

A reality check

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BANGLADESH has been dependent on foreign aid since its independence. Along with this dependence, there is a continuing debate about conditionality imposed by donors. Whenever structural reforms are associated with pain, as they often do, the blame goes to donors and the policy measures labeled as “conditionality.” Critics also observe that conditions tagged by donors and directives in setting policy agenda limit the country’s ownership and undermine democratic principles. This debate needs to be cast objectively. Bangladesh’s dependence on foreign aid has declined steadily over the last several decades, and the pace of decline has accelerated in recent years. From the high levels close to 10 percent of GDP in the 1970s and 1980s, foreign aid now accounts for only 2.5 percent of GDP. Over the last several decades foreign aid has virtually stagnated at around \$1.5-2.0 billion level in nominal terms. In the overall macro-economic context, foreign aid is relatively modest as a source of external financing. Since mid-1980s, Bangladesh’s exports have increased at least 15-fold, and remittance inflows increased by more than that. In 2007-08, despite the negative impacts on exports from political unrest, export receipts increased by \$2.5 billion and inflow of remittances increased by \$2 billion. Based on the likely continuation of this trend external resource inflow from these two sources should further increase by more than \$5.5 billion to

\$27 billion in 2008-09.

From a macro-economic perspective, a dollar received in the form of remittance or exports is no different from a dollar received as loan from donors. In some sense, the former categories of receipts are better since they are not associated with repayment obligations, unless the aid is in grant form. Then the question arises why foreign aid

is considered so important? There are two reasons:

First, although external financing of ADP has declined over time, at about 50 percent of ADP, it is still very high. This high dependence, in part, reflects the relatively small size of Bangladesh ADP (5-6 percent of GDP)

due to implementation capacity and the government's inability to generate domestic budgetary savings for public investment purpose. Much of the revenue growth is utilised for the rapidly growing current outlays, including transfers and subsidies for oil and fertiliser.

Second, very low cost of fund is the most important reason for utilising the high proportion of donor financing in the budget. Most multi-lateral loans are virtually interest free (less than one percent). Most bilateral aid is also

in the form of grant or with high grant components. In contrast, domestic borrowing is costly for the government given the very high interest rate structure on national savings certificates and on bank borrowing.

The reliance on foreign financing has paid handsome dividends. While foreign debt at end-June 2007 was

double the amount of domestic public debt, foreign interest payments accounted for only 17 percent of domestic

interest payments. Foreign debt service ratio, at about 5 percent of foreign exchange receipts, is one of the

lowest in the world and Bangladesh has never defaulted on its external obligations despite its low-income status.

Bigger countries like China and India also use highly concessional loans from multi-lateral organisations, even though they can do without such funding. Utilisation of concessional credit by these countries is primarily a financial decision, and nobody would claim that any multi-lateral and bilateral donor agency would be able to dictate policy conditionality to China and India today. These countries are also undertaking structural reforms and price adjustments in various areas, which in many cases are painful. Governments in these countries take full ownership of their reforms and price adjustments, and debates among the civil societies and political forces focus largely on the appropriateness of government policies. Donor agencies are not part of the blame-game, the governments decide for themselves and defend them in appropriate forum. How can Bangladesh achieve a similar relationship with the donors? Certainly Bangladesh needs highly concessional financing to fund its growing social and infrastructure needs. But moving away from blame-game relating to conditionality will require: (i) capacity to develop programs and projects for which the government takes full responsibility; and (ii) development of alternative sources of funding the projects and programs so that if the government considers them important they should be able to carry them out with or without donor funding. Strengthening government's own institutional capacity as well as relations with competent private sector institutions will be important. Development of alternative sources of funding for the budget over the medium term, including increased revenue mobilisation, will reduce aid dependence as well as create more options for funding projects and programs deemed necessary from national perspective. There is an asymmetry in

Bangladesh's macro-economic structure: the economy as a whole is in a surplus current account position, while the government is looking for external funding to cover its deficits. This surplus national savings provides the opportunity to secure funding for the government domestically. In particular, the government can issue bonds to the non-resident Bangladeshis in the form of an infrastructure development fund or in other forms to attract 8-10 percent of remittance inflows, potentially generating about \$0.8-1.0 billion per year (more than half of the amount of foreign aid received every year). Such an instrument, if developed on attractive terms and widely available at home and abroad, could serve as an important vehicle for channeling remittance income to major national projects and away from unproductive investments in land and real estate. The stage is set for the government to take ownership of programs and projects, and utilise foreign aid based on its financial attractiveness. Like China and India, foreign grants and concessional loans should continue to fund Bangladeshi projects with high social rate of return. However, for the debate on conditionality to die, in addition to government's taking full ownership of the programs, the reliance on foreign funding needs to come down in relative term. This should not entail a reduction in the level of foreign aid, but by reversing the declining trend in public sector investment in relation to GDP. Strengthened program formulation and implementation capacity and mobilisation of more domestic resources to fund expanded public investment programs would be key to this strategy.

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