Zaman, Nadeem Rizwan , and M. Abul Basher (SASEP) under the guidance of Sanjay Kathuria (Lead Economist, SASEP). The team acknowledges comments from Vinaya Swaroop (Sector Manager, SASEP) and Deepak Bhattasali (Lead Economist, SASEP). A.K.M Abdullah (SASFP) also contributed to the brief. Cover photo is from The Daily Star.

[3] Harvesting period: April-June.

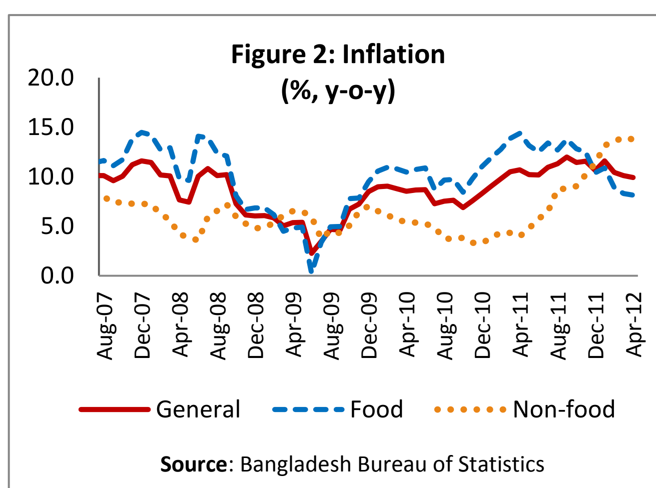
previous year. Slower growth in woven garments, knitwear, and leather and decline in export of frozen food and jute goods underpinned the slower export growth so far.

- *Private consumption growth kept pace with GDP growth.* Private consumption remained stable at around 75 percent of GDP. Remittances contributed to sustaining private consumption growth as they recovered strongly, with 10.7 percent growth during July 2011-March 2012, compared with 4.1 percent during the same period last year. There was at the same time a strong 45 percent growth in manpower exports in calendar year 2011 relative to calendar year 2010 (0.99 million in 2011 compared with 0.48 million in 2010). This bodes well for remittance growth next year.
- *Public investment increased* from 5.6 percent of GDP in FY11 to 6.3 percent in FY12. The government's Annual Development Program is the single largest source of public investment. Nominal growth in ADP spending in the first ten months was only 8.6 percent. Capital expenditures outside ADP are significant in magnitude, but even assuming that spending will be as per budget for these line items, it appears that total public investment in FY12 could be overstated.
- *Private investment growth slowed.* Private investment to GDP ratio declined from 19.5 percent in FY11 to 19.1 percent in FY12. Investors appear to have gone into a wait-and-see mode because of volatilities in the global economic environment and the stresses and strains emanating from domestic sources. The latter include high variability in inflation, tightening credit conditions in the financial sector as reflected in a significant reduction in growth in industrial term loan disbursement, resulting in negative net disbursements, energy shortage and policy uncertainties in the run up to elections in early 2014.
- *The national savings rate has declined* from 26 percent of GDP in FY11 to 25.2 percent in FY12. This reflected a decline in both private and public saving rates. Private savings rate declined from 22.6 percent of GDP in FY11 to 22.1 percent in FY12 while public savings declined from 3.4 percent of GDP to 3.1 percent. Private savings may have been hit by slower growth in real disposable income and the stock market debacle which hurt small investors generally. Slower revenue growth and large increases in subsidies contributed to the decline in public savings.

Double-digit inflation persists

Inflation continues to be volatile around double digits, with international food prices and expansionary fiscal and monetary policies at home playing a part. The inflationary upturn started in Q2 10, reaching 11.6 percent (y-o-y) in November 2011 before starting to decline; it was 9.9 percent in April (Figure 2).

The good news, particularly for the poor, is that food price pressure has declined, from 13.8 percent in September 2011 to 8.1 percent in April 2012. Satisfactory *aman* production, along with stock releases by traders in anticipation of a November-December bumper harvest, placed downward pressure on the retail price of rice, the largest single item in the CPI basket. The public food (rice and wheat) stock is at an all time high of 1.4 million tons, which has led the government to cut its rice import plan by 22 percent. The government has also revised its domestic procurement target upwards by 75 percent, to 0.35 million tons to provide price support to farmers. The declining



prices of food in the international market and in India have helped bring food price growth down in Bangladesh.[4]

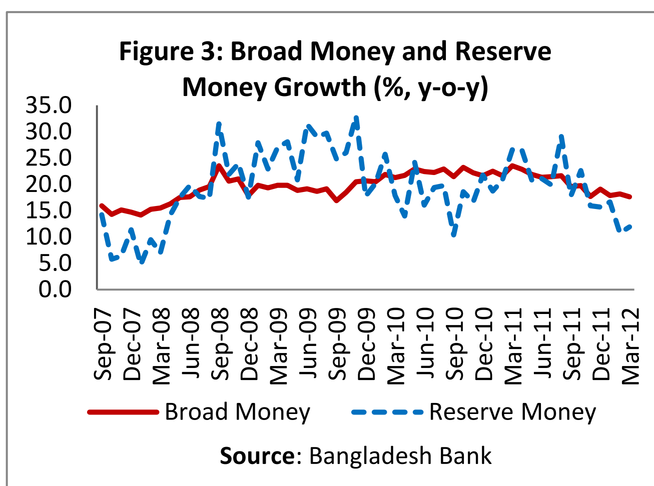
The bad news is that non-food prices rose to a 14 percent rate in March 2012, compared to 4.3 percent a year earlier. It declined slightly to 13.8 percent in April. Expansionary monetary and fiscal policies have driven the increases by expanding aggregate demand, which has also led to large nominal depreciation of the taka. Expansionary policies sustained excess demand leading to a general increase in non-food prices. This is evident from increases in all the sub-components of the non-food price index across the board.[5]

High inflation disproportionately affects the poor and vulnerable, non-poor households, but the impact may have been somewhat mitigated by increased wages. Nominal wages increased by 13.54 percent in February 2012 and real wages by 3.11 percent compared to a year ago, according to the Bangladesh Bureau of Statistics.[6] Beside the wage increase, various safety net programs are helping to cushion the impact of high inflation on poor households. As of March 8, 2012, 1.2 million tons of food grain had been distributed through the Public Food Distribution System (PFDS), which is 42.5 percent of the target for the fiscal year, compared with 37.7 percent of the target during the same period last year. Open Market Sales (OMS) resumed across the country on September 26, 2011, wherein rice is sold at Tk 24 per kg, about Tk 5 below the open market price. Besides OMS, food grains were also distributed through programs such as Food for Work (FFW) and Vulnerable Group Development (VGD) programs in rural areas.

There has been monetary tightening in recent months

Monetary policy remained accommodative for the most part of 2011 but gradual tightening is occurring. The Bangladesh Bank (BB) undertook tightening measures in the face of prevailing loose credit conditions and high inflation. In FY11, the BB again missed its reserve money target by a wide margin (8 percentage points). However, by March 2012, tightening measures had succeeded in reducing reserve money growth to 11.9 percent, compared with its 21.7 percent peak in December 2011. Broad money growth declined to 17.6 percent through March 2012, compared with 23.5 percent growth through March 2011 (Figure 3), on track to achieve program targets. Credit to the private sector grew by 19.5 percent (25.8 percent growth in FY11) and net foreign assets of the banking system increased

Figure 3: Broad Money and Reserve Money Growth (%, y-o-y)



Source: Bangladesh Bank

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4 The commodity price index for food declined by 9 percent in February 2012 compared to a year ago (Commodity Markets Review, World Bank, February, 2012). The grain price index declined by 6.3 percent during the same period. Food inflation in India has declined to 6.1 percent in February 2012 from 11 percent in February 2011.

5 Inflation in two categories, transport & communication and gross rent, fuel and lighting, went up from 4.3 percent and 3.5 percent in March 2011 to 14.9 percent and 14.7 percent in March 2012. Inflation in clothing and footwear increased to 19.6 percent in March 2012 from 6.3 percent a year earlier; furniture & household equipments increased to 14.2 percent from 7.8 percent a year earlier, and miscellaneous goods & services to 15.8 percent from 5.6 percent a year earlier.

6 Based on the BBS's monthly survey data.

by 4.6 percent (Figure 4). The BB has raised its repo rate since August 2010 by a cumulative 325 basis points to the current 7.75 percent, and also increased the cash reserve requirement in December 2010. Though helpful, this has so far proven insufficient to significantly dent inflation. The BB also increased the special repo rate[7] from 9.25 percent to 10.25 percent in late December 2011 and the reverse-repo rate from 5.25 percent to 5.75 percent in January 2012.

While realized money growth rates in the first nine months of FY12 are in line with the yearly targets, the composition of monetary growth is not. The reduction in monetary growth came mainly from a decline in growth of net foreign assets and the growth of credit to the private sector. Credit to the central government increased by 48.5 percent in the first nine months. Achieving the monetary program target of 17 percent broad money growth in FY12 will require credit to the public and private sectors to grow by no more than 11.5 percent and 2.1 percent in the last quarter of FY12 from its end-March levels (compared to end-June program targets). There is thus very limited room for credit expansion to both public and private sectors in the remainder of FY12. These will shrink even more if there is some reserve build-up due to, say, better than expected remittance inflows.

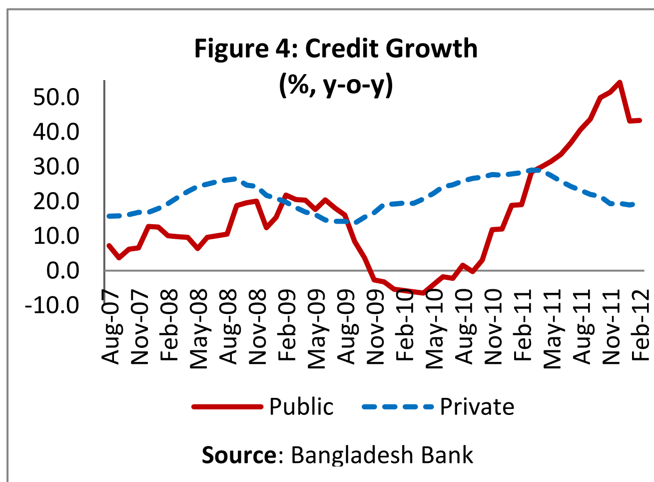
Further monetary tightening is needed. The burden of adjustment to ensure macroeconomic stability is falling on monetary policy, owing to fiscal policy accommodation of high subsidies and implementation lags in fiscal policy response. The BB's monetary policy statement for the second half of FY12 aims for further tightening to tame inflation, with a focus on achieving "single digit levels" of inflation. While the BB did not succeed in adhering to the monetary program targets in the recent past, it is on track to achieving the targets set for end-June, 2012. However, monetary policy actions take time to reduce inflation. Hence, BB will have to continue to hold the line on monetary tightening until the intended reduction in inflation is achieved.

Close surveillance to ensure banking system stability is crucial

The banking system has had to borrow constantly from the BB. Continuation of the liquidity shortage in the banking system is evident from the banks' persistent use of the repo window of the central bank. This has arisen from the need to make payments for petroleum imports and to facilitate the major increase in government borrowing. Several private commercial banks and non-bank financial institutions are also over-exposed to credit relative to deposits.

Private-sector credit flow may be restricted as the bankers adopt a wait-and-see attitude. Bankers are likely to remain cautious about lending to the private sector, given the continued heavy demands from government and tightening by the BB. The state-owned commercial banks (SoCBs), the largest source of liquidity in the system, are suffering most from the liquidity shortage.

The licensing of new banks will add to competition for deposits and challenge the supervisory capacity of BB. BB has issued license to 9 new banks which may add to pressures on the financial sector. Deposit growth in July-March, FY12 slowed to 12.2 percent, compared with 14.2 percent during the same period the previous year. Thus, a larger number of banks will have to compete for a smaller pie.



[7] This is the rate charged to banks who borrow from the BB after 12 noon on any given day. The BB has been using only this window (instead of the regular repo) to lend to banks for more than a month now.

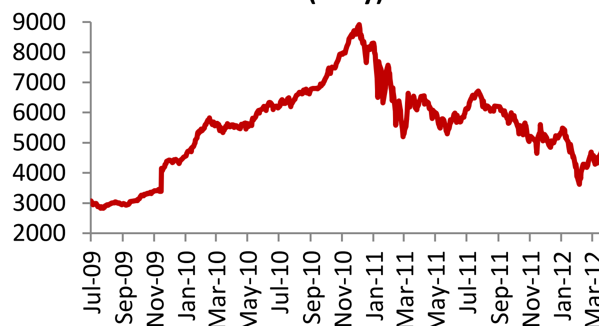
Also, lack of skilled human resources may make it hard for the new banks to find good managers and BB's supervision capacity will be challenged.

Exposure of banks to the capital market was around 4 percent of their total liabilities at the end of 2011. This exposure was well below the exposure at the end of 2010, when the stock market surge began to subside. Nonetheless, the generous exposure limits set by the BB need to be modified from 10 percent of liabilities to, say, 25 percent of regulatory capital, which, if implemented, would result in a very significant decline in the absolute exposure to the stock market.

Capital market recovers but its healthy development calls for committed regulatory reforms

The general index had a bumpy ride with a generally declining trend through 2011, with a recovery apparent since February 2012. The most recent period of decline was in mid-January 2012 in anticipation of further tightening by the central bank. The market reached its lowest level on February 6, 2012 when the benchmark index closed at 3,616, representing a 60 percent decline from the December 2010 peak of 8,919. Since then the market has been on a generally upward trend, crossing the 5,000 mark in the last week of March (Figure 5). Trade volumes have also picked up. The uptrend can be attributed to (i) market entry by some overseas private equity funds, as the fund managers consider good stocks to have reached their bottomed out,[8] (ii) re-entry by some of the local institutional buyers, as they find the stocks' current price attractive for long-term holding, and (iii) reaffirmation of a stable outlook for Bangladesh by Moody's and S&P in January and February 2012.

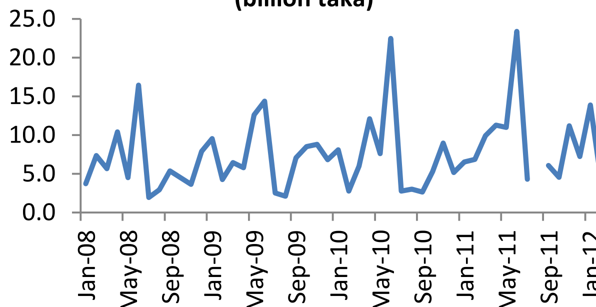
Figure 5: Dhaka Stock Exchange General Index (daily)



Source: Dhaka Stock Exchange

Regulatory reforms to ensure a stable trading environment are underway, but timely implantation is critical. The government has committed to strengthen the Securities & Exchange Commission's autonomy, ensuring it has sufficient supervisory mandate and capacity to properly oversee brokers, dealers, and merchant banks while developing the necessary contingencies to contain systemic risk. Options for demutualizing the Dhaka and Chittagong Stock Exchanges are under consideration. Banks' shareholdings limit is likely to be capped at 25 percent of the regulatory capital soon, subject to parliamentary approval of the amended Bank Companies Act. A time-bound implementation plan relating to these critical reform measures is key to stability and development of the capital market.

Figure 6: Monthly Project Aid Disbursements (billion taka)



Source: IMED

[8] Foreign portfolio investment appears to have picked up, reaching US$94 million in the first seven months, compared with US$40 million in the same period of the previous year.

The composition of public spending and finances needs correction

Rapidly rising subsidies may cause the fiscal deficit to overshoot the original budget target for FY12. Growth in subsidies and payment for food-import liabilities as well as clearance of pre-audit checks from the previous year has resulted in larger than anticipated public expenditures in the first half of FY12. The subsidy bill may rise to Tk 385 billion (4.3 percent of GDP) from the original allocation of Tk 204.77 billion (2.3 percent of GDP) at the end of this fiscal year. Given that the Annual Development Program (ADP) has been cut by 10.9 percent, to Tk 410 billion in the revised budget, and even considering that part of the subsidy (1.1 percent of GDP) is likely to be carried over to the next fiscal year, the budget deficit at year end may exceed 5 percent of GDP unless more fiscal austerity is applied.

Recurrent expenditures are likely to exceed the budget target. Recurrent expenditure growth in the first seven months of FY12 was 36.8 percent, compared to a target of 12.4 percent for the entire year. Growth in pay and allowances, interest payments, and goods and services are all ahead of the original budget targets, but it is growth in subsidies and transfers that is likely to cause an overshoot of the revenue expenditure target. Subsidies to public institutions such as BPC (petroleum corporation), BPDB (power development board), Biman (airline), BJMC (jute mills corporation) and BCIC (chemical industries corporation) are all projected to exceed budgetary provisions by significant margins. This is evident from the rise in net expenditure on loans & advances to Tk 59.1 billion in the first half of FY12 from Tk 1.46 billion in the period last year.[9]

ADP implementation has not improved. In the first ten months of FY12, 49.4 percent of ADP allocation was spent compared to 54.3 percent in the corresponding period of the previous year. The top ten ministries with the largest project aid allocations have a better implementation rate than average. Aside from the bridges division, the implementation rate for the remaining top nine ministries is even better.[10] The project aid disbursement during this period is 19.6 percent higher than the corresponding period of previous years even though monthly disbursements vary (Figure 6).

Tax revenue growth has been robust, even though it is growing slower than last year, largely reflecting base effects. NBR revenue increased by 19.2 percent during July-April, 2012 compared to 27.1 percent in the period a year earlier. Within subheads, trade-related taxes have increased by 12.4 percent, domestic VAT by 20.3 percent and income tax by 27.8 percent during this time, compared to 21.2 percent, 30.4 percent and 33.1 percent the year earlier. Non-NBR tax revenue has increased by 9.9 percent in July-December 2011.

Non-tax revenue collection has spiked up. Non-tax revenue collection accounts for about 14 percent of total revenue, and rose by 64.8 percent in the first six months of the fiscal year. However, the impressive growth is due mainly to spectrum and license-renewal fees from the mobile telephony network operators, and since these are one-time payments, it will be hard to sustain current growth in non-tax revenue.

Fiscal pressures appear in heavy bank borrowing, and raise concerns about crowding out of credit to the private sector. The central government budget deficit increased by more than 1.6 times, to Tk 258.2 billion during July-March, FY12 compared with Tk 162.9 billion in the same period of fiscal 2011. Combined with only 11 percent increase in the level of net foreign financing and a 59 percent decline in net non-bank borrowing, this led to a surge in domestic bank financing of the deficit. It amounted to nearly Tk 193 billion in the first nine months, which exceeded the original FY12 bank borrowing target for the whole year. About 28 percent of bank borrowing came from the BB's monetizing of the deficit.

[9] Budgetary financing of the deficits of public non-financial institutions is made through this account which appears outside the recurrent expenditure account.

[10] Independent Review of Bangladesh's Development 2012, Center for Policy Dialogue.

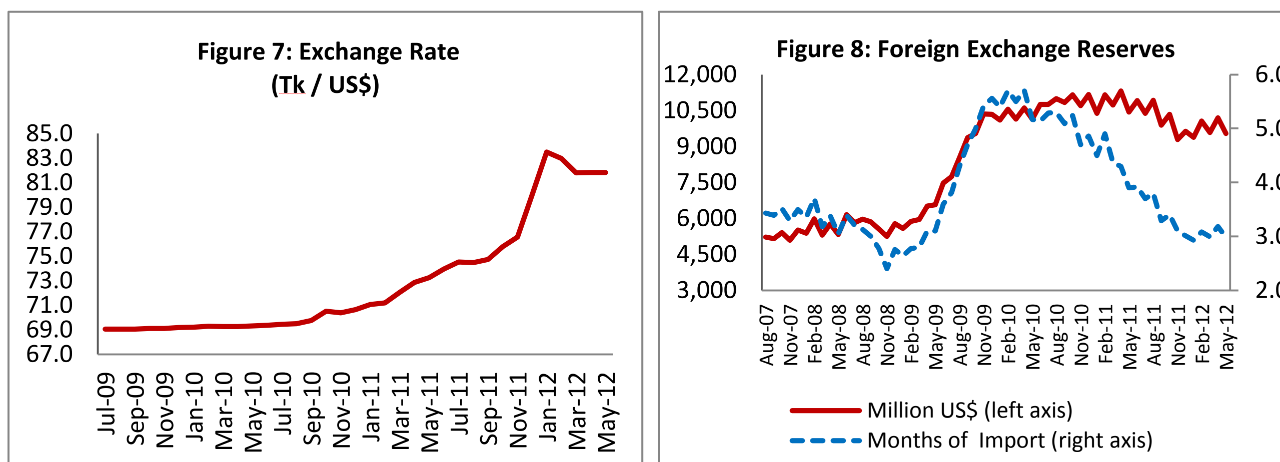
The rise in the government's domestic borrowing has raised concerns about crowding out of bank credit to the private sector.

External imbalances are growing, placing pressure on the exchange rate

The balance of payments (BoP) is on a deteriorating track, with reserves falling to below three months of imports and export growth turning negative in March 2012. The current account surplus during July-March, FY12 was US $456 million, compared to nearly US$710 million during same period the previous year. The biggest reasons for this 36 percent reduction in the current account surplus in the first three quarters were a 39.2 percent rise in petroleum-product imports to feed the liquid fuel-based power plants, and a slowdown in export growth to 10.1 percent. Despite the shrinking current account surplus, the overall deficit in the balance of payments decreased to US$ 419 million during July-March, FY12, compared with US$ 527 million during the same period the previous year. The decrease reflected a 35 percent reduction in outflows on account of trade credit and 15 percent increase in net MLT disbursements plus capital transfers. This slight improvement in overall balance may however be temporary as pressure on the BoP intensifies through the rest of the year, if export growth slows further due to continued problems in the Euro zone and likely increased disruptions in the power supply grid during summer. Export growth has already slowed from 29 percent at the beginning of FY12 to 8.4 percent through April, 2012. Knitwear export growth dropped sharply to only 3 percent in the first ten months of FY12.

The exchange rate has come under pressure. FY11 ended with the exchange rate at Tk 75.15 per US dollar. It remained around this level during the first five months of FY12 before depreciating sharply in December and January to Tk 84.46 per US dollar on January 30, 2012 (Figure 7). From end-June, 2011 to end-May 2012, the taka depreciated by about 10 percent. Gross official reserves were around US$11 billion at the end of FY11, equivalent to 3.9 months of actual imports of goods, and non-factor services below comfort levels. Reserves declined further to US$9.5 billion, equivalent to 2.8 months of imports as of mid-May, 2012 (Figure-8). The pressure on the taka stems from much larger oil imports and a slowdown in export growth, and this pressure is expected to continue in the near future, despite the improved competitiveness of Bangladesh's exports arising from a decline in its real effective exchange rate during December, 2011 and May, 2012. The pressure may ease somewhat if remittances continue to respond strongly to the recent depreciation of the taka.

Exchange rate flexibility will need to continue in order to protect reserves. There is little discussion of the BB's stance on the exchange rate in the monetary policy statement for the second half of FY12, apart from the indicated continued restraint on direct intervention in the foreign-exchange market. BB has so far allowed more exchange rate flexibility, thus succeeding in slowing reserve losses. This stance will need to continue, so that BB can keep to its program reserve targets.



Source: Bangladesh Bank

Outlook and Risks

Uncertainty in Bangladesh's leading trade markets poses risks to accelerated growth

Several downside risks and uncertainties continue to feature in the global economy. High unemployment, low business- and consumer-confidence, and volatility in financial sectors remain major threats to Bangladesh's two major export markets, Europe and the US. Recent data suggest that the Euro zone is already in a mild recession with economic activity falling much faster in March 2012 than in February, but less than the decline observed in the last quarter of 2011. Fiscal austerity and tight credit conditions continue to harm economic activity in the zone. Latest data (March 2012) show employment rates falling at the fastest pace in two years and new business orders declining. Thus, the deceleration is likely to continue in the near-term. In contrast, the US economy continues to show signs of strengthening: unemployment claims continue to fall and US industrial production in the three months leading to February has accelerated. An improving labor market situation has led to a rise in US consumer sentiment for seven consecutive months to March. The increase in sentiment has translated into stronger consumer spending. In Q4 of 2011, consumer spending contributed some 1.24 percentage points to US GDP growth. Consumer spending was up 0.8 percent (y-o-y) in February, its highest level in seven months.[11] This is good news for Bangladesh's exports. The heightened uncertainty of last year impinged on remittance flows to developing countries, with European and Gulf Cooperation Council (GCC)-dependent economies showing the greatest declines.

Bangladesh's export growth could slow to 9 percent in FY12 and 12 percent in FY13. The latest World Bank projections anticipate Euro zone growth to decline to -0.3 percent in 2012 and rise slightly to 1.1 percent in 2013, compared with 1.7 percent in 2010 and an estimated 1.6 percent in 2011.[12] The initial major impact on Bangladesh would be a decline in EU imports and trade finance, with a lesser impact from the US. Bangladesh can expect to suffer from second-round effects as well, including declines in non-garment exports and remittances due to reductions in derived demand from regions hit hardest in the first round. Export growth in FY12 could slow to 9 percent, and 12 percent the next year. While the direct effect of the Euro zone crisis on remittances may be small, the indirect effects could be

[11] Global Economic Monitor, March 26 2012.
[12] Global Economic Prospects, January 2012.

more significant. Annex A provides a more detailed examination of the likely impact of the Euro zone crisis on the Bangladesh economy.

Bangladesh has very little policy space to respond to the depressed international economy. The state of inflation, fiscal deficit, and reserves all conspire to give Bangladesh very little policy space currently to respond to the crisis, as it did during last global economic and financial crises.

The government should continue to build on the policies taken to ease pressures on the Bangladesh economy. The government has allowed increased interest-rate and exchange-rate flexibility, which has improved the availability of taka and US dollar liquidity, adjusted retail petroleum and electricity prices to contain the losses of the BPC and BPDB, and tightened monetary policy. The BB has avoided foreign exchange intervention to protect reserves, allowing the exchange rate to absorb some of the external pressures. These measures have enabled some easing of government borrowing pressure on the domestic market in recent months, while slower growth in non-oil imports has eased demand pressure in the foreign-exchange market. However, total subsidies remain large and oil-import demand continues to expand rapidly. Macro-policy tightening, therefore, needs to continue despite the uncertain global environment and attendant risk of growth slowdown.

Energy supply uncertainties pose as much of a risk to growth in Bangladesh as do global uncertainties. Gas supply has increased only marginally relative to demand growth during the last three years. As for electricity supply, official statistics suggest that a gross total of 3,000 MW have been added to the national grid in recent years, leading to an increase in the installed capacity to 8,005 MW as of March 2012. The maximum actual generation of power in calendar year 2012 till now reached 6,066 MW, compared to a maximum generation of 5,174 MW in 2011 and 4,698.5 MW in 2010. Currently, the generation capacity (as opposed to installed capacity) is in the range of 5,200-6,000 MW. The electricity supply situation could have been worse if the additional capacity had not come on board, but significant electricity shortfalls continue, due to fast-growing demand and a growing gap between installed and available capacity. Thus, the overall energy situation continues to deter fresh investments and expansion projects. The authorities need to proceed with longer-term solutions to the energy problem to ensure that the net additions to capacity already made can be sustained.

The longer-term growth outlook depends on acceleration of structural reforms to raise savings and investments rates, improve trade prospects and ensure BoP sustainability. This would entail modernizing the tax regime and strengthening public financial management, and require increased tax revenues to address the large infrastructure deficit. The authorities will also need to ensure the financial system is well-regulated, efficient and inclusive in order to serve private financing needs while minimizing fiscal and systemic risks. Government needs to undertake urgent reforms to address the looming skills deficit and enable a continuation of manufacturing and export growth. Finally, policymakers need to improve the investment climate and conduct trade-related reforms to increase domestic and foreign investment for faster, more inclusive and trade-enhancing growth.

Further progress on policy adjustments and structural reforms is expected under the government's IMF-supported program. The IMF's SDR 639.96 million (about US$987 million) three-year arrangement for Bangladesh under the Extended Credit Facility, approved on April 11, 2012, will support the government's program to restore macroeconomic stability, strengthen the external position, and sustain higher, more inclusive growth. The government has committed to take actions to help create fiscal space, rejuvenate the financial sector, catalyze additional revenues to boost social and investment spending, and tackle power shortages and the infrastructure deficit.

Annex A

Likely Effects of the Euro Crisis

The looming Euro crisis can affect the Bangladesh economy through exports, remittance, and aid inflows. World Bank projections anticipate euro zone growth to decline to -0.3 percent in 2012 and rise slightly to 1.1 percent in 2013, compared with 1.7 percent in 2010 and an estimated 1.6 percent in 2011.[13] The initial major impact on Bangladesh would arise from a decline in EU imports and trade finance, with a smaller impact expected in the US market. Bangladesh can be expected to suffer from second round effects as well, including impact on non-garment exports and remittance due to reductions in derived demand from regions hit hardest in the first round. Export growth in FY12 has already slowed considerably to less than 9 percent, and this may improve only marginally to 12 percent in FY13. While the direct effect of the Euro zone crisis on remittances may be small, the indirect effects could be more significant.

The previous global recession undermined growth in Bangladesh by stagnating real exports and adversely shifting the terms of trade in fiscal 2009. The impact on exports became apparent around October, 2008. The effect lasted 14 months before giving way to a short-lived boom (about ten months), led by knitwear in early 2010 (Figures 9-12). Another downturn appears already to be underway, since April 2011. Bangladesh's terms of trade declined by 4.6 percent in FY10 and by another 6.7 percent in FY11. The banking system had very low levels of exposure to the "toxic assets" which caused the crisis and a very low reliance on international borrowing from commercial sources. This insulated Bangladesh's financial system from the crisis to a large extent and limited the impact to a moderate slowdown. The fall in oil prices, from a high of US$140 in July 2008 to about US$45 over the next six months also helped, by reducing import bills at precisely the time when the effects of the crisis were beginning to be felt. Growth in payments on account of non-oil imports began declining from April 2008 and continued until December 2010. Growth in payments for oil imports were in negative territory from November 2008 through October 2009. Declining international commodity prices also helped to reduce energy SOE losses and contributed to lowering inflation.

The first-round impact on Bangladesh in a new international recession would stem from a collapse of EU imports and trade finance. Euro-zone import demand growth turned negative in Q3 2011, with imports dropping by 4 percent in both France and Germany, compared to Q2 2011. Month-on-month import growth in Bangladesh's other major export destination, the US, declined also, by 3.8 percent, in September.[14] An adverse effect on export earnings can result from falling export volumes as well as prices.[15] Bangladesh can be expected to suffer from second-round effects, as well, including declines in non-garment exports and remittances due to reductions in derived demand from regions hit hardest in the first round. The adverse impact may be exacerbated by squeezing of trade finance. Some European banks have indicated they will be reducing their trade-finance assets. European banks with Asian operations are reportedly scaling back, causing medium-sized companies to find less-readily available credit lines or payment guarantees.[16]

[13] Global Economic Prospects, January 2012.

[14] M. Malouche (PRMTR), Update on Trade Developments.

[15] Export prices reportedly started to decline from end-2011. There is, however, a silver lining: the prices of raw materials such as cotton, yarn and fabrics have declined by 50-60 percent relative to January 2011. According to some garment owners, they are beginning to receive substantial orders for the next six months as buyers attempt to lock in the lower export prices—*The Daily Star:* Low prices cut into RMG export growth, December 25, 2011.

[16] M. Malouche (PRMTR) and H. Scott Stevenson (CSGAE), Update on Trade Finance.

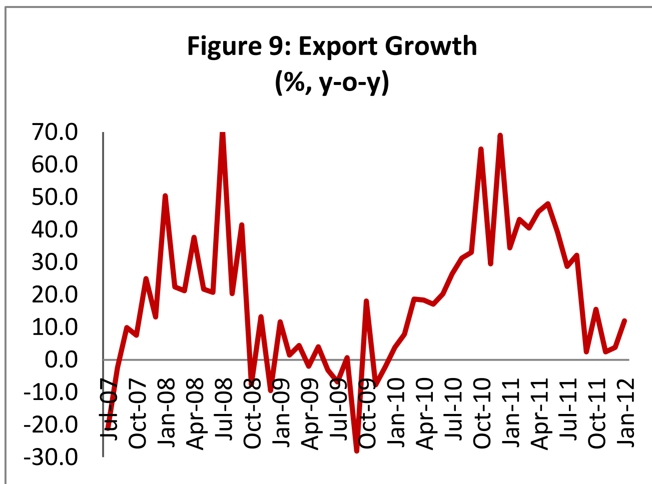


Figure 9: Export Growth (%, y-o-y)

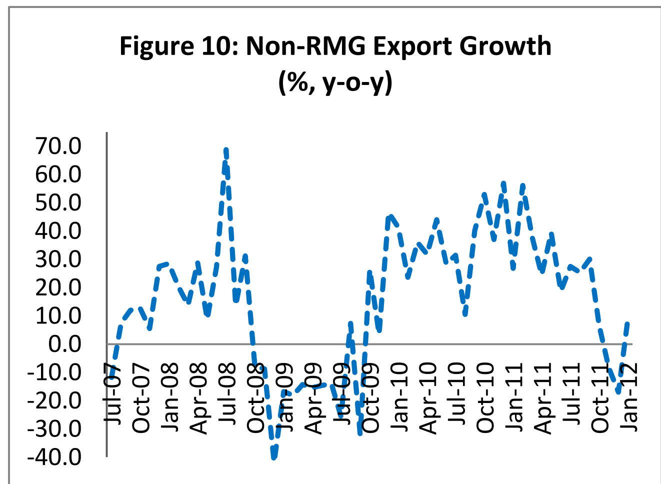


Figure 10: Non-RMG Export Growth (%, y-o-y)

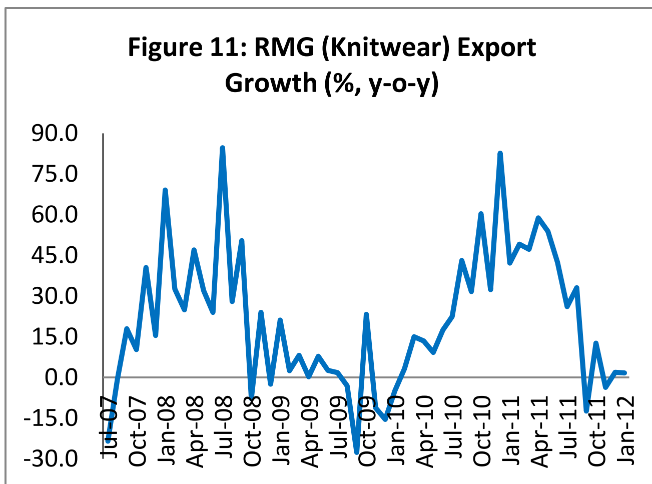


Figure 11: RMG (Knitwear) Export Growth (%, y-o-y)

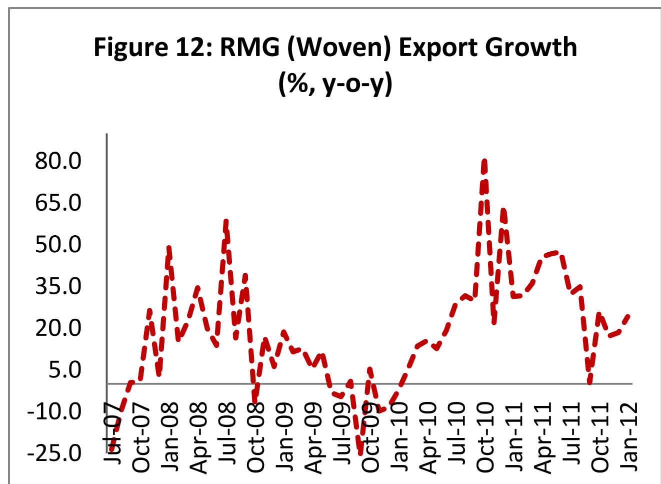


Figure 12: RMG (Woven) Export Growth (%, y-o-y)

Source: Bangladesh Export Promotion Bureau

Exports

With negative growth in the Euro zone, export growth forecasts from 2012 do not paint a healthy picture. The European Union (EU) is the main destination of Bangladesh exports. In FY11, 52.1 percent of Bangladesh's total exports went to EU, of which 87.7 percent were in the form of readymade garments (RMG). Monthly growth of RMG was around 25.3 percent in August, 2011. The Bank's Global Economic Prospects (GEP) forecast a growth of -1.1 percent in 2012 and 1.6 percent in 2013. Taking these into account, EU overall imports are projected to decline by 13.6 percent in 2012 and grow by 5.5 percent in 2013. Bangladesh's RMG export to EU was resilient in the last crisis period. In October 2008, the country's RMG market share in EU was around 4.3 percent, and gained momentum due to the so-called "Wal-Mart effect", increasing to 6.2 percent in April 2010. However, even market-share gains might not be sufficient to avoid the shock to export growth in a new Euro-zone crisis, because last time exports slowed noticeably in all categories from October 2008. Non-RMG exports to the EU may suffer more than those of RMG, as Bangladesh's share of non-RMG exports in the EU have averaged just 0.05 percent over the last three years.

RMG export growth to the US may be hit as well. The US is the second-largest export destination for Bangladesh after the EU, and Europe is the largest market for US exports. Hence, the US economy would also likely grow slowly over the next 18 months at 2.3 percent in 2012 and 2.4 percent in 2013. If so, US overall import growth would fall to 1.7 percent in 2012 (rising to 6.4 percent in 2013). So, even if the share of Bangladesh's RMG exports to the US were to rise from their current share of 5 percent to 6 percent, they would still lose ground through most of 2012.[17] RMG export growth may begin to improve in the latter part of 4Q 2012 and is predicted to increase in the first quarter of 2013. Bangladesh's share of the US non-RMG market has been 0.02 percent for the last four years and there are no early or significant signs of product diversification.

A number of scenarios are possible: The Bangladesh export market is highly concentrated in the EU and US. In FY11, Bangladesh exported around 74.4 percent of its total exports to these markets, but during the last financial crisis, 2008-2010, this fell to 70 percent. It is reasonable to presume, therefore, that a similar fall-off would occur if, as forecast, another Euro crisis were to occur over the next 18 months. A worst-case scenario envisages flat, or even declining, exports in that period. A base case foresees a significant decline in export growth from what occurred during the first eight months of FY12. Taking account of the projected import growth of the EU and US in 2012 and 2013, the share of imports from Bangladesh and the actual export performance over the first eight months of fiscal 2012, the export projection for Bangladesh is (Table A1):

Table A1: Projected Exports in FY12 and FY13
(without policy adjustments)

	FY11 (actual)	**FY12** (projection)	**FY13** (projection)
Exports ($ in millions)	23,008	25,079	28,088
Growth (percent)	41.7	9.0	12.0

Source: WB staff estimate

Note: Given the 13.0 percent growth to July-February of FY12, projected exports for the year imply a 3.6 percent growth over the same period the previous year.

Remittances

The direct effect of the Euro-zone crisis on remittances may be small, but the indirect effects could be significant. Europe's share in Bangladesh's total remittances is only about 8 percent, mostly from the United Kingdom and Germany. Thus, the direct effect of a Euro crisis on remittance inflows may not be significant. However, the indirect effects could be substantial, because of a possible slowdown of economic activities in the oil-exporting Gulf countries, combined source of about 78 percent of Bangladesh's total remittances. A decline in oil prices due to a Euro crisis would likely slow economic activity in those countries, the severity depending on the extent of the slowdown. This would harm remittance inflows from non-Gulf countries.

[17] Wal-Mart sources in Bangladesh say the company's spring and summer 2012 orders for the US amount to US$20 million, compared to US $37 million for the same seasons last year. Orders from the UK market are flat.

The recent rise in manpower exports provides some cushion. There is anecdotal evidence that many Bangladeshi migrant workers returned from trade-intensive countries such as Singapore and South Korea during the last global economic and financial crisis. However, at that time the oil price plummeted, thereby mitigating the weakening of remittances to Bangladesh. The jump in manpower "exports", from an average 270,000 annually during FY03-06 to 730,000 during FY07-09 dwarfed any possible impact of lower oil prices on the earnings of the Bangladeshi workers abroad (Figure 13). Manpower "exports" slowed to 430,000 in FY10 and 440,000 in FY11, though these were still significantly higher than the pre-FY07 level. Manpower exports in the first seven months of FY12 have been 74 percent higher than the corresponding period of the previous year. This suggests a cushioning of a negative impact of a new Euro crisis.

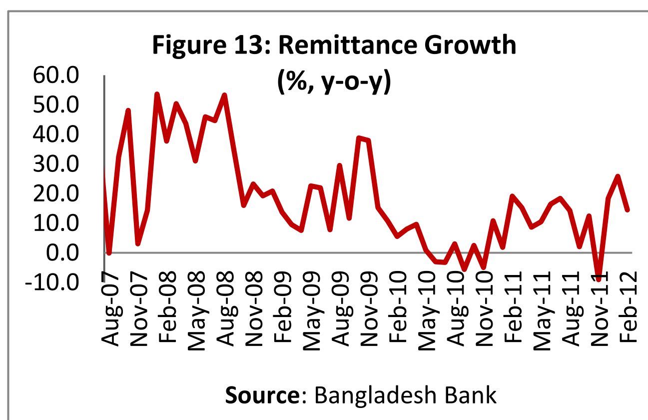


Figure 13: Remittance Growth (%, y-o-y)

Source: Bangladesh Bank

The impact may be most pronounced if GCC economies were infected. It is therefore not clear yet how strongly the remittance inflows of Bangladesh would be affected by a Euro crisis. It should be borne in mind, however, that GCC economies are vulnerable to a Euro-zone crisis, not just through weaker oil prices but also through weaker trade in general which may reduce their growth. Table A2 shows the possible effects of a 7-10 percent shortfall in remittances from Kuwait, United Arab Emirates, Qatar, Oman and Bahrain in FY12 and FY13 respectively. Even though the stock of Bangladeshis working abroad is rising, a significant weakening of GCC economies could result in temporary unemployment, fall in real wages and a decline in their propensity to remit, as workers hold on to larger portions of their earnings for subsistence or to face the rainy days.

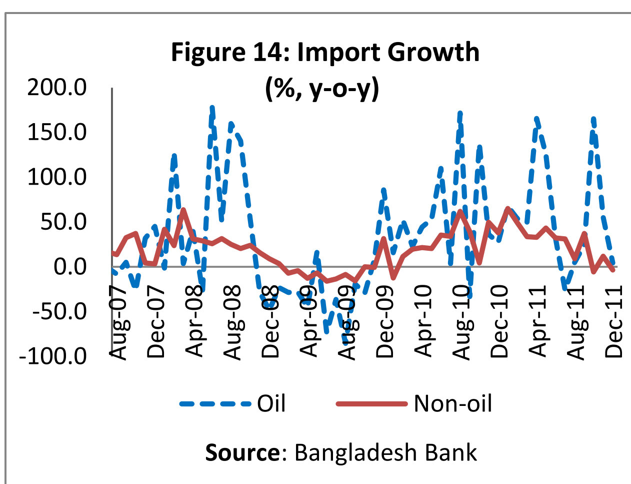
Table A2: Impact on Remittances

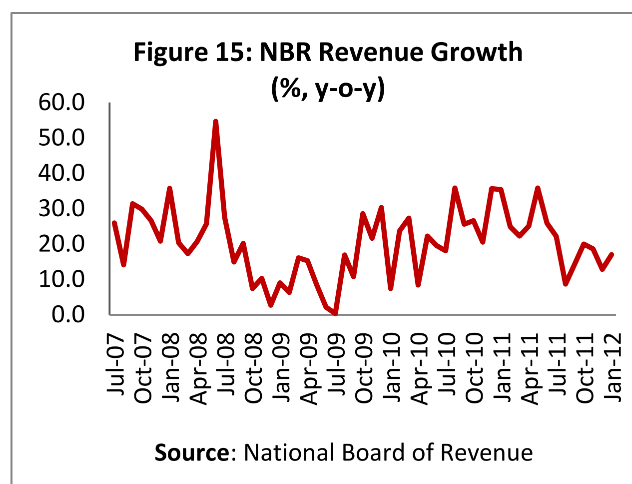
	FY12		**FY13**
	Passive	Active	Active
Projected Remittances (US$ million)	12149	12345	13104
Projected Remittance growth rate (%)	4.3	6.0	6.1
Shortfall in Remittances from GCC relative to pre-crisis projections (%)	7	4	10

Note: GCC includes Saudi Arabia, UAE, Kuwait, Qatar, Oman and Bahrain.
Source: Bank staff estimates.

Imports

Growth in import payments may slow. Petroleum and capital goods (metals and machineries) comprise about 37 percent of total imports to Bangladesh. Based on the experience of the last global economic and financial crises, a Euro crisis would reduce petroleum and metal prices. In fact, payment for oil imports declined during October-December 2008 (Figure 14). Effects of a Euro crisis on Chinese consumption of these commodities would also determine the exact fall in their prices, and Chinese growth is already slowing down. The price of other commodities would fall for the same reason. These declines are likely to be reinforced by the decline in intermediate inputs due to slower export growth. Therefore, growth in the total import bill of Bangladesh would likely decline as it imports commodities that are price-inelastic.





Fiscal Impact

Revenue growth could weaken. During the last global crisis, revenue growth in Bangladesh started slowing from August, 2008 and lasted until July, 2009 before entering a period of strong recovery (Figure 15). A Euro crisis could impact total revenue through declining growth of nominal GDP, depending on the tax buoyancy of the country. The crisis would likely reduce the growth of nominal GDP by reducing the growth of real GDP and inflation.

Table 3: Projected Revenues FY12-13

(Billion Taka)

	FY11	FY12			FY13
	Actual	Budget	Passive	Active	Active
Direct Tax	231.2	275.6	277.4	292	379
Indirect Tax	531.8	682.2	642.4	680	829
Total Tax Revenue	763	957.9	919.8	972	1208
Tax Revenue Growth (%)	22.1	25.5	20.6	27.4	24.3
Nominal GDP Growth (%)	13.4	14.2	16.6	16.4	16.7

Source: Bank staff estimate

Note: Projected revenues in the passive scenario are lower than budget, despite a higher nominal GDP growth relative to the budget, because of the overstated tax-buoyancy factor implicit in the revenues projected in FY12 budget. The budget assumes a tax buoyancy factor of 1.8, while Mansur and Yunus (2011) found it to be 1.245 and the ongoing World Bank study on creating fiscal space set it at 1.31.

Bangladesh's tax structure is dominated by indirect taxes, which contribute more than three-quarters of total tax revenue of the country. Tax buoyancy of indirect taxes is 1.252 and of direct taxes 1.202.[18]

[18] Mansur and Yunus, An Evaluation of the Tax System in Bangladesh, PRI presentation, undated.

Given the above tax buoyancy, total tax revenue will fall short by about 4 percent of the original, passive target in the fiscal 2012 budget. Because of new revenue measures in the active case, the projected tax revenues are 1.5 percent higher relative to the budget.

No exogenous shock to public expenditure is expected from a new Euro crisis other than the need for austerity that may be forced by a shortfall in revenues and perhaps external financing. There has already been an endogenous response, with the government expanding its cash subsidies for export by Tk 5 billion (about $65 million). A global or regional crisis tends to constrain market-based financing. It would be difficult for the government to access the international capital market with an issue of sovereign bonds or by borrowing from foreign financial institutions. Bangladesh traditionally has relied mostly on official bilateral and multilateral financing. These sources did not dry up during the last global crisis; a decline in aid inflow in recent years is primarily attributable to slower project implementation rather than adverse external factors. A shortfall in the foreign aid pipeline due to the crisis is not likely. However, it is possible that because of growing fiscal and debt crunch, the EU may not be able to fulfill its existing and new commitments under various bilateral and multilateral initiatives. But this should not cause any serious problem if the Bangladesh government intensifies efforts to accelerate use of the existing aid pipeline, which now exceeds US$12 billion.

Overall Macroeconomic Impact

Bangladesh has very little room for maneuver. In the worst-case scenario, slowdown in remittance reduces private consumption growth, uncertainties with respect to global outlook reduce private investment growth, and export growth is directly affected by an EU recession and slower growth in the US. A decline in export growth also reduces import growth. Under these conditions, GDP growth in FY12 is estimated to have declined to 6.3 percent. The implied macro balances, particularly fiscal deficit at 4.9 percent of GDP and domestic financing at 3.6 percent of GDP leave very little room for maneuver. Bangladesh cannot afford to see reserves depleting further; it cannot allow more subsidies because the deficit is being financed domestically and is crowding out the private sector, and monetary financing of the deficit has already been over-used.

Quantitative adjustment is needed. This would require macro policy measures on the following fronts: a tightening of monetary policy, increased exchange-rate and interest-rate flexibility, scaling back of energy subsidies, and measures to contain risks to financial-sector stability. These will restore investor and consumer confidence leading to higher consumption growth and investment growth. It will also contain the decline in the export growth rate, thus enabling the economy to maintain 6 percent-plus growth.

The impact on inflation in Bangladesh will depend on the extent to which global commodity prices soften as a result of recession in the Euro zone. Given the time lag in the transmission of international commodity price changes to changes in domestic prices, the impact is more likely to be visible in FY13. If a deep recession in Europe were to spill over to slow growth in China and India then international commodity prices could decline noticeably, leading to a decline in inflation in Bangladesh in ways similar to that experienced in 2009. In Bangladesh, the difference this time is rising non-food inflation which has constrained space for stimulus packages in response to the crisis. Another key difference is the resilience of international oil prices around US$100-US$110 per barrel, despite recession in Europe, weak demand in the US, and growth slowdowns in China and India. This is additional bad news for Bangladesh because it removes the mitigating effect on the balance of payments and prices that global recession brought in 2009 for net oil importers.