ISSUE 9

# ECONOMY ON A ROLL… BUT TOUGH TIMES AHEAD?

State of the Economy 2016

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"Booming Bangladesh" and "Bangladesh's economy is on a roll", beamed the leading British magazine The Economist in its largely effusive assessment of the Bangladesh economy and its prospects, on the eve of the visit of Chinese President Xi Jinping in October this year. It did not miss the point that the Bangladesh economy was on track to clock another year of 7%+ GDP growth, after recording its first ever 7% growth performance in the previous fiscal year, FY2016 -- all in tune with the targets of the country's 7th Five Year Plan (2016-2020). In this backdrop, as many as 27 memorandum of understandings (MOUs), project loans, and cooperation agreements were inked between China and Bangladesh, during the historic one-day visit of the Chinese Head of State, with financial commitments exceeding $20 billion. Japan, we are told, has some $7 billion on offer to build seaports, an LNG plant and several power plants. Russia has already committed loans totalling $11.5 billion for two nuclear reactors; and India is already sharing electricity from its grid in addition to committing $1.5 billion for a mega power plant. The World Bank and Asian Development Bank together seem ready to commit some $15 billion of concessional finance over the next 5 years. All of this commitment takes a big bite out of the resource constraint that Bangladesh faces in bridging the colossal resource gap to build its infrastructure of the future.

***State of the global economy:*** Aid and trade together make the Bangladesh economy far more integrated with the world economy today than it ever was. Prosperity around the globe brings good tidings for our economy as well. But there are challenges emerging from the state of the global economy and outlook for the near-term. "Economic stasis", a state of sustained low growth, appears to have taken hold of the developed economies of Europe and North America, the major export markets for Bangladeshi goods. IMF's Managing Director, Christine Lagarde, once described this as the "new mediocre" that the world will have to cope with. Fareed Zakaria, writing in the latest issue of Foreign Affairs, looks deeper into the malaise that afflicts developed countries and finds four principal determinants of the low growth syndrome: demographics, globalisation, technology and budgets. This is how he describes the deleterious impacts of these factors on growth. First, as families get smaller, fewer workers enter the labour force, while the ranks of retirees swell by the year. Second, with entrenched globalisation developed country markets are most open, and products can be manufactured in low-wage economies like Bangladesh and shipped to the advanced countries. Third, technology reinforces the effects of globalisation thus rendering certain low-skilled jobs obsolete. Finally, the rising fiscal burden in developed countries has sapped resources away from investment in productivity enhancing infrastructure, among others. The USA is strapped with a net debt-to-GDP burden of $18 trillion or 81% of its GDP, while the European Union averages 67%, compared to Bangladesh's public debt of only 40% of GDP. All these factors combine to stymie growth to the lowest levels experienced in decades. Bangladesh economy has to count on global prosperity for its export dynamism and job creation at home. The danger is that Bangladesh's export-led growth could become a casualty of sluggish growth in its major markets.

***Output growth:*** In its latest World Economic Outlook (WEO, October 2016), IMF projects global growth to decline to 3.1 percent in 2016 before recovering to 3.4 percent in 2017 (Table 1). The forecast reflects a more subdued outlook for advanced economies following the June BREXIT (Britain's exit from EU) vote in U.K. and weaker-than-expected growth in the United States. These developments have put further downward pressure on global interest rates, as monetary policy is now expected to remain accommodative for longer particularly in the developed economies.

**Table 1. Global Economic Outlook(October 2016)**

| | 2014 | 2015 | 2016 | 2017(p) |
|---|---|---|---|---|
| **World Output Growth** | 3.4 | 3.2 | 3.1 | 3.4 |
| **World Trade Growth** | 3.9 | 2.6 | 2.3 | 3.8 |

*Source: IMF, World Economic Outlook ,October 2016*

**Table 2. GDP growth and sector performance (%)**

| | FY 15 | | FY 16 | | FY 17 (7th FYP) | |
|---|---|---|---|---|---|---|
| | Share | Growth | Share | Growth | Share | Growth |
| **Agriculture** | 16.00 | 3.33 | 15.33 | 2.79 | 14.5 | 3.3 |
| **Industry** | 30.42 | 9.67 | 31.28 | 11.09 | 29.8 | 10.5 |
| **Of Which Manufacturing** | 20.16 | 10.31 | 20.77 | 10.30 | 19.1 | 11 |
| **Services** | 53.58 | 5.80 | 53.39 | 6.25 | 55.7 | 6.4 |
| **GDP Growth** | 6.55 | | 7.11 | | 7.20 | |

*Source :BBS , 7th FYP*

The IMF notes several underlying weaknesses as reflected in continuing decline in consumer spending in developed countries; Eurozone economic crisis and poor investment prospects are all adding to the slow growth to no growth situation. Declining real wages, rising unemployment, high levels of household debt are further exacerbating the current economic woes. Eight years on, the developed economies are still in a sluggish recovery mode following the Global Financial Crisis (GFC). The precarious nature of the recovery and the spectre of economic stagnation could ignite persistent calls for protection given the rising grip of populism in developed democracies. Such a fear is also shared by the OECD in its 2016 Annual Report pointing to the growing political and social opposition to freer trade that finds ardent constituencies in Europe and North America. Perhaps the November 8 election in the USA which catapulted highly protectionist Donald Trump on to the world stage could well be the harbinger of trade wars in the offing reminiscent of the 1930s beggar-thy-neighbour tariff hikes. If Mr. Trump's pre-election harangues about disappearing manufacturing jobs in the US were 'stolen' by China and Mexico are to be believed, and he makes good on his promises to his largest constituency, blue collar working class Americans, then a trade war could really be in the horizon. With that the post-GFC initiatives of G20 countries to keep global recovery on track by keeping protectionism at bay could become the first major casualty of Trumpism for the world to take note.

BRICS economies, the other group of large economies and potential future market for Bangladeshi products, are doing no better, though prospects differ significantly across countries and regions. Both Russia and Brazil are projected to achieve negative growth this year (i.e. in recession) but in 2017 they are expected move into a very modest positive zone. Russia is struggling with economic sanctions and falling oil prices. On the other hand Brazil's economic woes are further compounded by the political crisis resulting from the impeachment of President Rousseff. South Africa is also in deep economic and political crises. Falling exports, rising inflation, rapidly depreciating currency are all seriously impacting the economy though it is the political crisis arising from widespread corruption that is inhibiting the government's ability to address the economic crisis. But the Chinese growth prospects appear to be on track as envisaged in the 17th Five Year Plan (2016-20) at 6.5 to 7 per cent per annum. India is the star performer now among BRICS countries and is expected to achieve a growth rate of 7.6 percent this year and the next. India's drive to bring in economic reforms, lower oil prices and falling interest rates and inflation are contributing to this growth performance. Despite the current crises faced by many BRICS countries, it will remain a significant player in the global economy given its sheer size and vast resources. The combined nominal GDP of five BRICS countries now stand at US$16.6 trillion accounting for 22 percent of global GDP.

***Trade growth:*** The other global economic indicator of concern to the Bangladesh economy is the state of global trade.


Table 3. FY2017 GDP Growth Projections (%)

| | |
|---|---|
| World Bank | 6.8 |
| ADB | 6.9 |
| IMF | 6.9 |
| 7FYP | 7.2 |

According to WEO October 2016 the subdued performance of world trade flows persisted into 2015 and 2016, with the volume of world trade hovering at 2.6 and 2.3 per cent -- the lowest growth rate since the global financial crisis. The weakening pace of trade liberalisation and the recent uptick in protectionism are holding back trade growth, even though their quantitative impact thus far has been limited. The decline in the growth of global value chains has also played an important part in the observed slowdown. Global trade growth is expected to pick up to a moderate pace of 3.8 per cent in 2017, outpacing real world GDP growth, but still considerably below the rates witnessed during the pre-crisis period.

Continuing poor economic performance in the wake of the GFC in developed economies and very subdued economic growth prospect for developing economies are creating a fortress mentality in those countries. The WTO has forecast very slow growth in trade reaching the lowest level at just 1.7 percent this year since the GFC of 2008. Trade growth in 2017 is estimated to lie between 1.8 percent and 3.1 percent (Table 1). In the pre-GFC period trade was growing at double the rate of global GDP but in the post GFC period it is barely keeping up with the global GDP growth which itself also has declined significantly. Since the mid-1980s to 2007 world trade grew at an average of 6.5 per cent per annum but that figure reached 2.5 per cent in 2015 and is likely to be no better for 2016. One major factor that contributed to impressive growth in trade in the pre-crisis period was the fragmentation of production across countries around the world (known as global value chains or GVCs). This enabled the MNCs to exploit comparative advantage of individual countries to achieve global competitiveness. That also stimulated the flow of FDI. Many developing countries including Bangladesh took advantage of the globally fragmented production process. This was mostly facilitated by a more liberal and open trading and investment regime that evolved through 1990s under the auspices of the multilateral institutions. The expansion of GVCs and rapid growth of the Chinese economy largely contributed to the rapid growth of trade during this period. Now weak demand in the EU, recessions in Russia and Brazil, and slow growth in China are all contributing to very slow growth in world trade. What is troubling for the future of the global trading system is the rising populist voice against trade openness in developed economies. That has prompted US Trade Representative Michael Froman recently to call for "pragmatic multilateralism". WTO Director General Roberto Azevedo pitched in to say that the global trading system needs reforming so that everyone benefits. All these pronouncements only indicate a very troubled global trading system now incapable of fostering trade growth which has historically been the principal engine of global economic growth.

**Table 4. Saving-Investment and Investment-growth nexus**

| (In percent of GDP) | FY14 | FY15 | FY16(p) |
|---|---|---|---|
| Gross Domestic Investment | 28.58 | 28.89 | 29.38 |
| Private | 22.03 | 22.07 | 21.78 |
| Public | 6.55 | 6.82 | 7.60 |
| Gross National Saving | 29.23 | 29.02 | 30.31 |
| Saving-Investment gap | 0.65 | 0.13 | 0.93 |

*Source: BBS*

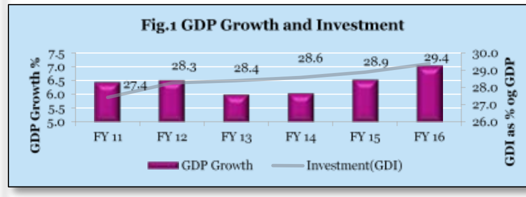
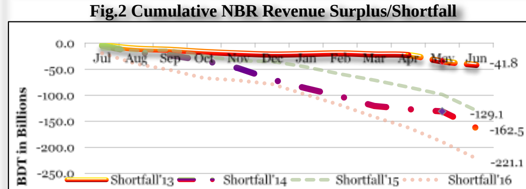



**Fig.2 Cumulative NBR Revenue Surplus/Shortfall**



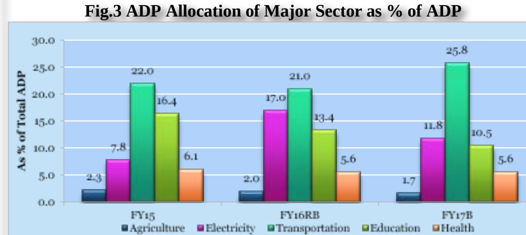

*Source: NBR and PRI Staff estimates*

**Table 5. Record of NBR Revenue Growth (%)**

| Revenue Sources | FY01 | FY05 | FY10 | FY15 | FY16 | FY17B |
|---|---|---|---|---|---|---|
| Import- based | 21.4 | 14.6 | 9.49 | 15.3 | 7.52 | 34.4 |
| Domestic-based | 27.2 | 15.6 | 23.8 | 12.5 | 10.5 | 35.0 |
| **NBR tax revenue** | **24.1** | **15.1** | **18.1** | **13.3** | **9.64** | **34.9** |

*Source: NBR*

**Fig.3 ADP Allocation of Major Sector as % of ADP**




*Source: Ministry of Finance*

***Bangladesh growth performance and outlook:*** Despite weaknesses in the global economy, recent performance and near-term outlook for the Bangladesh economy remains positive primarily due to policy certainty created by a steady political environment, improved energy situation, sustained growth in exports and remittances, and favorable public investment pipeline. Current growth performance provides indications that Bangladesh could be moving out of the 6 per cent growth trap. In FY2015-16, Bangladesh Bureau of Statistics (BBS) estimates gross domestic product (GDP) growth at 7.11 per cent (Table 2), modestly above the 7th FYP target of 7%, aided by revived exports, sound industrial performance, and sustained domestic consumption spending. In a departure from past pessimism about growth outlook, key development partners (e.g. WB, IMF, ADB) appear upbeat, all projecting close to 7% GDP growth for FY2017 (Table 3), against the 7th Plan target of 7.2%.

The agriculture sector registered 2.79 per cent growth last fiscal year, down from 3.33 percent recorded for fiscal 2014-15 as low domestic rice prices discouraged farmers' expansion of crop area. Weak agricultural performance was compensated by industrial sector growth at 11.1 per cent, exceeding the 7th Plan target of 10.2% and fiscal 2014-15 growth of 0.7%. The services sector registered 6.25 per cent growth for fiscal 2015-16, up from 5.8 per cent a year earlier, the main impetus for growth coming from public administration, education and health. Power plants, Padma Bridge construction, flyovers, expansion of industrial units, especially in garment and textile, spurred capital machinery imports. A decline in prices of capital machinery in international markets appear to have encouraged entrepreneurs to get into new ventures or expand their existing businesses. The construction sub-sector performed better in fiscal 2015-16 than a year earlier. Real estate, renting and business activities have also performed better. The real estate business recently recovered due to property price corrections, falling interest rates on home loans and sustained political stability.

***Poverty reduction on track:*** Bangladesh's dynamic and stable growth performance has been accompanied by a steady and sustained decline in poverty. Projections from a variety of research sources including the General Economics Division (GED) of the Planning Commission suggest that the decline in moderate and extreme poverty is likely to have continued after 2010, possibly at a more rapid pace owing to higher GDP growth. That would give an indication that the poverty rate in Bangladesh has declined to 24.8 per cent in 2015 while the rate of ultra-poor people dropped to 6.5 per cent of the population. Research shows that a major driver of poverty reduction in Bangladesh was the rate of GDP growth. Importantly, the effectiveness of GDP growth to reduce poverty improved sharply during 2000's as compared with 1991-2000. Poverty reduction is even higher when growth is more inclusive. That is precisely the growth strategy being articulated to reach upper middle income status and eliminate extreme poverty by fiscal year 2030-31 (per capita income of more than US$4136). Detailed analysis of poverty profile done for the Bangladesh Delta Plan 2100 shows that the incidence of extreme poverty is much higher in the rural areas (mostly hard to reach and ecologically vulnerable areas), which are heavily dominated by traditional agriculture as the main means of livelihood. Therefore, growth strategy must be better aligned to sustainably address the extreme poverty issues by combining export-oriented manufacturing development with higher-productivity agriculture, and proliferation of SME-based rural non-farm employment linked to industry and services.

***Savings-investment scenario:*** With growth on track the immediate challenge is to raise the level of investment to 30 per cent of GDP in FY2017 which appears within reach given BBS estimate of 29.4 per cent in FY2016 (Table 4 and Fig.1). Public investment, particularly in mega infrastructure projects, has been rising. Seven mega development projects by the government are well underway and are expected to have significant positive impact for the country. All of the seven top priority Fast Track Projects costing around $40 billion have now gained pace, although some of them are a few years behind schedule. The projects are the Padma Bridge, Rooppur Nuclear Power project, Paira Sea Port, the coal fired large power projects of Matarbari and Rampal, Metro Rail and LNG terminal. Physical progress in completion of these investments will be critical in boosting investors' confidence (both national and foreign).

The main policy challenge will be to stimulate private investment, which has been pretty stagnant at around 22 per cent of GDP for the past five years. Unless the rate of private investment gets a boost in the medium-term it would be a stretch to reach overall investment of 34.4% of GDP by FY2020, in order to attain the coveted 8% GDP growth at the end of the 7th Plan period.

An adequate rate of national savings is essential to achieving higher investment and consequently higher economic growth. The ratio of savings and investment to GDP has remained stagnant over the years and the gap between savings and investment has continued to remain positive, suggesting that the macroeconomic strategies of government fall short of converting savings into investment, resulting in large amount of capital flight. The gap reached 0.65 per cent, 0.13 per cent, and 0.937 per cent of GDP in FY 2013-14, FY 2014-15, and FY 2015-16. In addition, large scale illicit capital outflows every year constrain national savings and investment thus stunting capital formation in the country.

***Fiscal performance:*** The essential story in the fiscal arena has been one of ambitious targeting of revenue mobilisation as well as public expenditures, with actual performance falling well short on both counts. Nevertheless, fiscal prudence and stability has been ensured with expenditures holding within the revenue envelope with fiscal deficits in the sustainable range of around 5% of GDP. The July 1 militant incident in Gulshan had seriously hurt business morale and consumer confidence in what was otherwise a peaceful year. However, in terms of FY2016, which ended in June, the incident may not have had much impact. On the deficit end, the government continued its prudent fiscal policy of containing the fiscal deficit below 5 per cent of the GDP, at 3.1 per cent last year, despite weakness in revenue generation.

NBR revenue collection experienced significant shortfall from target for four consecutive years (Fig.2), with FY16 recording the highest shortfall. In FY2016, revenue growth was only 9.6 per cent, compared to 13.3 per cent in the previous year (Table 5). Most analysts attribute the shortfall to the fact that the target was over ambitious and thereby not achievable. Besides, businesses and investors have been on a "wait and watch" mood throughout the year, further contributing to the revenue shortfall. Given this backdrop, the target for FY17 at 35 per cent appears over-ambitious since revenue growth has never reached the 30 per cent mark in the past.

On the revenue mobilisation front, there is progress in modernisation: VAT automation, the VAT Online program, is set to be advancing and will be up and running by the end of the year. Although the initial launch will be soft, in only limited scale, the prospect is very promising. It will improve taxpayers' life, making the filing of all aspects of VAT related process easy. Nonetheless, challenges exist both from within and outside the government machinery. The expectation is that businesses will change gradually and adapt to the new reality.

Certain quarters of the business community will also resist because of their unwillingness to be systematically registered for taxes. The major winner of VAT automation will be the taxpayers. It will iron out bureaucracies by modernising the tax compliance and tax administration structure. A change of this scale will never be easy. It calls for massive retraining of the human resources. There is no doubt that the implementation of the program will require strong political will. Given its smooth implementation, the revenue generation is expected to increase, particularly in the long run. Experience of other countries show that the automation will reveal its full results in about two years.

In FY16, the Annual Development Program (ADP) utilisation rate, at 93 per cent, shows continuing improvement from previous year (FY15 at 91 per cent). As usual, weakness in revenue collection prompted drastic cuts in the revised budget of FY16. This trend is expected to continue in FY17. ADP utilisation problems persist. The utilisation rate only sees an accelerated hike in the period prior to the next budget. The practice needs major modification whereby the implementation ought to be much more efficiently spread throughout the year.

In terms of the ADP allocation for FY17 budget, it seems very high in nominal terms since it has crossed the BDT 1 trillion mark. However, in terms of growth the ADP budget is not unprecedented. The increased ADP is expected to help the ambitious economic growth target for FY17. However, implementation challenges will remain, and based on past experience, actual ADP utilisation may be 15-20 per cent less than the budgeted amount. On the upbeat, the sectoral allocation pattern of the ADP for FY17 indicates a further increase in allocation for the transport sector owing to the Padma bridge project, along with major railways and Dhaka Metro projects.

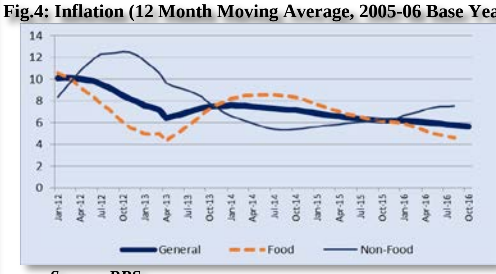
In the FY17 budget expenditure, greater emphasis has been given to communication infrastructure. Although allocation for the power sector in relation to GDP appears to be lower in FY17 budget (6.3 per cent to 4.4 per cent), it is not a matter of concern because most of power sector generation are being done under private initiative. The increase, from 4.4 per cent to 4.9 per cent of the GDP, in allocation in social sector is a welcome move. Expenditure on all key social sectors like education, health, food and social security had stagnated in recent years relative to GDP and their share in total spending had declined. However, it is noteworthy that the increase is primarily attributable to the very large increase in salaries of public sector employees. To what extent such wage increases will lead to improvement in the quality of services is yet to be seen.

**Table 6: Rate of General Inflation (as measured by CPI, base 2005-06)**

| Inflation rate | October, 2016 | October, 2015 | October, 2014 | October, 2013 |
|---|---|---|---|---|
| Point to point | 5.57% | 6.19% | 6.91% | 7.03% |
| 12- Month moving average | 5.66% | 6.21% | 7.18% | 7.47% |

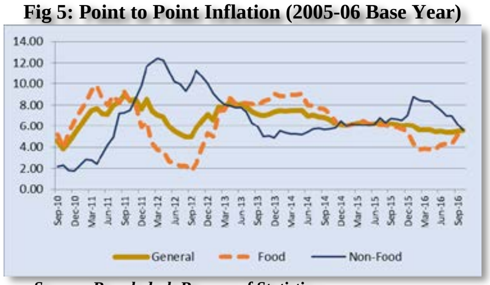
*Source: BBS*

**Fig.4: Inflation (12 Month Moving Average, 2005-06 Base Year)**



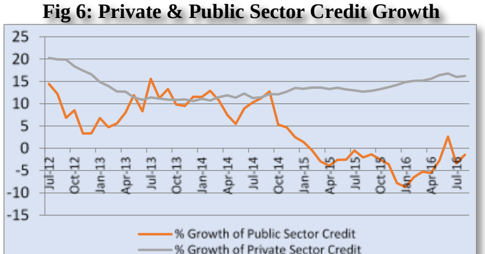

*Source: BBS*

**Fig 5: Point to Point Inflation (2005-06 Base Year)**




*Source: Bangladesh Bureau of Statistics*

**Fig 6: Private & Public Sector Credit Growth**




*Source: Bangladesh Bank*

***Inflation and monetary management:*** In the span of a few years, Bangladesh Bank has been effective in containing inflation to a more desirable level by adopting an appropriate monetary stance. The downward trajectory of the general inflation rate in recent times (Table 6 and Fig.4) can be attributed to falling food prices, due to favorable agricultural production and minimum supply disruptions on account of natural or man-made calamities. Stable exchange rate and uninterrupted import throughout the year also played important roles in bringing the general inflation down, in addition to a rate of money supply growth consistent with output growth.

A sharp drop of twelve month average inflation was witnessed in May 2016, thanks to the massive Boro harvest and stability in commodity prices in the international market. It is also important to note that the year 2016 has been blessed with minimum political turmoil making it easier for inflation to reach its targeted level within the desired period of time.

Following the decreasing trend in food inflation, the average general inflation settled at 5.66 per cent in October 2016, consistent with the inflation target of 5.8 per cent for FY17. In contrast to the average general and food inflation, the average core inflation that counts non-food and non-fuel inflation, has inched up from 6.65 per cent in January 2016 to 7.53 per cent in August 2016 (Fig 4). The upsurge in average nonfood inflation observed in early 2016 could be attributed to the consumption boost in the wake of the historically highest salary hike in the public sector.

In January 2016, the point to point CPI non-food inflation spiked to a three year high of 8.74 per cent, caused by a rise in house rent, educational material prices, and school admission fees. The rate has been easing down since then (Fig.5).

In developing countries like Bangladesh where a large amount of household incomes is spent on food, the point to point food inflation is the one to watch closely. This increased from 3.81 per cent in May 2016 to 5.1 per cent in September 2016 -- the Eid-ul-Azha effect of a temporary hike in prices of food items. However, the general inflation rate eased down to 5.37 per cent in August, the lowest in more than 10 years, mainly due to the declining trend for the last couple of months and downtrend in food inflation.

Point to point general inflation rose once again in October to 5.57 per cent primarily because of the hike in prices of essential commodities like rice, lentils, vegetables and edible oil. However, the rate is still lower compared to the food inflation observed in October last year which was at 6.19 per cent.

It is true that the point to point inflation has come down but it is still not low enough. With the existing wage pressures, inflation expectation is still quite strong. Bangladesh Bank expects inflation to be around 6 per cent for much of this fiscal year which, though consistent with target, is still quite high compared to that of Bangladesh's main trading partners. Bangladesh Bank should remain watchful about inflation and reduce tolerance for higher inflation in the future.

***Credit growth scenario:*** Domestic credit in Bangladesh has always been dominated by private sector credit claims. According to the Monetary Policy Statement (MPS) 2016, the government is expected to borrow more money from the banking system in the ongoing fiscal year. However, when it comes to actual financing needs of the government, some discrepancies are always observed between the projected and the real growth of public credit, depending on the cash flow situation which is affected by current expenditures and revenue mobilisation. The Government's borrowing from the banking system is also influenced by savings mobilisation through various savings certificates. In June 2016, public credit registered a positive growth of only 2.6% compared to BB projection of 18.7%. The growth remained negative throughout the year as government was getting adequate money from saving instruments. Due to the slow but constant fall in the deposit rate and banks' reluctance to collect deposits due to excess liquidity in the system, money started flowing towards government saving instruments reducing the need for public credit.

In contrast, private sector credit growth has been relatively stable over the last few years. An exception would be the drastic fall witnessed in FY13, when private credit growth reduced to 10.8 percent from a high of 20.3 percent (Fig. 6). The growth rate has been slower since then. Part of this fall could be attributed to the limited interest in borrowing for new investments within the business community. From Dec-14 onwards, the growth rate has been stubbornly hovering around 13% until the beginning of 2016 when it started going up again. Although a slight fall was witnessed in July 2016, the growth rate quickly bounced back to the 16% mark due to a growing demand for implementation of mega projects in the infrastructure sector. According to officials, import of capital machinery and different construction materials resulted in higher private credit growth by the end of August 2016. The upward trend of private sector credit growth is however not a concern for Bangladesh Bank as Advance-Deposit Ratio (ADR) is well within the recommended limit.

The downtrend in lending rates also contributed to the higher private credit growth. In August 2016, it reached 10.24% compared to 11.51% in the same period last year. Banking sources tell that good borrowers are getting loans at a single digit interest rate while a very few loans are being offered at between 10% and 11%. This has stimulated private demand for credit over the past year. Nevertheless, with government borrowing from the banking system rather sluggish, it is leading to a situation of excess liquidity which will remain unchanged if the government continues borrowing from saving instruments instead of banks.

Bangladesh Bank (BB) has announced a cautious and accommodative monetary policy to boost private sector credit, discouraging non-performing loans, for the period from July to December 2016. Domestic credit is expected to grow by 16.4 per cent year-on-year in FY17, with credit to private sector growing by 16.5 per cent and credit to the public sector by 15.9 per cent.

According to the latest MPS, the target of 16.5 per cent private credit growth appears to be adequate to support output growth ranging from 7.1 to 7.3 per cent. Against this backdrop, the current rate of 16.2 per cent (as of August 2016) should be sufficient to maintain the desired output growth target of 7.2 per cent for the ongoing fiscal year. It is important that Bangladesh Bank takes appropriate measures to create room for private sector credit expansion (while avoiding accumulation of nonperforming loans) and maintain its momentum in order to help the economy sustain the desired level of output growth.

Non-performing loans: The banking sector performance during the last quarter of FY16 exhibited some concerns compared to that of the previous quarter. Several key indicators such as gross nonperforming loans (NPL) exhibited deteriorations during this quarter. The amount of NPL is historically very high and has become an ever-increasing phenomenon in the banking industry of our country. For example, the non-performing loans (NPLs) of PCBs in mid-2016 was 5.4 per cent, while it was 25.7 per cent for state owned banks and 26.1 per cent for public specialised development banks. This is primarily due to questionable quality of loan portfolio, inefficient fund management, obligatory financing towards priority sectors and poor quality of the regulatory standards.

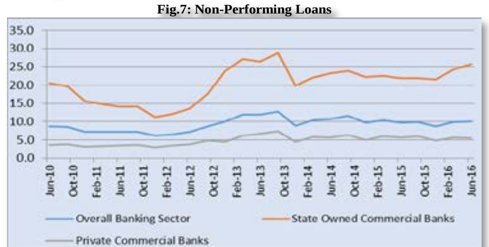
The recent unfortunate scandals involving the state-owned banks, fraudulent practices and loan defaults are raising serious questions regarding the health of the banking sector of Bangladesh. In a span of 8 years, the amount of NPLs in the banking system has almost doubled. Where NPL as percentage of total loans and advance in private commercial banks and foreign commercial banks remained between 5-10 per cent, state owned commercial banks held around 25 per cent by end June 2016 (Table 7).

**Table 7: Gross NPL Ratio in the Banking system**

| Gross NPL ratios | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | End of Jun-2015 | End of June-2016 |
|---|---|---|---|---|---|---|---|---|
| Gross NPL ratios | 9.2 | 7.3 | 6.1 | 10 | 8.9 | 9.7 | 9.7 | 10.06 |
| State-owned commercial banks | 21.4 | 15.7 | 11.3 | 23.9 | 19.8 | 22.2 | 21.9 | 25.74 |
| Specialized development bank | 25.9 | 24.2 | 24.6 | 26.8 | 26.8 | 32.8 | 25.5 | 26.14 |
| Private commercial banks | 3.9 | 3.2 | 2.9 | 4.6 | 4.5 | 5 | 5.7 | 5.44 |
| Foreign commercial banks | 2.3 | 3 | 2.9 | 3.5 | 5.5 | 7.3 | 8.3 | 8.33 |

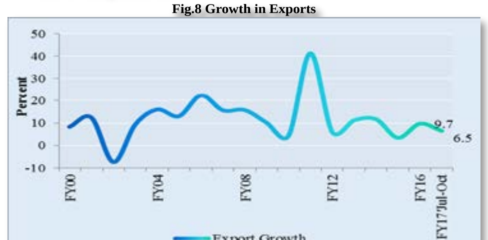
*Source: Bangladesh Bank*

**Fig.7: Non-Performing Loans**




*Source: Bangladesh Bank*

**Fig.8 Growth in Exports**




*Source: Export Promotion Bureau; Bangladesh Bank*

**Table 8. Growth and Shares of Broad Categories of Imports, FY16**

| Broad Categories of Imports | % Change in value, FY16 over FY15 | % share of total imports in FY16 |
|---|---|---|
| Food Grains | -29.1 | 2 |
| Consumer goods | 17.8 | 8 |
| Intermediate goods | 2.6 | 55 |
| Capital Goods | 6.4 | 23 |
| Others | 24.4 | 11 |
| Total | 5.5 | 100 |

*Source: Bangladesh Bank*

A significant portion of classified loans in the country lies with the state-owned banks and specialised banks. This is primarily due to the nature of their operations such as inefficient fund management, obligatory financing towards priority sectors and the size of their loan portfolio. The volume of default loans of state owned commercial banks in Bangladesh has been increasing at an alarming rate. It is not a new issue but the tendency of fraud, embezzlement and loan default is in a serious situation in recent years due in part to excessive political interference. It is notable that foreign banks and private commercial banks usually maintain relatively higher provisions against NPLs compared with SCBs. Due to this fact, they have had the lowest net NPL ratios for many years now. Though gross NPL ratio in 2015 decreased, a deteriorated provision shortfall in SCBs, coupled with a lower provision surplus recorded in other bank categories, caused the industry to sustain a much higher provision shortfall in the last two quarters of FY16. It is very important that state-owned banks make larger provision due to the persisting high NPL ratio.

Stringent identification of problem loans can also be the reason for the increase in NPLs. In order to accommodate borrowers in financial difficulties and thus, avoid defaults, a temporary relaxation in loan rescheduling standards was allowed in 2013. Fig.7 shows that overall NPL scenario in 2016 seems quite similar to that of earlier years. The exception would be the period from mid-2012 until early 2014. The primary reason for the increase in reported NPL was the withdrawal of the one-time relaxation of the loan rescheduling procedure, which was given in 2013 (Financial Stability Report). The overall NPL ratio temporarily spiked in response to that event.

In sum, inflation stability and moderate decline in its rate can be attributed to improved and consistent monetary management that has been accommodative to growth concerns. The high rate of NPL continues to be the Achille's heel of the banking sector partly due to weakness in banking supervision. The Government needs to rethink the strategy for supervision of both public and private banks. In addition to efforts at improving the performance of private banks, public banks must also be brought fully under the regulatory supervision of Bangladesh Bank and must be required to comply with all prudential norms.

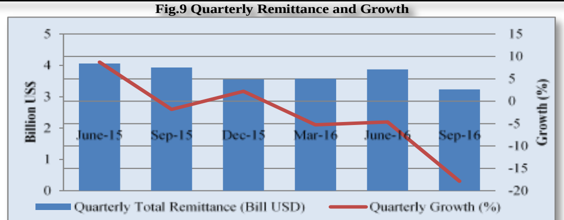
***Export prospects:*** With exports of $34 billion FY16 was not one of the best years for export growth though it ended on a positive note of 9.7% growth for the year (Fig.8). Exports remained sluggish during the first four months of FY17 growing at only 6.5%. For FY17, the Export Promotion Bureau has set a modest growth target of 8% in light of sluggish output and trade growth globally. Export diversification still remains a challenge for Bangladesh not just product-wise but also destination-wise. RMG exports made up 82% of the total export basket and grew by 10% in FY16. The next promising export product, footwear, also clocked 10% growth in FY16 after averaging over 20% growth for the past decade. For July-Oct FY17, it has again clocked 20% growth; this product is certainly the one to watch as potentially the next RMG.

But anti-export bias of trade policy whereby sales in the domestic market are relatively more profitable than exports cast a deep shadow on export dynamism. Except for footwear, no other non-RMG exports display sustained growth high enough to reduce export concentration. Meanwhile, the near-term export prospects of Bangladesh have weakened in the light of the 'growth stasis' that has gripped much of the advanced economies of Europe and North America -- the primary export markets of Bangladesh. Two major global events underway, the exit of U.K. from E.U. (known as 'Brexit') and the emergence of Donald Trump as the U.S. president-elect, could have negative implications for our export performance though it is too early to conclude anything with certainty. Both the U.S. and the U.K. are major export destinations for Bangladesh. It is not clear if Brexit would deprive Bangladesh of GSP facilities for its exports to the U.K. Thus far all indications are that the UK will continue offering DFQF facility to Bangladesh. On the other hand the prospects of reinstating GSP by the USA does not look bright in the light of the highly protectionist views expressed by the President-elect on the campaign trail.

***Import scenario:*** Import performance is intricately linked to export performance and domestic manufacturing activity. FY16 merchandise imports at $39.7 billion remained sluggish in keeping with the moderate growth of exports, registering growth of 5.5% compared to 11% in FY15 (Table 8). In part the slower growth of imports is attributable to the fall in oil prices in the global market. Bangladesh is an oil importing country with oil and oil products being some of the top items in Bangladesh's imports basket. The imports of crude oil and petroleum products accounted for 6% of imports shares right after textiles (14%), capital machinery (8%), iron and steel (8%). In FY16, imports of crude oil, refined oil products and furnace oil fell by 16%, 2% and 52% respectively. Imports of Food Grains experienced the largest decline in FY16, a value of -29%. Imports of Edible Oil and Oil seed grew by 55% and 44% respectively in FY16 compared to FY15. Intermediate and Capital Goods together make up roughly 80% of the total import basket. Import activity has improved in the first quarter of FY17, with growth of 17% compared to the same quarter of FY16. Most notable is the spike in imports of capital machinery whose LC opening doubled to $1.8 billion from $820 million, driven by mega public sector infrastructure projects and garment factories on track to upgrade and expand existing plants. Compared to first quarter of FY16, only Petroleum experienced a negative growth in L/C opening in the same months of FY17.

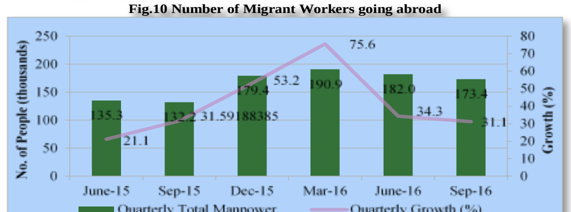
***Services trade:*** Bangladesh's services trade balance has traditionally recorded deficits. As of FY16, the services trade balance stood at a deficit of $2.8 billion. The bulk of the services payments was made towards transportation services (shipping). The services trade gap has reduced since FY12 as global shipping costs have declined. According to UNCTAD, the global shipping industry's growth was lowered by the limited growth of dry bulk commodity trade, especially coal and iron ore, and by the poor performance of container shipping, that is responsible for shipping around 95 per cent of the world's manufactured goods.

**Fig.9 Quarterly Remittance and Growth**



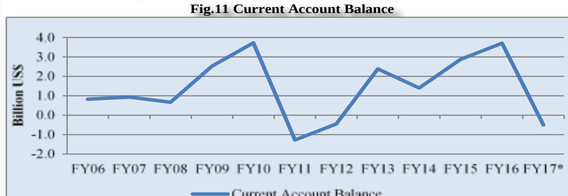

*Source: Bangladesh Bank*

**Fig.10 Number of Migrant Workers going abroad**




*Source: Export Promotion Bureau; Bangladesh Bank*

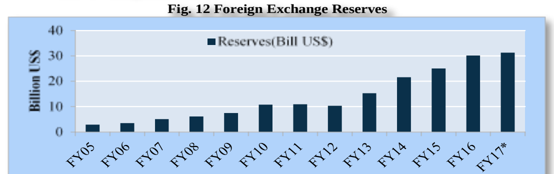
**Fig.11 Current Account Balance**




* The current account balance as of July-Sep'

*Source: Bangladesh Bank*

**Fig. 12 Foreign Exchange Reserves**




*FY17 Reserve figures are till Nov'2016

*Source: Bangladesh Bank*

***Remittance:*** Remittance takes center stage this year as remittance figures experienced a fall in FY16 ($14.7 billion), recording a decline of 2.5% after a satisfactory growth of 7.6% in FY15 ($15.2 billion). More recently, remittances steadily declined almost every month in FY16 and the declining trend is still continuing in the first quarter of FY17 (Fig.9).

What is puzzling is that this decline in remittance growth is in sharp contrast with the statistics of migrant workers going abroad, the latter showing robust growth (Fig.10). Workers are going abroad but Bangladesh's remittances have not increased in tandem with it. Two factors could explain this puzzle. The first being the decline in global oil prices leading to a fall in income earned by migrant workers. Middle East oil exporting countries which are the principal employers of Bangladeshi migrant workers typically budget public expenditures based on stipulations of oil revenue that in turn is linked to oil prices. OPEC's full-year 2016 oil export revenues will probably fall further by about 15 percent, down for the third straight year and possibly the lowest annual average level in more than a decade. OPEC members Saudi Arabia, UAE and Kuwait are some of the world's highest oil exporting countries and also the top migrant destination countries. Saudi Arabia has the highest percentage of Bangladeshi migrants, about 27.1 percent. The UAE, ranking second, is currently home to more than 2.3 million Bangladeshi migrants, while Oman ranks as the third largest overseas employment country with 11.9 percent of the total Bangladeshi migrants. The decline in oil prices has hurt the export revenues of these countries and has led to a decline in wages of foreign workers in those countries. Another factor is the pervasive use of hundi. Bankers in Bangladesh surmise that hundi is being used to facilitate transactions of over $250m annually. Hundis are used as a form of remittance instrument to transfer money across borders, as a form of credit instrument and even as a bill of exchange in trade transactions. Hundi is very common among the expatriates who send their remittances back home. The foreign currency comes to Bangladesh, bypassing the official banking channel that collects charges for money transfers and deposits to the public exchequer. Currently there is a spread of Taka 3-4 between the official and parallel exchange rate. If there is such a high spread involved, it doesn't give much incentive to the Bangladeshi workers to use the legal banking channels to remit their money back to the country.

***Current account balance:*** Bangladesh's current account has been recording surpluses in all but one of the past ten years. In FY16 the current account balance stood at $3.7 billion (Fig.11), or about 1.5% of GDP. Foreign exchange earnings from exports and remittances continue to exceed import payments. Apart from export powerhouses like China and South Korea, other countries that enjoyed a positive current account balance in 2015 include, Nepal, Vietnam and Thailand, all major recipients of remittance inflows, though South Asian neighbours like India, Sri Lanka, Pakistan and Bhutan reported current account deficits. In the case of Bangladesh, sustained current account surpluses signal under-investment with a positive savings-investment gap.

In the first three months of FY17, the current account displayed a deficit of $0.5 billion. This was due to the pickup in imports and one of the largest decline in growth of remittance earnings.

***Capital and financial account:*** Foreign Direct Investment (FDI) was the only entity in the capital and financial account that performed well, achieving a growth of 9.3% whereas Portfolio Investments suffered a decline of 67%. The sectors that attracted maximum FDI (Net Inflows) for the fiscal year 2015-16 include textiles & apparels (US$ 396.05 million), telecommunication (US$ 267.12 million), banking (US$ 254.20 million), gas & petroleum (US$ 222.32 million) and power (US$ 207.84 million). The top five sources of FDI inflows in FY16 were the United States of America (US$ 449.74 million), the United Kingdom (US$ 306.96 million), South Korea (US$ 138.49 million), Singapore (US$ 132.34 million) and Hong Kong (US$ 126.90 million). Policies governing Bangladesh's FDI are very liberal. There is no restriction on ownership or holding period, or repatriation of profits. On the other hand, Bangladesh has strict regulations for the outflow of FDI. There are also restrictions on the outflow of portfolio investments, derivatives, money market investments, foreign loans and domestic currency accounts of non-resident Bangladeshis. In the light of comfortable reserve situation, it is time to carefully review the restrictive regime on foreign exchange outflows which could be a hindrance to attracting foreign and NRB investors to Bangladesh.

***Reserves in the comfortable zone:*** There was a hiccup faced by Bangladesh Bank in February 2016 when $100 million was siphoned off from its foreign currency account held in Federal Reserve Bank of New York by hackers. Technological advance comes with its set of challenges and Bangladesh Bank had to pay the price. So far, Bangladesh Bank was only able to recover part of the money. Almost one-third of official reserves are in the form of liquid assets held with the Federal Reserve Bank in the US and the Bank of England. The rest is invested in treasury bonds and gold. The foreign exchange reserves continued to grow despite the hiccup owing to an overall surplus in the balance of payments and capital account restrictions imposed by the government. As of November 2016, reserves stood at $31.3 billion (Figure 12). At 8.5 months of imports in FY16, reserves appear comfortable and above the corresponding levels in many developed countries in 2015 like Singapore (5.9), South Korea (7.8), Hong Kong (5.6) and was close to that of India's (9.5), though lower than that of China's (17.6).

***State of trade openness and Bangladesh prospects:*** Bangladesh counts on global prosperity and openness in trade and investment in the coming decades to achieve its own growth and poverty reduction objectives. The 7th Plan has articulated a strategy for higher manufacturing growth coupled with export expansion and diversification predicated upon an export-oriented trade policy. Bangladesh was counting on reaping the demographic dividend by creating millions of jobs in labour-intensive export industries by emulating the much-revered export-led growth model that transformed so many East Asian economies into developed countries from poor agrarian countries. While making growth inclusive, a highly productive agriculture and double digit export-oriented manufacturing growth form the core development strategies to reach upper middle income status and eliminate extreme poverty by fiscal year 2030-31. For anyone keeping score, globalisation has been a boon to Bangladesh. Achieving success in these strategies will require deepening of globalisation and Bangladesh's increasing integration with the developed, emerging, and developing economies.

As noted earlier, recent trends in global politics and economics of trade openness have raised some red flags. This happens in the context of stymied global growth in output and trade. Anti-globalisation backlash has overtaken public opinion in many advanced economies which happen to be the major markets for Bangladesh exports. Further trade liberalisation is being increasingly resisted. Much of the backlash can be viewed as a reaction to the underlying policies that, in the past, have produced many "losers" -- not just "winners" -- and especially have increased income inequality, across and within countries. The winners were the top 1%, the global tycoons, and the middle class in newly emerging economies (e.g. in China, India, Brazil, Bangladesh); the losers were those at the bottom and the middle and working classes in the advanced countries. Not surprisingly, globalisation is increasingly blamed for job losses, rising wage inequality and sluggish GDP growth. A strong wind of right-wing populist economic nationalism, anti-globalisation, and anti-establishment is sweeping much of Europe and North American politics, from prosperous Sweden and crisis-ridden Greece, to the USA, leading to the election of inward-looking leadership in the UK, the USA, Hungary, while similar prospects threaten France, Italy, Austria, and even Germany. Much vaunted plurilateral pacts, the Trans Pacific Partnership (TPP) and Trans Atlantic Trade and Investment Partnership (TTIP) are facing their steepest challenge yet and may be destined for the ashes of history. As bad as this might look, it could provide the much needed impetus to multilateralism which could be the saving grace in the end. Whereas China's export prowess could be an envy of the West, LDCs like Bangladesh are not on their radar yet. Bangladesh should take heart from the statements of WTO Chief Azevedo who described the spread of anti-globalisation sentiment in advanced economies as a "wake up call" in light of sluggish global growth in trade and output. What could be disastrous for countries like Bangladesh is if the currents of economic nationalism lead to misguided policies of trade protectionism in advanced economies. That would not only result in further trade contraction but would be harmful for job creation and economic growth in developed and developing countries alike.

True, there could be tough times ahead for economies like Bangladesh dependent on trade in general, and exports in particular. But there is no scope for export pessimism or any policy reversal. In the past year, the global slowdown of trade as well as exports has raised doubts in many minds, elsewhere and in Bangladesh, as to whether export dependence is a good idea, and whether it would be prudent to reduce such external dependence. Voices are being heard in seminar circles to the effect that it is time to shift focus from exports to the domestic market. The point must be made that even slow growth in advanced economies create enormous demand for Bangladeshi apparels and footwear. Some $40 trillion of global GDP and market demand is tied up in these markets. Our domestic market is growing fast with a rising middle class expected to grow to 27-30 million by 2025, according to a report by Boston Consulting Group. Yet this is no match to the potential global market that beckons our entrepreneurs and the two million workers entering the labour force every year.

In the end, rest assured we can count on the resilience of the Bangladesh economy and its hard-working people to withstand and navigate any future global transition or external shocks. Meanwhile, our fervent hope would be to see the rapid dissolution of de-globalisation trends in the West, and the emergence of enlightened leadership in our major trading partners, something we had taken for granted for decades.

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