Economic Recovery faces Bumpy Ride

State of the Economy 2014

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Fractious politics, street violence, and frequent nationwide work stoppages, that prevailed for the better part of 2013, left a badly bruised economy. This year has seen relative calm across the country though undercurrents of political discontent remain. Nevertheless, it presents a window for the economy to get back on track. As the curtain falls on the year 2014, it is once again time to take note.

Economic recovery is an expression coined in the developed economies to describe the expansion of economic activity following a recession that occurs when national output declines for at least two consecutive quarters and, typically, continues for several quarters thereafter. By that reasoning, our economy seldom if ever experiences a recession. Bangladesh economy has been on a stable and positive growth path for decades, its average decadal growth rising steadily. It does however faces slowdown in growth, -- a decline in the rate of growth of Gross Domestic Product (GDP), which is the real value of goods and services produced in a year. A recovery is associated with such a slowdown in annual growth. By all accounts, the first half of fiscal year 2014 (July-December 2013) saw the economy battered by politically driven work stoppages and street violence that shook the confidence of investors and businesses alike. Growth was expected to be a casualty of this predicament. Yet official figures turned out to show that economic activities in the second half of the fiscal year had compensated enough to yield a growth rate of 6.12% (provisional) for the entire fiscal year, surprisingly -- though not convincingly -- a tad higher than the growth rate of 6% in the previous fiscal year.

Economy in retrospect: Turning our attention to 2014, what could have been a year of speedy economic recovery now seems to be closing without the desired sparks. After a tumultuous year of destructive *hartals*, this past year has seen relative political calm with few if any 'effective' *hartals* in the capital city, though a few stray *hartals* were recorded in the district towns of the country. Yet it would be too early to declare victory over the regimen of political confrontation as the underlying causes of the malaise have not been removed for investors and businesses to take heart. The ghosts of 2013 are still fresh in our memory. What seemed like a race to the bottom might have met with a temporary pause. This uneasy calm could well be a lull before the storm, many analysts say. Politics and economics are intricately inter-twined. Anyone who thinks otherwise must be living in a vacuum.

Be that as it may, life has to go on, and the economy does not sleep. This fiscal year the economy is expected to grow at a respectable pace though not nearly as high as the planned 7.2% for the current fiscal year. What is most worrisome is that investment – which constitutes accumulation of capital that enhances the productive capacity of the economy – appears to have become one of the casualties in this predicament. After a year of political turmoil during which investors were running for cover, this could have been a boom year for investors of all shades and sizes. But signals are mixed at best. Private investors typically look at a longer time horizon before opening up their wallets. The current street perception of a stable political environment seems to indicate a limited window. That sort of time horizon does not give them the certainty of sustainable return on investment. For one, bank credit growth, a bellwether of economic activity, slumped in mid-2013 and is yet to show signs of picking up from the 11% growth rate since June-2013, falling well short of Bangladesh Bank's target of 16.5% growth. The state of bank credit growth tells the story of current activity levels as well as future productivity from investment – not encouraging signs for both of these activities.

Then again, there is the pick up in imports as shown in the data of the first quarter (July-Sept) of FY2015. Capital machinery imports are up 53% signaling an uptick in investment while intermediate goods imports are also up a respectable 15%. Given the sluggish investment climate around, some analysts speculate that import values of capital machinery might be inflated through the practice of over-invoicing in a product category that is subject to the minimum or zero tariffs. But these concerns relate primarily to the large-scale manufacturing sector which makes up only 9% of manufacturing establishments. The vast majority of enterprises belong to the small and medium category which, I would think, continue to invest at their own pace largely unaffected by the so-called investment climate. Finally, there is noticeable movement in public and private investments in high profile infrastructure projects in transport, energy, and power sectors that has gathered pace despite the outward impressions of a political standoff.

Another disappointment so far has been the export sector whose performance is entirely driven by the readymade garment sector. Whereas the previous fiscal year which ended in June 2014 registering a respectable 13% annual growth on the heels of Rana Plaza episode and political turmoil, the first four months of the current fiscal year shows no growth at all, for both RMG and non-RMG products. This happened when many analysts hoped that the Rana Plaza episode and *hartals* were behind us. Non-RMG exports have been and continue to be laggards with the result that our export basket continues to become even more concentrated on one product. Industry sources report that while efforts at meeting international compliance standards are on and buyers are gaining confidence, the lagged effect of some order cancellations or diversions as an immediate fallout of the Rana Plaza disaster coupled with political turmoil is now showing up in export data. The hope is, according to industry insiders, garment exports will see a pick up in the first half of 2015.

Exports slowdown notwithstanding, official foreign exchange reserves continue to build up largely due to sluggish imports and steady flow of remittances, reaching a record level of $22 billion with an import cover of nearly 7 months. While such build up of reserves provides a cushion against any threat on balance of payments, it also puts pressure on the exchange rate to appreciate, a pressure that Bangladesh Bank has been successfully averted through appropriate interventions in the foreign exchange market. A comfortable reserve level comes with more positive elements for the Bangladesh economy than any of the costs associated with its development.

Being a petroleum importing country whose demand is rising exponentially, one recent international development that will have important ramifications, mostly favorable, for the Bangladesh economy is the sharp fall in the price of petroleum since June 2014, from $115 for a barrel of Brent crude in June, to $70 following the inconclusive OPEC meeting in November -- a drop of 40% in price. With petroleum imports of $3.6 billion in 2013 and growing at 9.5% a year, this could mean a significant terms of trade gain for Bangladesh which could free up foreign exchange resources for other essential imports. Analysts argue that the end game in these price developments is yet to be played out as OPEC, the cartel of oil exporters, is now essentially engaged in a price war with US producers of shale oil. The cartel's strategy is to let prices keep falling in the hope that many of the newest drilling projects in the US will prove unprofitable and shut down. How far this price fall can be absorbed by OPEC members, some of whom like Iran and Iraq find their budgets running deficits at anything below $85 a barrel of oil. Others, like Saudi Arabia, holding $785 billion of foreign exchange reserves, have much greater leverage to play on. What is especially interesting here is that Saudi Arabia and OPEC appear to be ceding their long-standing role in modulating the global supply of oil. Instead, they will leave that up to the markets. Meanwhile, at least for the time being, Bangladesh should be ruling the roost and even consider stockpiling some oil, if that were feasible.

In the realm of regional cooperation, the 18th Summit of South Asian Association for Regional Cooperation (SAARC) ended last month in the Himalayan country of Nepal. India, by far the largest SAARC member by population and economic size, has come to be regarded as the prime mover for taking the regional agenda forward. This time all eyes were on the "neighbors first" motivated Indian Prime Minister, Narendra Modi, said to be on a fast train for regional cooperation. The high point of this Summit was supposed to be the three ambitious connectivity agenda that were put on the table: energy, road, and rail. After some cold-shouldering between him and the Pakistan Prime Minister, the Summit salvaged a deal only on energy connectivity in light of incomplete "internal processes" cited by Pakistan. Regional economists, civil society, and diplomats have been hard at work to forge a semblance of "deeper regional integration", the main theme of this year's Summit. That goal is becoming harder due to the seemingly endless squabbling between the two largest economies in South Asia. Pakistan continues to renege on its commitment to provide MFN treatment (non-discriminatory market access) to India, thus holding up the highest potential of inter-regional trade between them and causing intra-regional trade in the South Asian region to remain stagnant at a pitiful 5% of the region's total trade. Meanwhile, China, with observer status, swiftly offered $30 billion of investment in road infrastructure and promised to raise trade flows to $150 billion in the next five years. Thus concluded the 18th SAARC Summit with an outcome that fell short of expectations, as some analysts put it.

At the multilateral level, Bangladesh was looking for some progress on market access and trade facilitation areas under the Doha Development Agenda. There was little disagreement among members on the "trade facilitation" agenda: efforts to ease trade through simplified customs rules and automation. But the Bali Ministerial in December 2013 only produced an accord after much bickering over foodgrain stockpiling and subsidies in India. Following the Bali meet, the implementation protocol for trade facilitation which was expected to be signed by July 2014 ran into difficulties that lingered as late as November when the contentious issue of stockpiling foodgrains for "food security" purposes was finally resolved as an exception to the rule for capping agricultural subsidies. Again, it was perhaps the new government in India striving to resolve gridlocks in multilateral trade in order to boost India's rising export and investment opportunities globally. The logjam removed, the Protocol of Amendment on Trade Facilitation can now move forward, following ratification by all members of course, with the hope that when fully implemented, this trade facilitation global initiative will add $1 trillion annually to global GDP and create 21 million jobs, with Bangladesh as a significant beneficiary. The WTO might well have survived this Round, with some bruises.

Finally, it seems that 2014 will close on a note of disappointment as the GSP facility in US remains suspended. Besides Bangladesh, the GSP facility in USA had expired for many other countries and the USTR was yet to review and recommend reinstatement of the facility. Consequently, reports indicate that a large number of small and medium enterprises in USA had to lay off workers or close down due to the extra tax hike amounting to some $1 billion a year. The USTR had placed 16 conditions on Bangladesh, including issues related to worker safety and labor rights, most of which had been met, according to a report from the Commerce Ministry. These developments notwithstanding, a formal review and reinstatement of the GSP facility for Bangladesh does not appear in close sight and next year this will have to remain a major focus under the recently concluded US-Bangladesh Trade and Investment Framework Agreement (TICFA). For now, analysts watching the developments closely see the need for a diplomatic rapprochement with the US as more pressing than anything else.

Global economy in 2014 and outlook for 2015**:** The elites of the financial world gathered in Washington last September for the annual meetings of International Monetary Fund (IMF) and World Bank. They heard some sobering news from the hosts about prospects of the world economy in the short- to medium-term. Indeed, it has become a pattern: the widely watched IMF's *World Economic Outlook* starts with an optimistic projection at the beginning of the year, following up with downgrades to global growth, every quarter thereafter. Whereas in April 2014, IMF appeared bullish and expected the global economic recovery to be sustained, albeit with some downside risks, the final quarterly update of October 2014 has put a damper on those predictions. Christine Lagarde, IMF's erudite boss, has even coined a new expression to describe the state of the global economy and its outlook, "the new mediocre". That sounds like a definite downgrade from the predictions of leading thinkers on the global economy who were describing the current state of affairs as "the new normal", i.e. a state of play when the world economy, and, particularly, the advanced economies, are expected to grow at sub-optimal rates while emerging market economies would drive global growth higher.

The state of geopolitics and the economic recovery are interlinked. In 2014, geopolitics has taken a turn for the worse. Rising tensions between Russia and the West have the potential of upsetting the cart of European recovery. In the Middle East, the Arab Spring has morphed into a continuum of discordant forces rising in several countries, among which of course are Syria, Iraq, Libya, and Yemen. The Ghaza episode showed that the Palestinian problem remains a powder keg ready to erupt and derail the inconclusive peace process. Brazil's presidential election this month will determine whether the country makes progress toward a new, more sustainable growth model or becomes more deeply mired in a largely exhausted economic strategy that is heading nowhere. Thus, in a recent round up of the global economy, Mohamed El-Erian of New York University sees global markets encumbered by uncertainty in several areas, not just geopolitical tensions.

China's appetite for investment in properties and infrastructure appears to be cooling leading some analysts to predict that the economy's honeymoon with 7-8 percent growth was probably coming to an end. Abenomics in Japan is showing results, but the Japanese economy has been too long and too deep in the zero growth environment to become a significant player anytime soon. With monetary easing and fiscal expansion in place, much depends on Prime Minister Abe's ability to get structural reforms – the "third arrow" -- moving in Japan to spur growth. India is yet to come out of its quagmire of growth slowdown. Investors, domestic and foreign, are counting on Premier Modi to deliver on his election promise of economic resurgence in order to regain the lost growth momentum. With the exception of Germany, European economies are still reeling under the burden of debt, high unemployment, and slow growth, to have any meaningful impact on global economic recovery. Whatever little movement that is expected in the world economy is likely to come from the US economy which has shown modest dynamism in the past year, creating jobs at a steady pace and bringing unemployment down. According to leading macroeconomist, Martin Feldstein, the US economy is expected to register its best growth rate since the crisis of 2008. So the US economy remains the only hope for a global recovery to keep up a positive momentum.

Table 1. Global Economic Outlook(October 2014)

	2012	2013	2014	2015(p)
World Output Growth (%)	3.4	3.3	3.3	3.8
World Trade Growth (%)	2.9	3.0	3.8	5.0

Source: IMF, World Economic Outlook ,October 2014

The IMF World Economic Outlook (WEO) update of October 2014 suggests that the world will experience a minor rise in output growth of 3.8 % in 2015 compared to 3.3% in 2014 and trade growth is expected to be 5% in 2015 whereas it was 3.8% in 2014 (Table 1). Emerging markets are adjusting to rates of economic growth lower than those reached in the pre-crisis boom and the post-crisis recovery. In 2014–15 growth is expected to strengthen across most advanced economies, but the pace of recuperation remains different across regions. The strongest rebound in growth is expected in the United States, whereas the crisis legacy brakes will ease only slowly in the euro area, and growth in Japan will remain modest. Growth elsewhere, including in other Asian advanced economies, Canada, and the United Kingdom, is projected to be solid. Global trade is projected to pick up ahead of GDP as the global recovery strengthens as trade growth typically outstrips output growth in an expanding global economy. Given a weak recovery next year, the difference between trade and GDP growth is projected to remain below recent pre-crisis averages. Nevertheless, a 5% projected trade growth is expected to provide the tailwinds necessary to give Bangladesh exports the needed shot in the arm in 2015.

GDP growth to pick up, but slightly. The whole of 2014 calendar year has seen only a few disruptions in economic activity that is associated with *hartals*. But there are clouds on the horizon and many analysts are prone to describe this as an uneasy calm, not exactly the kind of environment in which investors go for long-term commitments. Economic activity therefore must rely on existing capacity rather than new productive capacity. GDP growth is expected to reflect this situation.

The new twist in national accounting this year is the rebasing of GDP, an adjustment undertaken by BBS about every ten years. This year BBS has rebased the GDP figures from base year 1995-1996 to 2005-06. Provisional estimates of GDP for FY 2014 indicate an expansion of the economy with a growth of 6.12% in real terms as compared to 6.10% (final estimate) in FY 2013 (Table 2). As compared to FY 2013, the higher GDP growth in FY 2014 is mainly due to higher growth in Agriculture, Construction, Education, Health and Social Works. Economic analysts reviewing this GDP data have raised the question: how GDP growth in FY2014 could be same as in FY2013, when half the year saw violent political confrontations that frequently halted production in factories and blocked movement of traffic on roads and highways. Was the recovery in the second half of the year enough to compensate for the disruptions in the first half? With the current state of political stability, and hoping it will remain that way until end of this fiscal year, the projected growth rate (PRI estimates) in keeping with the rebased GDP for FY2015 stands at 6.35%. This results from a slight decline in agricultural growth rate from 3.35 to 2.88 percent primarily due to little change (forecast) in total rice output in the current fiscal year 2014-15 compared to last year. For FY2015, Industry sector which accounts for about 30 % of GDP is expected to show modest uptick in growth thanks to the absence of production disruptions assumed in FY2015. The same rationale applies to the service sector which should experience modest improvement in growth arising from industry and trading activities.

Table 2. Sectoral Growth Rate and Share of GDP (%)

	FY 13		FY 14(E)		FY 15(pr) PRI estimate	
	Share	Growth	Share	Growth	Share	Growth
Agriculture	16.78	2.46	16.33	3.35	15.70	2.88
Industry	29.00	9.64	29.61	8.39	30.36	9.08
Of Which Manufacturing	19.00	10.31	19.45	8.68	20.02	9.54
Services	54.22	5.51	54.05	5.83	53.80	6.02

GDP Growth	6.01	6.12	6.35
Source :BBS ,PRI Staff Estimate			

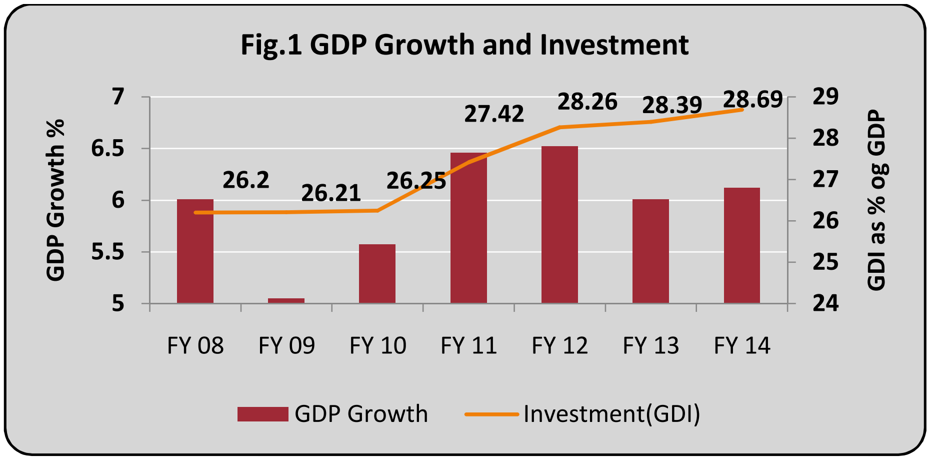
Growth recovery has begun with the return of a semblance of political calm. The Gross Domestic Investment (GDI), which appears some 2% of GDP higher in the rebased accounting by BBS, is hovering at 28 percent of GDP from FY2012 to FY2014, with the share of private investment declining along with a slight increase in public investment from 6.64 percent in FY2013 to 7.2 percent in FY2014 (Table 3, Fig.1). The FY2015 budget has set a very ambitious 7.3 percent growth target. Given an average incremental capital output ratio (ICOR) of 4.5 for FY2012-14, achieving this would require the total investment to GDP ratio to rise by over 5 percentage points—from 28.7 percent in FY2014 to 33.8 percent (new 2005/06 base). If the ICOR and GDI ratio are to be accepted, then the targeted growth rate of 7.2% appears to be highly implausible as the GDI ratio cannot be raised by 5% in a year. A careful professional review of the BBS data is now an absolute imperative.

The national savings rate, of which only the remittance data (factor income from abroad) is recorded while the balance is computed as residual from the savings-investment identity, has hovered around 30 percent during the three past years, although still 1.85 percentage points higher than the domestic investment rate. The excess of national savings over investments reflects weakness in domestic investment expenditure which is also borne out by the positive current account balance. Question to be answered: are we exporting our savings?

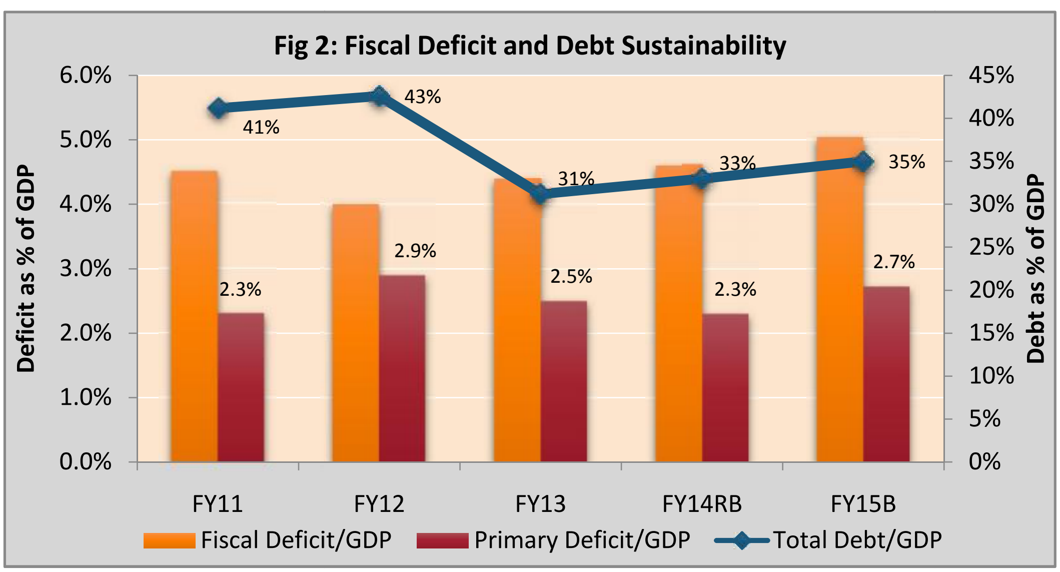
Table 3. Saving Investment and Investment-growth nexus

(In percent of GDP)	FY12	FY13	FY14(p)
Gross Domestic Investment	28.26	28.39	28.69
Private	22.5	21.75	21.39
Public	5.76	6.64	7.3
Incremental Capital output ratio (ICOR)	4.33	4.72	4.69
Gross National Saving	29.86	30.53	30.54
Saving-Investment gap	1.6	2.14	1.85
Current Account Balance	-0.3	1.6	0.9

Source: BBS



Macroeconomic foundations remain strong and stable. Despite all the talk you here on the street about investment and revenue slowdowns, major macroeconomic indicators remain on track, if not slightly improved. According to most analysts, the economy continues to have sound macroeconomic fundamentals needed for a take-off into higher growth trajectory. Sound macroeconomic management for prolonged period has yielded (a) higher average growth every decade, (b) low volatility of growth rate, (c) sustainable fiscal deficits through prudent expenditure management in the face of low revenue yields, (d) low internal and external public debt (Fig.2), and (e) stable balance of payments and exchange rates leading to accumulation of comfortable foreign exchange reserves, to name a few. Prudent debt management for a long time has contained Bangladesh's overall public debt at 35% of GDP, which has been on a declining trend in the past decade. External debt at 18% of GDP with debt servicing ratio of 8.6% also reveals sound external debt financing capability. On the downside, though inflation has been moderating lately, thanks to



Source: Ministry of Finance

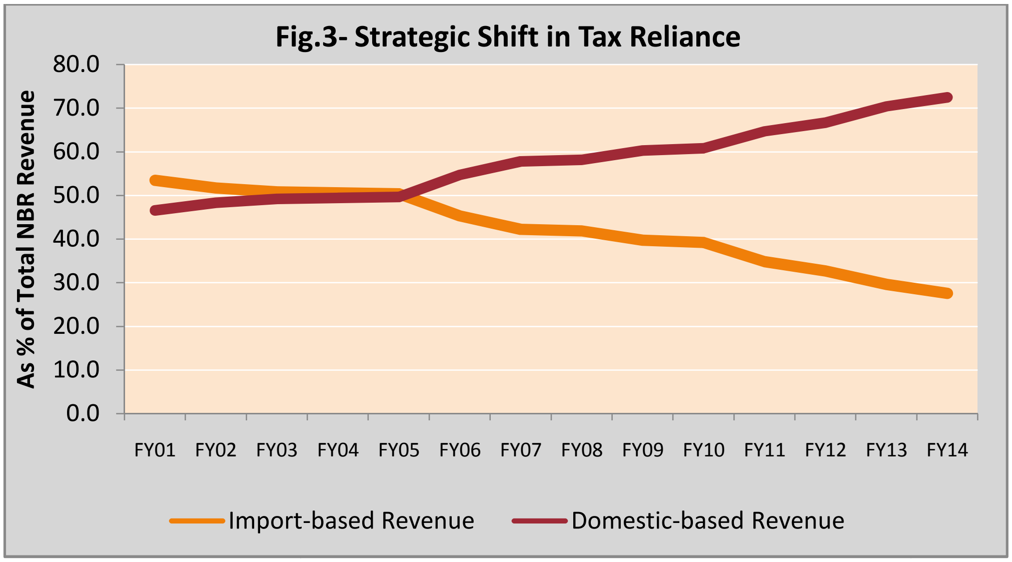
decline in non-food inflation, overall inflation remains stubbornly high in excess of 7%. There are major problems in financial intermediation stemming from deep-rooted ailments in the banking sector – scams, insider lending and non-performing loans, predominantly in state-owned banks. The equity market which remains shallow has been only marginally helpful in mobilizing investible resources for a fast-growing manufacturing and service sector.

Table 4: NBR Revenue Growth (%)

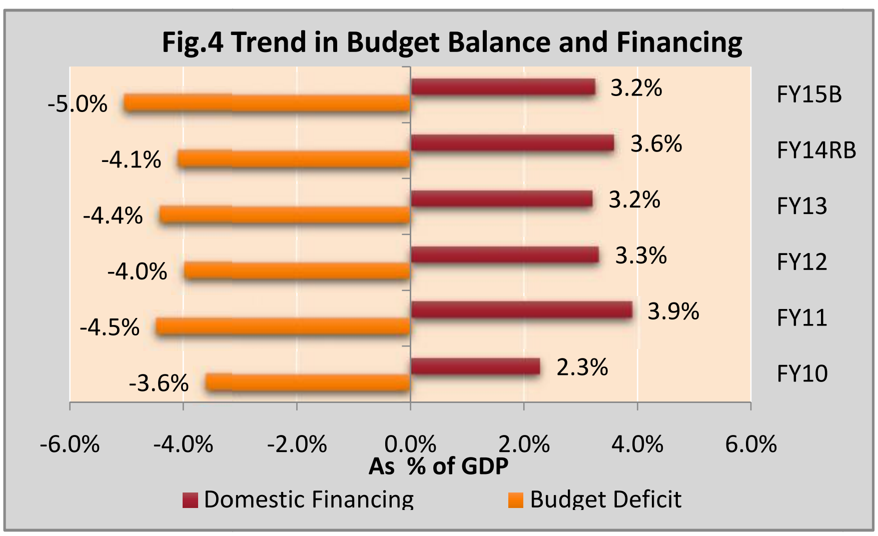
	FY10	FY11	FY12	FY13	FY14	FY05-09	FY10-14
NBR tax	**13.9**	**32.4**	**19.4**	**15.6**	**10.4**	**15.2**	**18.3**
Custom duty	9.2	9.7	18.7	-0.4	2.4	5.9	7.9
VAT (Import)	6.9	26.0	8.5	10.6	3.2	16.3	11.0
SD (Import)	45.3	17.6	3.7	1.5	3.3	10.2	14.3
Import- based	**12.2**	**17.7**	**11.9**	**4.6**	**2.9**	**10.0**	**9.9**
Income tax	16.8	40.2	24.4	31.4	15.6	24.8	25.7
VAT (Domestic)	15.1	41.6	23.7	19.6	10.9	20.8	22.2
SD (Domestic)	11.0	41.8	23.8	-0.2	13.9	12.0	18.1
Others tax	8.3	30.9	-33.7	127.1	6.8	10.7	27.9
Domestic-based	**14.9**	**40.8**	**23.0**	**22.2**	**13.6**	**19.8**	**22.9**

Source: NBR

Slowdown in Fiscal Development. The political turmoil that plagued the country in FY14 adversely affected business sentiment and confidence, in addition to affecting consumer confidence. Revenue collection became a casualty. This was clearly reflected in the revenue performance for the year which slowed down considerably, in both the domestic and the import side. The month-on-month performance of NBR taxes showed a burgeoning deficit, which worsened during the second and third quarter of the year. However, after the general election was held and relative calm was achieved in the political front, the last quarter showed some improvement. Despite this, the cumulative revenue shortfall from target for the year was significant amounting to BDT 162.2 billion, which is almost four times higher than the shortfall in FY13 of BDT 41.8 billion. Almost 80% of the shortfall came from domestic based taxes, which reflects the slowdown in economic activity and the decline in consumer and business confidence. The NBR revenue growth target has been set at 13.7% in FY15 which is lower than the FY14 revenue growth target. It seems to be a prudent move considering the poor revenue performance in FY14. Despite this, NBR revenue must grow by almost 33% in FY15 over that of FY14 owing to the huge shortfall for the year.



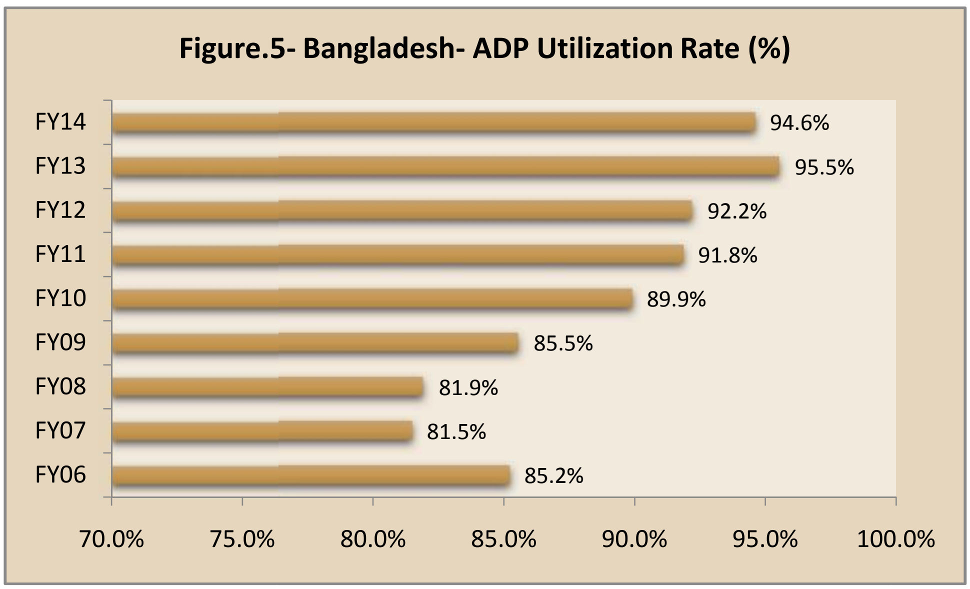
The trend of revenue collection continued to reveal the strategic shift from import-based revenue to domestic revenue (Fig.3). This is an encouraging trend since reliance on import-based taxes create significant distortion of incentives in the market resulting in misallocation of resources. Tax reforms consistently focus on increasing reliance on domestic based taxes on consumption (e.g. VAT) or direct taxes on individual and corporate income. In that sense, NBR's tax effort appears to be moving in the right direction but rather slowly.



Source: Ministry of Finance

The government's fiscal management during the year was prudent as they managed to adjust government expenditure in line with the slowdown in revenue, thereby maintaining the deficit at below 5% of GDP, at 4.1%. However, as shown in Fig. 4, the major portion of the deficit was financed not from foreign but domestic sources, a higher cost financing mode with adverse implications for inflation and private investment. The political instability in the country affected foreign lenders as well. Slowdown in project implementation adversely affected the inflow of foreign funds into the country. In FY15, the government seems confident in its fiscal management abilities and has set the budget deficit target at 5% of GDP, despite a seemingly overambitious revenue target. It is expected that the inflow of foreign financing of the budget deficit would be about 1.8% of GDP in FY15, which may materialize if the political situation in the country remain stable.

The implementation of the Annual Development Program (ADP) slowed down significantly in the second and third quarter of FY14, with delays in project implementations. This raised serious doubts about whether the government would be able to maintain the 95.5% implementation rate of ADP which was achieved in FY13. However, as has been the trend in the past, the government managed to utilize a significant portion of the ADP budget in the last quarter of the year and achieved a respectable utilization rate of 94.6% for the year (Fig.5).



Source: Ministry of Finance

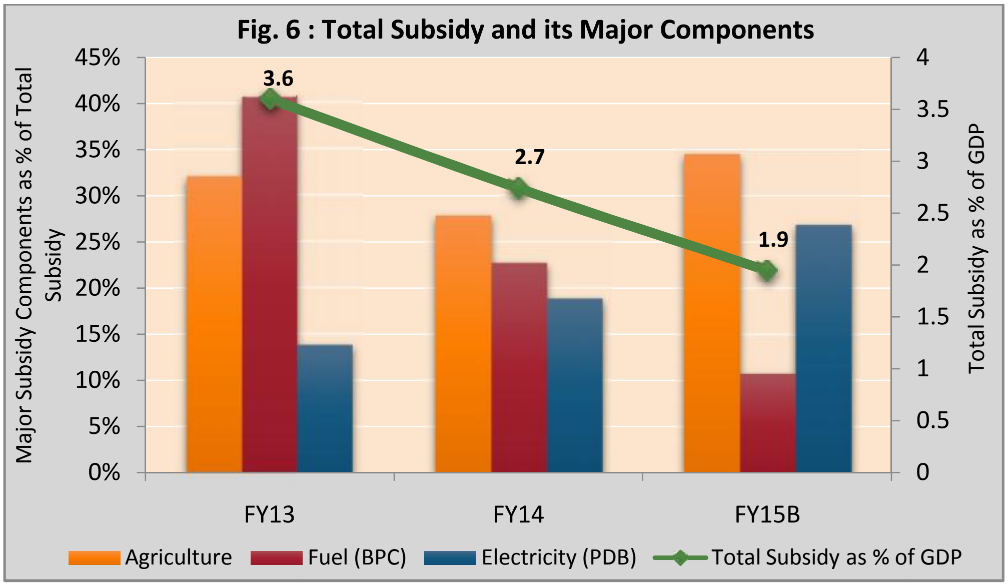
Table 5- Trend in ADP Allocations

ADP Allocations by Major Sectors (% of Total ADP)							
	FY09	FY10	FY11	FY12	FY13	FY14RB	FY15B
Total ADP	100%	100%	100%	100%	100%	100%	100%
Agriculture	5%	6%	6%	6%	4%	4%	7%
Electricity	10%	9%	16%	16%	14%	15%	12%
Energy and Mineral	1%	4%	3%	2%	3%	4%	3%
Transportation	10%	12%	14%	14%	15%	26%	24%
Education	13%	15%	13%	10%	14%	15%	15%
Health	11%	10%	8%	7%	7%	7%	5%
Social Welfare	1%	1%	3%	4%	5%	4%	5%
Source: IMED							

In light of this, a large ADP budget of BDT 800 billion was set for FY15 which is 33.6% larger than the revised ADP of FY14. This means that in order to maintain the utilization rate of 95%, the government must put in much greater effort as the budget is more than one-third larger than that of FY14. The sectoral allocation of ADP for FY15 (Table 5) shows that greater emphasis has been given to the agricultural sector; while there have been minor declines in allocation to the transport sector. Education remains a priority with allocations remaining stable at 15% of total ADP budget, and allocation for the social welfare has been increased. While government's interest in the social sector is encouraging, the decline in health expenditure allocation from 7% to 5% of total ADP from FY14 to FY15B is a cause of concern. There has also been a decline in allocation for the electricity and energy and minerals sectors which is a red flag, since it is evident that the power sector is in dire need of funding and development.

To be fair, the government's fiscal management in FY14 appeared quite judicious in light of the prevailing political situation, and the consequent economic slowdown. While increased efforts need to be put on the revenue generation side, NBR needs to step up its efforts – through tax reforms and efficiency improvements -- in order to achieve the ambitious target for FY15. The government should continue to monitor its expenditure in line with the revenue performance so as to maintain the deficit at a manageable level as well as achieving the necessary development targets for the year.

One of the challenging areas in fiscal management continues to be the subsidy bill which has tended to get out of hand recently due to the rising demand for petroleum by fuel-based power projects that have come on stream. But there is some good news on that front. For the first time in many years, the subsidy bill is falling, primarily due to the fall in international price of petroleum. After exceeding the budget target in FY13 and FY14, a lower target of BDT260.5 billion has been set for FY15 on the expectation of significant reduction in fuel oil prices which have fallen 40% in the first four months since June 2014 and is expected to slide further, according to forecasts. As a share of GDP, after rising to 3.6% in FY13, the subsidy bill is on a downward slide and is expected to be only 1.9% of GDP in FY15, if fuel prices continue on their current course. As usual, agriculture takes the lion's share of the subsidy bill (e.g. due to input subsidy on fertilizer), followed by electricity, both of which are expected to rise in FY15 (Fig.6).



Inflation moderates but private credit growth eludes monetary impetus. Inflation is moderating, but much slower than one would like. Food inflation, which is more responsive to international price movements, remains stubbornly high though non-food inflation has declined significantly in response to monetary tightening directed towards achieving an annual inflation rate of 6.5% for FY15. Despite efforts by the Bangladesh Bank, private credit growth, stifled by political uncertainty, barely rose from its lows of 11% throughout the year.

Point-to-point inflation data shows that the problem of inflation control was made difficult by the steady rise in food inflation from 5.02% in December 2012 to 9.09% in May 2014 (Fig.7). Part of the rise was due to supply disruptions caused by the unrest of late 2013. Point-to-point food inflation rate, however, has since come down to 7.16% in October 2014, with general inflation at 6.6%, and non-food inflation at 5.7%. A feature of recent food inflation is that the gap between rural and urban food inflation has narrowed and the higher rural food inflation could be due to higher purchasing power from rural wage growth and expanded safety net coverage. Point-to-point non-food inflation steadily declined, from 9.09% in January 2013 to 5.16% in May 2014. This is most likely due to the adherence to the contractionary monetary program as well as a slowdown in credit growth and remittances. Average inflation has declined from 7.5% in December 2013 to 7.2% in October 2014 (Fig.8), largely due to the decline in non-food inflation while food inflation remained stubbornly high. All in all, progress towards achieving the targeted 6.5% inflation rate appears slow.

Fig.7: Point to Point Inflation (2005-06 Base Year)

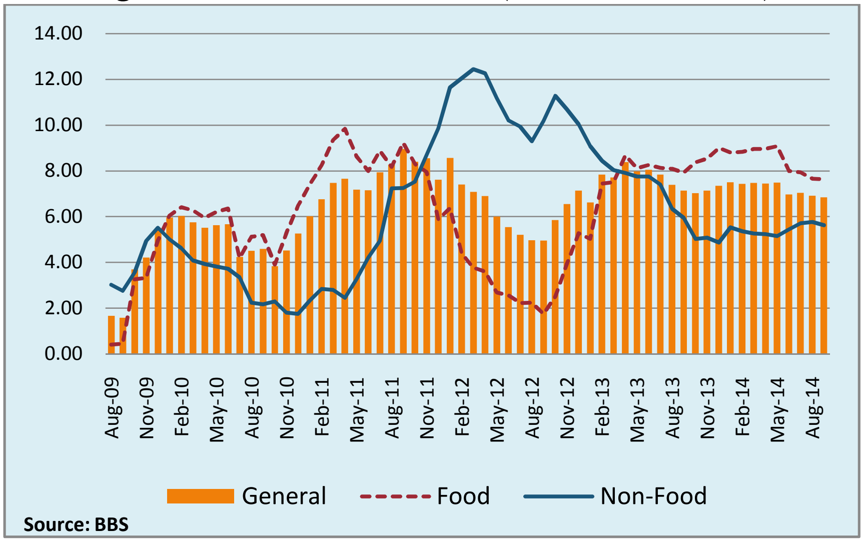
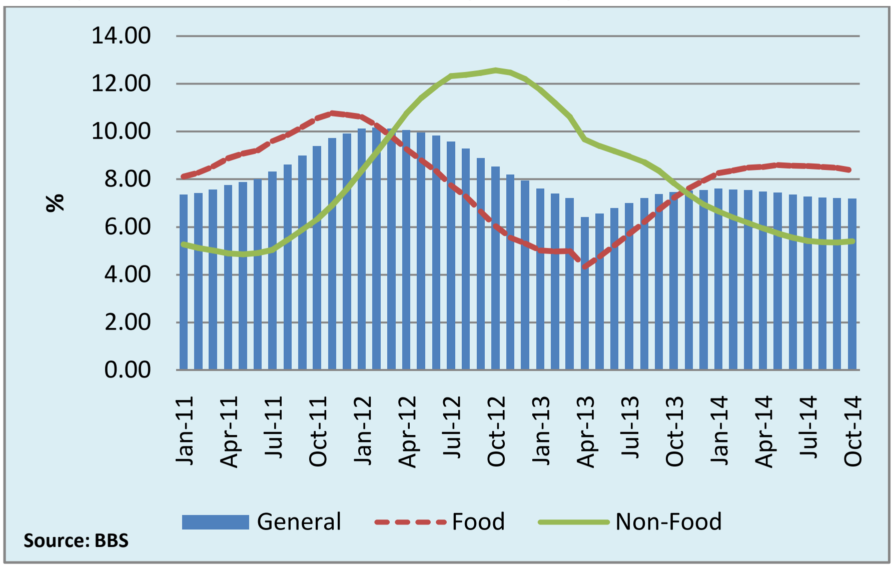
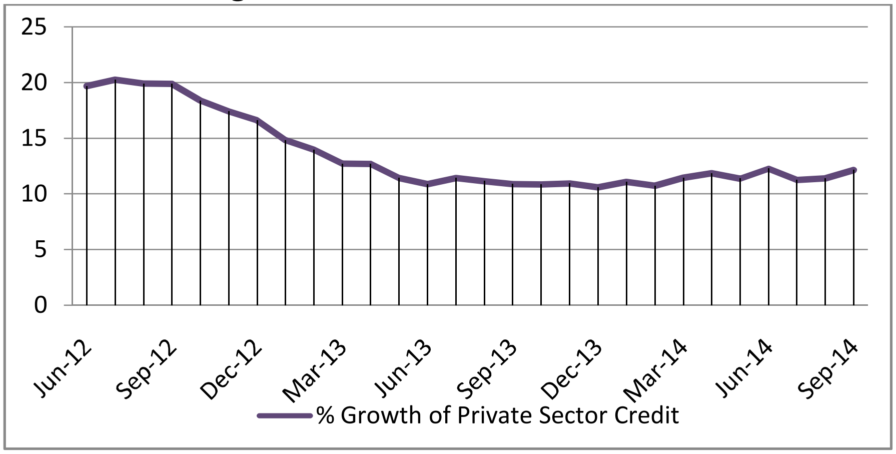


Fig.8: Inflation (12 Month Moving Average, 2005-06 Base Year)



Private sector credit. With a view to keep inflation under control (aiming to bring average inflation down to 6.5% by end of FY15), the central bank has tightened its monetary policy stance in part by restraining growth of private credit, the larger component of domestic credit (while ensuring that credit growth is sufficient to stimulate inclusive economic growth). In 2013, this was accomplished without much effort as private credit growth began to slide throughout the year, reaching 11% at end of FY13, in the absence of any appetite of the business sector for borrowing to finance new investments. Furthermore, since then the growth rate has largely hovered around the 11% mark (Fig. 9), with declining interest rates having helped private-sector credit growth in the past several months. Private sector credit growth rose to 12.15% in September, as the overall import payment increased significantly in the first quarter (Q1) of the current fiscal year. This latest trend in modest growth of private credit may be attributed to a stable political climate since January. However, it seems highly unlikely that the target private credit growth of 16.5% by end December can be met.

Fig 9: Private Sector Credit Growth

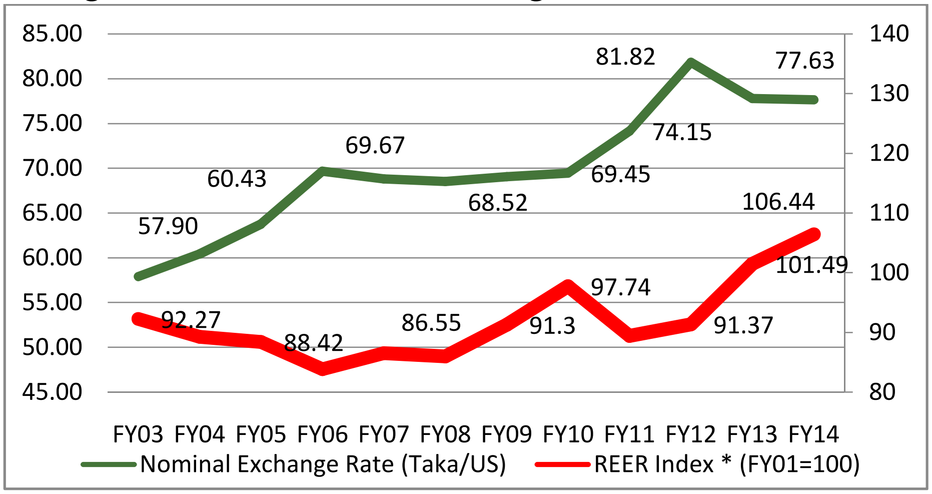


Source: Bangladesh Bank

Exchange Rate Management and trends. The latest Monetary Policy Statement (June – December 2014) has continued on the stance to preserve external sector stability, build up reserves and avoid excessive volatility of the exchange rate. Improved external balances are reflected in the accumulation of international reserves of about USD2.8 billion during second half of FY14 with gross reserves of around 21.6 billion at the end of June 2014, sufficient to cover over six months of projected imports. The Taka - US Dollar nominal exchange rate remained stable in second half of FY14 and BB's interventions in the foreign exchange market have significantly limited the loss of external competitiveness by stemming any significant appreciation of the Taka, as well as keeping the Real Effective Exchange Rate (REER), which adjusts the nominal exchange rate for differences in domestic inflation and those of its main trading partners, from significantly appreciating and thus hurting export competitiveness. In FY14, while the Nominal Exchange Rate of Taka against the US Dollar has hovered closely around the 77.6 mark (End Value in FY14 was 77.63, compared to 77.77 in FY14), higher relative inflation meant that the Real Effective Exchange Rate had appreciated considerably since FY12 (Fig.10).

It is reported that the relevant agencies in Bangladesh are mulling options in the coming days to promote depreciation of Taka against US Dollar in order to prop up sluggish exports, which showed no growth during the first four months of FY15. As mentioned earlier, a persistent trend of high inflation has led to appreciation of Taka's real effective exchange rate in past two fiscal years, and since this trend threatens to undermine Bangladesh's export competitiveness, perhaps a prudent approach would be to address this issue of appreciation of real effective exchange rate so as to remove bottlenecks to export competitiveness.

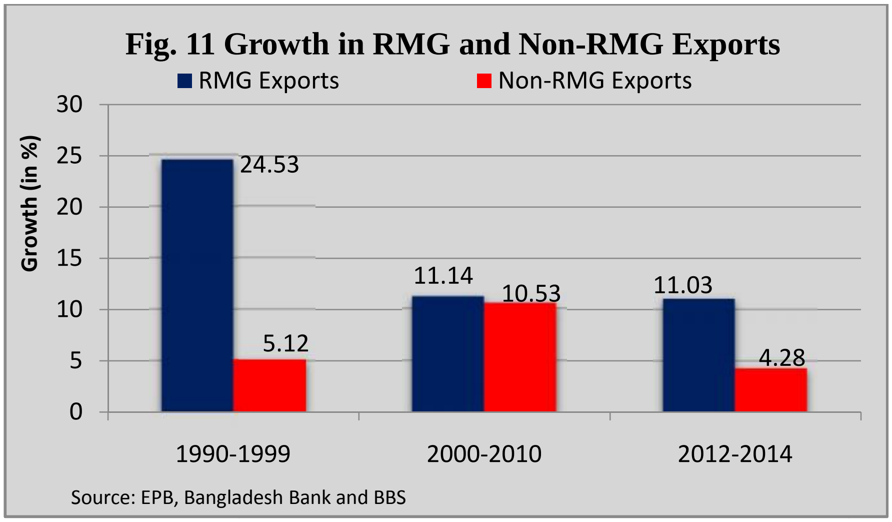
Fig.10: Trends in Nominal Exchange Rate and REER Index



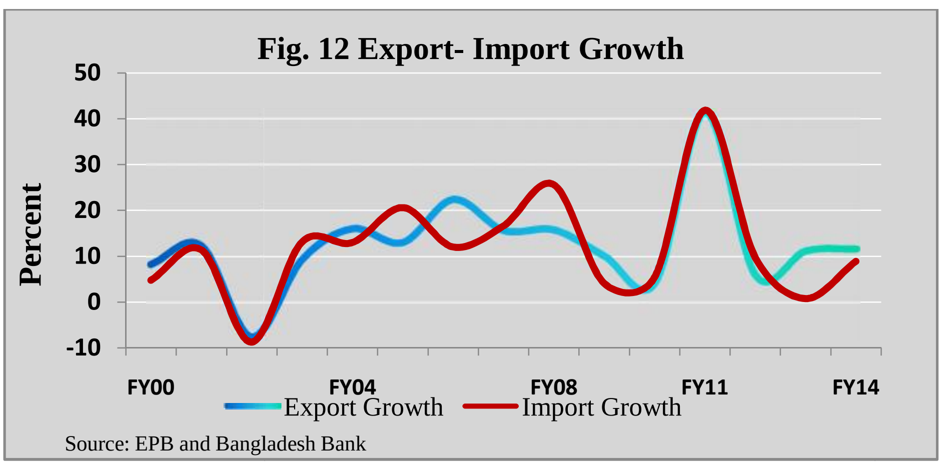
Source: Bangladesh Bank; * Increase in REER Index value implies appreciation

Export-Import performance. Exports, which grew by 13.6% in FY14, have been flat since the beginning of the current fiscal year, registering a decline of 1% during July-October, compared to the same period of last fiscal year. In order to clock 10% growth for FY15, exports will have to grow by some 15% in the next eight months. Overall exports might have suffered due to a number of reasons: (a) modest appreciation of the Taka, (b) lagged effect from the political turmoil of last year, (c) the image crisis suffered by RMG exports following the Rana Plaza collapse and Tazreen fire incidents, (d) the hike in labour wages, and (e) cancellation of orders by buyers from firms operating in shared buildings (30% of RMG firms operate under shared buildings). Some buyers switched to alternative RMG producing countries like Vietnam and India due to the non-compliance of safety standards by many Bangladeshi firms. The depreciation of the Indian rupees and the granting of GSP facilities to Pakistan were some other factors to note.

Non-RMG exports, which grew by only 3% in FY14, have been sluggish for the past several years and this year is no exception (Fig.11). Slow recovery of European and emerging market economies from the economic crisis of 2008-09 could be one proximate factor but the primary reason for their continuous poor performance is the prevalence of significant anti-export bias of the domestic trade regime.



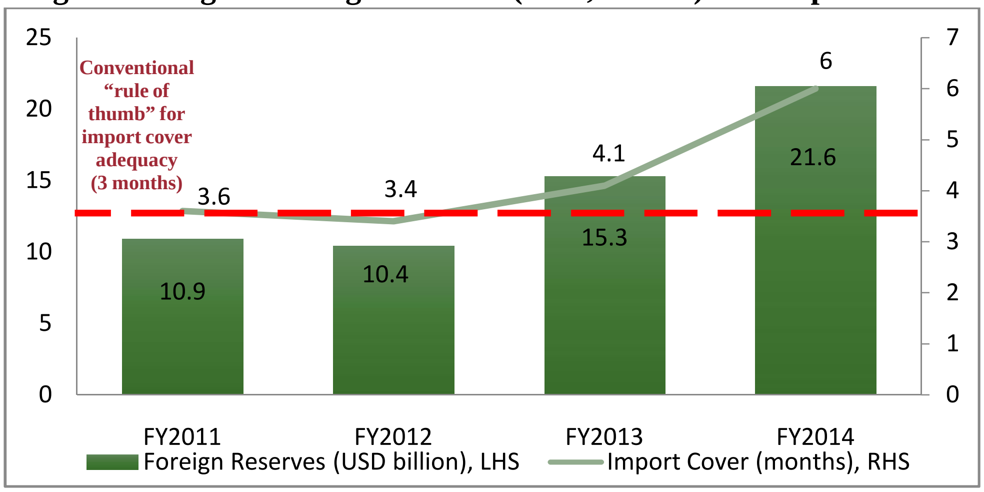
Imports. Imports have been sluggish for the past two years (Fig.10), averaging only 5% for FY12-14. Imports have started to pick up this year growing 13.6% in July-September compared to the last fiscal year. This was primarily due to an increase in imports of crude oil, industrial raw materials and capital machinery as business confidence is picking up to and domestic investment might be getting back on track.



The Current Account Balance. The current account balance of Bangladesh has been positive for most of the years since 2001 due to the superior performance of exports and significant inflow of remittances. The deficit in merchandise trade (export minus import) has been more than compensated by foreign exchange earnings from exports and remittances. A positive balance however also signifies under-investment in an economy like Bangladesh which needs to investment heavily on building human capital and infrastructure. The country's current account balance has remained within prudent limits of under 1% of GDP even when running deficits.

Foreign Exchange Reserve developments. As of November 2014, foreign exchange reserves stood at USD 21.5 billion (Fig.13). With this, Bangladesh becomes second (behind India) in the holding of foreign exchange reserves in the subcontinent. This improved performance in FY14 may be attributed to the positive impact of recently announced 6-month monetary policy statement, improved remittance inflows, increase in export as well as a decline in imports (over the past year), complemented by the recent inflows of extra remittances on occasion of Eid-ul Fitr and Ei-ul Azha in August and October respectively.

Fig.13: Foreign Exchange Reserves (USD, Billion) and Import Cover



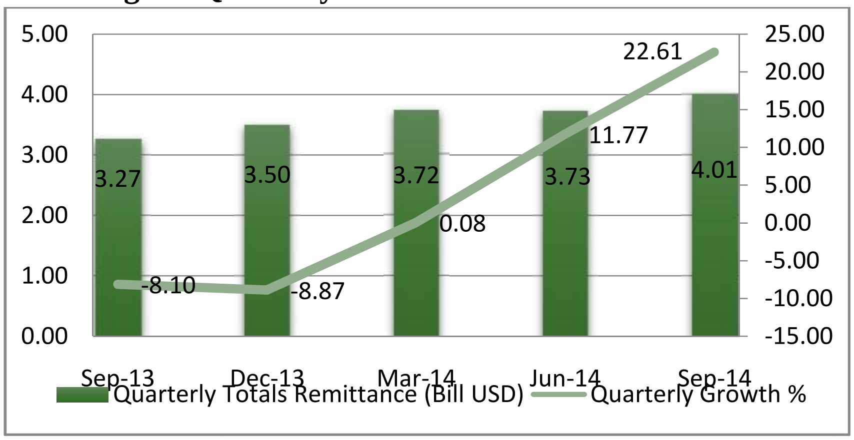
Source: Bangladesh Bank

These high reserves are expected to settle import bills for around six months, which is comparable to many East Asian economies like South Korea, Singapore, Hong Kong, Indonesia and Malaysia. The high reserves will help boost the country's credit rating. It will be possible to make foreign borrowings at competitive rates, which will help increase investment. In addition, these high levels of reserves may also act as a cushion against balance of payments crises (for example, this strategy paid off handsomely for the East Asian economies as they were significantly less affected by the recent global economic crisis).

However, reserve buildup is not without its associated costs. First, return on foreign exchange reserves is generally much lower than return on domestic assets in developing countries, and, in case of Bangladesh, it is less than 1%. This implies a significant income loss for the central bank. Second, a rapid reserve buildup also complicates monetary management for the central bank, as in the case of Bangladesh, for every dollar increase in reserves, Bangladesh Bank injects more than Tk. 77 of high powered money into the banking system. When reserves accumulate at a faster pace than envisaged under the monetary programme underpinning the Monetary Policy Statement (MPS) of Bangladesh Bank, both reserve money and broad money would tend to exceed their targets established under the MPS. This would lead to tensions in monetary management and can potentially undermine the inflationary target of the central bank and the government. That tension was partly averted by the slower growth of private sector credit. Finally, if the central bank were to intervene in the money market to sterilize the excess liquidity by issuing treasury bills or central bank bonds, it would incur significant quasi-fiscal costs and reduced central bank profit.

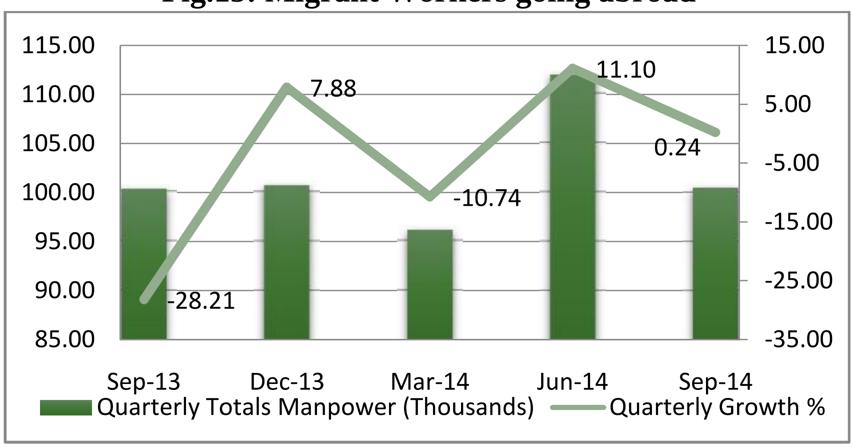
Manpower Exports and Remittance Situation. For the first time since 1999, remittance inflows declined by 1.6% in FY14. There is a turnaround in that situation as remittance inflows in the first quarter of FY15 grew 22.6 % over the same period of FY14 (Fig. 14), perhaps due to mounting inflows due to Eid-ul-Azha. The forecast is for a pick up for the rest of this fiscal year, helping to compensate for the lackluster performance in FY2014.

Fig.14: Quarterly Remittance Flows and Growth



Source: Bangladesh Bank

Fig.15: Migrant Workers going abroad



Source: Bangladesh Bank

Bangladesh has once again taken a spot among top ten remittance-earning countries on the back of an upgrade in the legal status of migrant workers in Gulf countries, according to a World Bank report, thanks to resolution of some of the problems relating to the legal status of Bangladeshi migrants in GCC (Gulf Cooperation Council) countries. Thus growth in remittance to Bangladesh this fiscal year is likely to be better than the South Asia average of 5.5 percent if the remaining legal status problems are addressed and the freeze on Bangladeshi labour recruitment in Middle East is lifted. There is an improved outlook from the rise in skilled migrant workers, such as to Korea and Malaysia. Consequently, there is a slight uptick in migrant worker outflow in the first quarter of FY15, compared to a decline of 7.3% for the entire FY14 (Fig.15). What may factor for the relatively large rise in remittance despite a relatively small increase in number of migrant workers going from Bangladesh can be an increase in average earnings per migrant, which may be attributed to a recent revision in workers' pay scale in the Middle East.

The Direction of Trade Policy. The last year has seen some positive change in the direction of Bangladesh's trade policy scenario which could have some impact on its trade performance over time. Bangladesh, a major beneficiary of the multilateral trading system represented by WTO, supported the Trade Facilitation Agreement (TFA) emerging from 9^{th} WTO Ministerial in Bali as an essential part of the Bali package. When implemented by all WTO members, the global scheme is expected to add one trillion dollars to global GDP and create employment for 21 million with significant gains expected for low income countries. In this respect, TFA will enable Bangladesh to reduce transaction costs through investment of both the technical and financial nature in trade related infrastructure along with a new orientation in trade policy. As an LDC, Bangladesh can tap into these benefits from the TFA, if it is able to identify the problem areas and make infrastructural development and policy changes to practice modern customs systems and behavior in order to access the full merit of the Bali outcome on trade facilitation.

On the domestic front, the two main policy changes coming from the 2014-15 budget are (a) reduction of supplementary duties on over 700 products or tariff lines, and (b) reduction of input duties for selected locally produced consumer products and medicines. These notable tariff and para-tariff adjustments carry significant consequences for economic activities and agents through the transmission mechanism of tariffs to prices. While trade theory provides analytical basis for price effects of tariffs, domestic producers are smart enough to know how tariffs protect them from import competition – inaccurately described as 'uneven competition'. Import tariffs work as an indirect subsidy for domestic import substituting producers allowing them to increase their unit price by at least the tariff mark-up. On the other hand duties on imported raw materials drive up the producers' costs reducing profitability. So lowering tariffs on inputs has the effect of increasing profitability just as raising tariffs on competing imports. To summarize, higher tariff on an imported consumer product creates the scope for a domestic producer of import substitute to raise prices and increase profitability; lowering of tariffs on inputs also raises profitability by reducing costs.

Supplementary Duty (SD) is the main component of para-tariffs in Bangladesh's trade policy. SD was introduced in 1991 under The VAT Act as a trade neutral tax, i.e. imposed at an equal rate on imports as well as domestic production. In application, SD and RD serve as the standard means for raising revenue or affording protection to domestic import substituting industries. This is borne out by the fact that SD is imposed only on products that are already subject to the highest CD rate of 25%; and 83% of products subject to SD are final consumer goods (FCG) with competing domestic production (Table 6).

Table 6: Distribution of Top CD and SD by Product Category (FY2015)

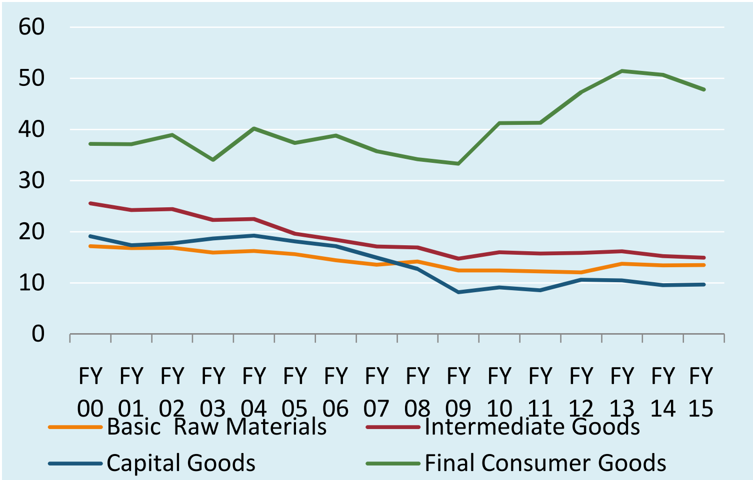
	Top CD Rate (25%)		Supplementary Duty		Average NPR (%)
Product Category	**#HS8 Codes**	**Share (%)**	**#HS8 Codes**	**Share (%)**	
Final Consumer Goods	**2140**	**74.13**	**1216**	**82.89**	**48.0**
Intermediate Goods	**517**	**17.91**	**152**	**10.36**	**15.1**
Capital Goods	**159**	**5.51**	**60**	**4.09**	**9.7**

Basic Raw Materials	**71**	**2.46**	**39**	**2.66**	**13.9**
Total	**2,887**	**100**	**1,467**	**100**	
Average (IG, CG, BR)					**12.9**

Source: Operative Tariff Schedule based on NBR ASYCUDA database; PRI staff estimates

Excluding the high rates on cars, alcoholic beverages, and cigarettes, PRI estimates that the average nominal protection rate (NPR) works out to 48% for final consumer goods, against the average of 15% for intermediate goods that are mostly imported. The average for all the input categories (IG, CG, BR) works out to only 12.9%, creating a deep wedge between output (consumer goods) and input tariffs in Bangladesh indicating a very high rate of tariff escalation (Fig.16).

Fig.16: Average Tariff on Import Categories



Source: PRI staff estimates; NBR ASYCUDA database

The incentives created from such a tariff regime effectively protect domestic industries from competition, creates revenue loss from too high tariff rates, and finally generating anti-export bias for firms which engage in both production for export and domestic sales. The direction of change in SD in the current budget towards reducing half of the tariff lines subject to SD, i.e. 773 out 1467 predominantly for FCG, half of which has domestic production, indicates a moderate shift in the direction of lowering protection. In consequence, on a positive course, average NPR on consumer products declined by two percentage points where it was on a rising trend since FY09 (Table 7). This in affect translates to some relief for consumers in the form of lower prices allowing for a modest doze of import competition if this change is carried forward as a long-term trend. In terms of revenue outcome, this move is likely to be favorable as some of the high protective tariffs served as de facto bans on imports.

Table 7: Recent Tariff Trends

Tariffs (%)	FY 01	FY 09	FY 14	FY 15
Avg. CD (Un- weighted)	21.1	13.8	13.2	13.2
Avg. para-tariffs	7.4	6.3	14.9	13.5
Avg. Nominal Protection	**28.5**	**20.1**	**28.1**	**26.7**
Top NPR	59.0	72.5	108.0	108.0
Top CD rate	37.5	25.0	25.0	25.0
Share in NPR (%): CD	74.7	68.8	47.0	49.3
Share in NPR (%): Para Tariff	25.6	31.2	53.0	50.7

Source: NBR & PRI staff estimates

The subsequent key tariff adjustment mentioned in the budget has been to reduce protection on a wide range of domestically produced consumer goods. A number of high profile sectors were identified for protection support (raising profitability and protection levels) primarily by scaling down CD on inputs which are basic raw materials and intermediate goods. These sectors include Alopethic and Ayurvedic medicines, poultry and livestock industry, paper, ceramics, furniture, plastic, baby diaper, and electrical goods. Despite this being a popular move, these choices are similar to the focus of our industrial policy in picking winners by selecting and promoting 'thrust' sectors (e.g. ship building) through incentives without a thorough understanding and research reflecting what makes these choices the most viable sector for future export. The selections decided in the current budget leaves unclear as to the rationale behind selecting this particular sectors and not other equally or more promising sectors and if the price effects and consumer interests related to these duty adjustments have been properly thought through.

The problem here lies with granting discriminatory effective protection levels to different industries or products as a result of a protection policy relying on non-uniform tariffs. Consequently, these discriminatory tariff adjustments become subject to lobbying by particular business quarters making it difficult for policy makers to come to a judicious assignment across all sectors. However, economic principles dictate that consumers are bound to get some price relief on those FCG facing reduction in SD. However in the case of input tariff reductions, this will simply reduce cost and raise profitability for concerned domestic producers rather than translating to any improvement in efficiency or production.

Nevertheless, the present direction of cut-backs in para-tariffs brings a refreshing change to the trade regime. In addition, policies and trade infrastructure have been focused with our inclusion in the TFA and the way forward. This includes working towards paperless and electronic customs procedure by expanding the coverage of ASYCUDA World system to other Land Custom stations to ensure easy and automated trade transactions. The "Single Window" idea of trade facilitation needs to be embraced and rapidly implemented to let traders cut through multiple layers of bureaucracy and dispersed location of trade certification agencies. Following the policy and procedure of WCO, Bangladesh has ratified International Convention on Simplification and Harmonization of Customs Procedure of WCO or Revised Kyoto Convention (RKC). Accordingly, Bangladesh customs will follow WCO standards and procedures allowing for faster and efficient trade. Within an ever globalizing arena, it is important for Bangladesh to reflect carefully on its trade policy choices which may require difficult adjustments away from simply protecting the interest of its domestic producers and towards integrating itself globally and regionally through a more diversified and competitive export basket.

Emerging mega trade partnerships. Finally, it is important to take note that multilateralism of the WTO kind is not dead but in serious trouble. Two mega free trade and investment agreements (termed as partnerships) -- TTIP (Trans Atlantic Trade and Investment Partnership) and TPP (Trans Pacific Partnership) – are under negotiation among countries of the Atlantic rim (TTIP) and the Pacific rim (TPP). USA, belonging to both rims, is reportedly driving the initiative to bring the negotiations to closure. Together, these partnerships bring together countries that make up some 60% of the global economy. China is conspicuous by its absence in both partnerships though it is a major Pacific rim country. Another similar partnership that is well advanced is the Regional Comprehensive Economic Partnership (RCEP), the grouping of ASEAN+10 (i.e. ASEAN plus countries that have signed FTAs with it, including China and India). Perhaps as a bulwark against the possible emergence of TPP and TTIP, China, the host of the recently concluded APEC summit in Beijing, proposed a fast track free trade agreement for developed and developing countries under the much larger umbrella of Asia-Pacific, namely, the Free Trade Agreement of Asia-Pacific (FTAAP). Geographically, Bangladesh is not eligible for the first two partnerships, but it could be a candidate for RCEP and FTAAP. However, it would have to prepare itself for reaching FTAs beyond South Asia and that would require significant transformation of its current posture in trade policy, where domestic producers will have to learn to live with much lower levels of protective tariffs than currently exists.

There are several reasons for the emergence of these partnerships beyond the multilateral institution represented by WTO; disenchantment with the WTO decision making process is certainly one of them. WTO decisions are based on consensus among ALL members, and negotiations close on the principle that nothing is agreed until everything is agreed --- the single undertaking. Result? WTO Rounds are taking longer to come to closure; the Tokyo Round (1964-67) took 4 years, Uruguay Round (1986-94) took 9, and the Doha Round which began in 2001 is yet to come to closure. The Atlantic and Pacific partnerships, once signed, are likely to be elite clubs involving free flow of goods and capital, but with stringent compliant rules on standards relating to SPS and TBT, rules that low income countries will have difficulty meeting without special and differential treatment, something that these partnerships would be reluctant to grant.

So, while abiding by the rules of WTO multilateralism, Bangladesh should gear up its economic diplomacy in order not to be left out of some of the emerging mega trade and investment partnerships. Because, just as China will lose out when TTIP and TPP are functional, Bangladesh will lose by being left out of the free trade and investment arrangements that will be exclusive to members of the mega partnerships. However, properly positioning itself for a possible FTA deal with ASEAN+ and under the larger umbrella of FTAAP sometime in the future would remain an option for Bangladesh to pursue.

Looking back to look ahead. The standard narrative on the Bangladesh economy has been that it has made significant strides in growth, poverty reduction, and many indicators of human development. Should this give rise to complacency in policy making circles it is time that that narrative take in to account what most analysts at home and abroad have been saying, that this country has tremendous potential to grow at a much faster pace than what has been achieved. While Bangladesh economy has registered rising and stable growth every decade, other comparator countries have done even better and some like Vietnam, Indonesia, and Myanmar appear poised to seize growing opportunities in international trade and investment. Much of our future economic progress will depend on our ability to create productive jobs for the two million workers joining the labor force every year, and this would have to be through massive expansion of trade and investment, sourced from local and foreign investors. However, several widely watched global indicators like the World Bank's Doing Business and Logistics Performance Index, do not see Bangladesh as improving its rank over time. Our trade orientation and investment climate for foreign investment leave much to be desired though it must be recognized that lately some high level diplomatic overtures to East Asia (e.g. Japan, China, Malaysia) should yield significant positive dividends if the follow up domestic support activities are timely and adequate.

Indeed, East Asia holds bright prospects for Bangladesh's economic integration with some of the fastest growing Multi-National Enterprises (MNEs) who have established production networks in ASEAN and South Asia, including India. It is high time for Bangladesh to take a slice of the fast growing pie of East Asia value chains and benefit from the fastest growing segment of international trade – trade in tasks, or its equivalent, trade in intermediate goods. Bangladesh cannot afford to miss this boat in which even Myanmar, Cambodia, and Laos are about to get on. A new approach to our industrial and trade strategy needs to be incorporated into our forthcoming 7th Five Year Plan (2016-2020), one that promotes joint ventures with MNEs in the production of parts and components (e.g. auto parts, and parts of electronic and electrical goods) of final goods and then engage in trade across borders in a "high-frequency synchronized" transaction mode. That would call for developing a seamless customs regime of the 21st century, one that is focused on trade facilitation rather than revenue collection, which is the ultimate goal of the Trade Facilitation Agreement that Bangladesh has endorsed under the Doha Development Round (DDA).

Just as trade-led economic growth in Bangladesh has contributed significantly to the attainment of several key Millennium Development Goals, the same would be expected for trade to play in the delivery of the Post-2015 Development Agenda, christened as the Sustainable Development Goals. With that objective, trade will have to be mainstreamed in Bangladesh and trade policy recognized as a development policy instrument that is not limited to the trade liberalization process but as a mechanism to seize the opportunities created by the rules-based multilateral trading system under the WTO and the evolving industrial patterns around the globe.

Let us hope that the political clouds will clear soon and the inherent dynamic but latent forces will be unleashed again to restore growth momentum to the upper limits of the economy's potential. If history and past record of resilience is any guide, the nation will come up with ways to overcome its odds, formulate a mix of orthodox and indigenous policies to confront economic challenges, diversify its stubbornly concentrated exports basket, exploit the demographic dividend, attain higher goals of human development, and eventually eradicate poverty in a generation.

Dr. Sattar is Chairman, Policy Research Institute of Bangladesh
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