

# State of the Economy-2012

## Economy in the grip of sick politics

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The economy is in the grip of politics that has become sick

✘to the core. In December 2012, Hartals with associated destructive violence have become part of everyday life. Ordinary citizens are stuck between the rock and a hard place; caught in the cauldron of a lose-lose predicament. Make no mistake, it is the poor who are hurt much more than the rich, as they are the ones who bear most of the human costs of this malaise. The economic cost to the nation is not negligible either. After excluding the agriculture sector and other sub-sectors which are only partially affected by national work stoppages and prevention of movement of goods and people, rough estimates of dollar equivalent cost of one day of Hartal works out to a minimum of \$200 million. This is merely a ballpark figure based on a quick and dirty estimate - not a precise one that could be done after an appropriate survey. It does not account for the reverse multiplier that takes effect when economic activity shrinks. Yet, it shows that if the nation were to experience 10 days of Hartal in this fiscal year - a modest assumption perhaps — it could cost the economy the equivalent of \$2 billion (almost 2.0% of FY12 GDP), which is slightly less than the foreign loans expected for financing the Padma Bridge. Having said that, readers must be reminded of the extraordinary resilience of Bangladeshi workers and entrepreneurs who seem to find a

way to work around Hartals and minimize its impact on economic activity, so that the actual costs could be far below what the numbers say.

### Collision course defies logic

Bangladesh has long ago dispelled its “basket case” image and earned a place in the comity of nations to be reckoned with, as a “test case for development”. Middle income country status is within sight. But the war against poverty and illiteracy has not been won, though progress has been made. Gone are the days when it was dismissed as a resource poor country going nowhere. Now, its economic potential as a manufacturing powerhouse has been recognized, and there is more opportunity at every step. Global investment houses like Goldman Sachs and JP Morgan have gone bullish on Bangladesh, as the “frontier five” and “next-11” investment destinations after BRICS. Should we simply throw away the economic opportunities that beckon us?

But economic progress does not happen in a political vacuum. Since our return to pluralistic democracy in 1991, economic performance has been relatively better than in the previous two decades, proving that democracy is not inimical to economic progress. Alas, that is only possible if democracy comes with a sense of responsibility and accountability in the pursuit of the common good. As election season approaches, the consequences of confrontational politics we witness in the streets with unfailing regularity can be described, at least in the economic context, as politics of shooting ourselves in the foot. A winner-take-all version of democracy that we practice is taking its inexorable toll on the economy. Even the Padma Bridge episode rings of political overtones that does not help resolve the matter and put back on track an infrastructure project of the highest national interest with substantial positive impact on growth and poverty reduction. Thus our economic locomotive appears to be on a collision course with destiny that defies logic.

### 2012 in Perspective

As the curtain falls on the year 2012, both exhilaration and disappointment grips the Bangladeshi psyche, thanks to the roller coaster turn of domestic economic and political events since the beginning of the year. Macroeconomic stresses that emerged at the turn of the year was, in large measure, deftly handled to restore macroeconomic stability, albeit at

some costs to private sector activity. But the sordid saga of Padma Bridge financing remains a sore point that, if resolved, could have broken the gridlock on domestic investment and lifted the economy on to a higher growth trajectory. The RMG sector continues to amaze us with its global successes, but with a compliance record that will surely haunt us for long. After the heady days of 2011, the Bangladesh equity market hit rock bottom and is yet to show any sign of positive movement.

✘ Global developments, which must now be intensely and regularly factored into our policy premise, are not looking very bright either. Bangladesh economy, with its growing global interconnectedness, can hardly be immune to these ominous trends, if they do occur. The Eurozone crisis is far from over. The International Monetary Fund (IMF), which has already made a downward revision of its outlook for the world economy in 2013 (Table 1), notes in its October 2012 report that massive fiscal tightening in the United States in early 2013 (if the economy actually slips over the fiscal cliff) “is a primary risk to global economic stability”, adding that protracted gridlock in Washington would stall the U.S. recovery “with significant spillovers to the rest of the world”. Events in the Eurozone are raising serious questions about the futility of austerity measures in times of weak economic performance. Even the IMF has lately moderated its stance on what the speed of deficit and debt reduction should be, thus allowing more time and space to beleaguered economies such as Greece, Spain and Portugal. The experience of fiscal austerity in Europe has been anything but pleasant at a time when in some countries as much as a quarter of the labor force is unemployed. IMF, in its WEO update of October 2012, suggest that these developments will only result in a minor setback to the global outlook, with global growth at 3.3 percent in 2012 and 3.6 percent in 2013, marginally lower than in the April 2012 World Economic Outlook. These forecasts, however, are predicated on two important assumptions: that there will be sufficient policy action to allow financial conditions in the euro area periphery to ease gradually and that recent policy easing in emerging market economies will gain traction. Growth momentum has also slowed in various emerging market economies, notably Brazil, China, and India. All this reflects a weaker external environment for the globally inter-connected Bangladesh economy.

Add to that the looming “fiscal cliff” in the United States that, if left unresolved by year end, will not only bring recession to the faltering US economy, but will unleash spillover forces on to the Eurozone, emerging market economies, and beyond. Developments in the US economy will have repercussions around the world, and Bangladesh, being a growing part of the inter-

connected global economy, can hardly escape the loss of export demand that might ensue if there is no quick bipartisan deal in Washington. So jobs and income are at stake here at home for what happens in the distant US capital.

But first, some good news. For a change, the popular British magazine, *The Economist*, which in the past, made no bones about what was wrong with Bangladesh, finally turned around and admitted that Bangladesh had also made extraordinary improvements in almost every indicator of human welfare in the past two decades, despite what it called “wretched politics” and poor growth. Its judgment on Bangladesh’s growth record could be contested by repeated evaluations made by the World Bank and other international agencies which found Bangladesh’s recent growth performance resilient in the face of global shocks and above the average growth rates in South Asia, East Asia and the Pacific, though still below potential.

#### Growth sputters below target

To project growth performance in fiscal year 2013 without taking political developments into account will be unrealistic. So, in Table 2, while FY11 and FY12 are BBS figures, FY13 projection of 6.5% GDP and sectoral growth are based on economic scenario prior to the onset of Hartals with high frequency. Once Hartals are factored in and no resolution to the political confrontation is in sight, it is a fair assessment that GDP growth for FY13 could be well shy of 6.0%. Therefore, it appears certain that growth performance will again fall short of the Sixth Plan target of 7.0% plus GDP growth, after sputtering in the 6.0-6.5% range for the past two years.

✘ It is important to note that Bangladesh GDP growth, for the most part, continues to be determined by factor accumulation (labor and capital) rather than rise in their productivity. Under these circumstances, sustained higher growth can only be had from an increase in Gross Domestic Investment (GDI), which, as a percentage of GDP, has been stagnant for too long (Fig.1). Breaking this investment gridlock is essential for moving the economy to a higher growth trajectory. Without that happening, even a 7.0% growth rate would not be sustainable, let alone 8.0% growth which requires 30%+ investment rate, given an estimated Incremental Capital Output Ratio (ICOR) of about 3.8. As can be observed, the break from a decadal average of 4.8% growth in the 1990s, to 5.8% average growth in the last decade was prompted by a rise in the investment rate from 17% in FY95 to 23% in FY2000. That rate has

been quite stagnant around 24% of GDP for the past three fiscal years. In theory and practice, investment is a binding constraint on growth. Unless the economy can come out of this logjam, there is no hope for reaching the heights of 7.0-8.0% GDP growth, essential for achieving growth targets of the Sixth Plan. What is more, the hopes of achieving middle income country status by 2021 could also be receding.

It is accounted for by the stagnancy in private not public investment. In contrast with past trends, it is the former that has been stuck at around 19% for the past three years, although public investment was rising. It is a stark reminder that all the loose monetary policy and private credit growth averaging 25% during this period failed to boost private investment. Then where did all the private credit go? By now, it is common knowledge that a good chunk of it went into equity markets contributing to the speculative bubble that was experienced there and in the real estate sector.

Of course, the power and gas situation was not much help either. Thanks to the commission of some high cost rental power plants, power supply in terms of actual (maximum) generation has certainly increased steadily (43 per cent) during 2010 through July 2012. Currently the peak generation stands at 6,330 MW, compared with 4,002 MW in 2009. Despite the marked increase in generation, demand supply imbalance continues at 1000 MW shortfall by June 2012. Perhaps more acute is the demand-supply imbalance in the gas sector where connections to households and business units have been held up at a time when industrial demand is growing at 13% per annum. Add to this the poor state of transport infrastructure, and you have a classic case of an unfriendly investment climate that is instrumental for slowing down investment.

Then there is the growth poverty reduction nexus, not to be ignored. While Bangladesh has made commendable progress in poverty reduction since independence, World Bank research has shown that progress in poverty reduction has accelerated in the past decade, going from 48.9% of the population below the poverty line to 31.5% in 2010 (some 45 million people). This is partly because economic growth has had an increasingly favorable impact on poverty reduction. But the country still faces the challenge of lifting an estimated 45 million poor people out of poverty. It is for this reason that there is no scope for letting down our guards in the quest for higher growth. Failure to raise GDP growth by one percent will leave some 1.5 million people below the poverty line, when they could have graduated above it. And

Hartals don't help. That is how we need to assess the human and economic costs of Hartals.

### Macroeconomic stability restored

With the exception of a few occasional lapses Bangladesh has been credited with maintaining decent macroeconomic balance for the past two decades primarily through sensible management of its revenue resources and expenditures that kept fiscal deficits and public debt — domestic and foreign — within prudent limits. That situation came under strain at the close of 2011, when macroeconomic management appeared to be in disarray due to adverse movements in several macroeconomic indicators which threatened macroeconomic stability: (i) alarming rise in the rate of inflation which had crossed double digits; (ii) rapidly growing subsidy bill of the budget arising from high cost power projects and mounting deficits of public enterprises; (iii) growing imbalance in the trade account of the balance of payments (goods and non-factor services) without compensating inflows in the capital account; (iv) rapid depreciation of the taka; (v) persistent instability in the stock market; and (vi) difficulties in mobilizing foreign financing.

The good news is that at the close of 2012, macroeconomic stability appears back on track. Monetary tightening measures taken by Bangladesh Bank have helped tame inflation by containing domestic demand. Point-to-point inflation is down to single digits by October 12, and on target set by BB. With improved fiscal discipline, fiscal deficit was constrained within 4.0% of GDP for FY12, while slower growth of private credit helped squeeze import demand to restore balance of payments stability. Meanwhile, a slow recovery of exports but robust growth of remittances has restored comfort in foreign exchange reserves (soon to be propped up by a reported deposit of \$1.8 billion from Qatar) and stabilized the nominal exchange rate.

### Fiscal developments merit attention

A stellar tax revenue performance in recent years played a critical role in restoring macroeconomic stability (Table 4). For the first time in the history of Bangladesh, the National Board of Revenue (NBR) has exceeded the tax revenue targets specified in the budget for three successive years. This remarkable performance in revenue mobilization has been recorded despite a strategic shift in tax reliance – from imports to domestic production

and consumption. Buoyant performance in domestic based taxes-VAT and direct taxes in particular-helped reduce dependence on import based taxes and better anchored the revenue performance to developments in domestic economic activity.

✘ Despite setting quite ambitious targets for both VAT and income tax, revenue from both these sources exceeded their respective targets during the last 3 years. Though base expansion was a factor, a closer review of the strong performance indicates that, in case of both VAT and income tax, revenue collection exceeded their respective base expansion, implying that extra revenue also came from reforms and new approaches to tax collection.

Much of the VAT revenue growth came from domestic sources, which now accounts for 62% of revenues from VAT. Growth in domestic VAT surged to an average of 25% during the same 3-year period, almost double the pace of expansion in domestic consumption. On the income tax side also gains have been certainly made in relation to the tax base. Total income tax collection increased by 26.6% during FY07-FY12, while the expansion of the tax base during the corresponding period was 12.7%. An examination of income tax collection process indicates that although income tax from source deduction has remained important, revenue from income tax returns has gained more importance over time. Income tax deducted at source declined at an alarming rate from 61.5% in FY04 to 48.2% in FY10. While the increase in tax payments through submission of returns is a welcome development, the decline in withholding at source indicates a fundamental weakness in direct tax administration and the current focus and inadequacies of the withholding measures. The structure of tax withholding in Bangladesh is very old-fashioned and does not indicate proactive management of tax withholding agents.

Despite the recent gains, achieving the SFYP tax revenue targets remains challenging. Though potentials remain on both domestic and trade tax fronts, these can be reaped only through sustained structural reforms in tax policy and in the much needed modernization of the overall tax system.

Though growing subsidy bill arising from high cost rental power plants became a major challenge for macroeconomic management, overall fiscal prudence was maintained in FY12 so that even with modest net foreign financing of under 1.0% of GDP, domestic financing of the 4.0% deficit was limited to 3.3%, compared to 3.5% in FY11. Government borrowing from

the banking system

✘ remains the most worrisome component of domestic financing at a time when inflation still remains untamed. Budget deficit for FY13 has been targeted at 5.0% of GDP, which again is likely to be undershot, as in FY12, partly due to the predictable under-utilization of an ambitious ADP of Tk. 550 billion with a projected external finance of \$2.2 billion, which appears unlikely to be met as long as there is no traction in completion of the Padma Bridge financing formalities. As for domestic financing, heavy reliance has been placed on bank borrowing which, if materialized, could upset BB's monetary management strategies to curb inflation.

Modest success in taming inflation

The inflation situation has improved markedly in the second half of 2012 after a one and half year's episode of high inflation that appeared to go astray. Inflation on a point-to-point basis reached 12% in September 2011 and average inflation rate exceeded budgetary targets by a fair margin

✘ for the second consecutive year in fiscal year 2012. But inflationary pressures started to ease from the first quarter of 2012, and inflation started a downward trend helped by lower food and non-food inflation. By mid-year, inflation was in the single digits (under 9.0%), thanks to stability in international prices accompanied by monetary tightening measures adopted by Bangladesh

✘ Bank. By year end, all the drivers of inflation appear to be on track.

In October 2012 inflation rate was 7.2% and is little above the comfortable level. However, food inflation rate has fallen more sharply-currently at 5.6% which was more than 12% almost throughout 2012. This sharp decline in food inflation was possible due to good inventory positions after couple of years of bumper harvest and international food price stability. Sharp decrease in the food price inflation was a positive development. Now inflation hurts lower income group much less than in 2011. Non-food inflation rate showed a rising trend from the second half of 2011 and is currently more than 10%. Although part of it can be attributed to lag effect of food price hike in 2010 and 2011, it was mostly due to upward

adjustment of fuel and power prices. So, by and large, non-food inflation was cost push inflation.

Monetary tightening measures taken by Bangladesh Bank have helped tame inflation by containing domestic demand. Although Bangladesh Bank implicitly expressed need for reducing money supply growth in its Monetary Policy Statements of FY11 and FY12, it did not adhere to its stated policy before last quarter of 2011. Actually, private sector credit growth started being squeezed from the second half of 2011 (beginning of FY 12) but initially, due to lack of fiscal and monetary coordination broad money growth did not decrease by much. Since last quarter of 2011 broad money growth has started slowing down in keeping with MPS target (Fig.5). This slowing down in monetary growth contributed to price stability as well as exchange rate stability.

Inflation outlook for coming months looks bright. Monetary growth rates usually have lag effects on inflation rate (usually around 18 months). Monetary tightening of last one year should help keep inflation at the current level in next one or two quarter. Bangladesh Bank looks set to keep monetary growth rates at reasonable levels. Much lower reserve money growth at 10.5% in September 2012 indicates that broad money growths rates should remain stable

in next few months. International food and other commodity prices including oil have been stable for last one year. IMF's sober growth outlook for OECD and EME countries suggest commodity price trends to be tame. Non-food inflation will largely depend on pricing of fuel and power. As our reliance on small-sized and rental power plants increase, keeping power price at current levels will be a formidable task.

In sum, unless this combination of international price stability and sound monetary management is upset by imprudent domestic fiscal developments, it will not be surprising to see inflation around 5.0% by close of fiscal year 2013. That would be a validation of the money-inflation nexus in Bangladesh.

Export performance: End of the Surge

Trade-to-GDP ratio rose to 47% in FY11, from 37% in FY10, due to a surge in both imports and exports of 42%

and 39%, respectively. It showed that even a modest pick-up in world output and trade has strong positive consequences on the Bangladesh economy. That surge has ended as both exports and imports grew 5.0-6.0% in FY12. If import performance is the harbinger of export performance, the prospects do not look good both from a review of actual imports in the first quarter of FY13 (+2%) and LC openings (-11%). Export performance so far of both RMG and non-RMG has mirrored the sluggishness on the import side (Fig.7-8).

Export pessimism is in the air once again. And for good reason. When the Eurozone is in the grip of a crisis, Bangladesh exports cannot be immune to that event. Because countries of the European Union together buy 51% of our exports, and, in an integrated world, a Eurozone crisis can become a global economic crisis in no time.

Yet, these events are beyond our control. For Bangladesh, integrating with the world market is good for the long-term – even along with the ups and downs of the world economy. Access to the wider global economy presents a much larger market for Bangladeshi goods with the potential for job creation and economies of scale that might not be possible from even a growing domestic economy. Recall that we are adding about two million people to our labor force every year, and we have a persistent problem of under-employment. So reliance on exports and efforts at ensuring and strengthening export competitiveness should continue to be the long-term policy strategy to absorb the additional labor force.

As discussed earlier, the only hope for a better export performance in FY13 will have to come from the positive resolution of two global crises: (a) the fiscal cliff in the US, and (b) the Eurozone debt crisis. As witnessed in FY11, even a modest pick up in OECD countries pays high dividends in terms of our exports. Though emerging market economies are evolving into significant buyers of our major exports, they are still not in that league by a long shot.

### Remittance boom puts a shine on foreign exchange reserves

The saving grace appears to be remittance growth in recent months (Fig.9). Bangladesh has already emerged as a leading South Asian player in the export of factor services (labor) to a wide range of countries, especially in the Middle East. In absolute dollar amount India leads the race with \$66 billion inflow in FY2012, followed by Pakistan (\$13.2) and Bangladesh (\$12.8 billion). However, given the varying size of these economies, the share of GDP is a

more meaningful indicator of the relative importance in terms of impact on the respective economies. Measured by this indicator, Nepal leads the way with a whopping 20 percent of GDP followed by Bangladesh at 12.6 percent of GDP.

While much of the impetus to the surge of remittance in Bangladesh has come from the private sector, government policies have generally played a supportive role, especially through a range of enabling policies to support outward migration of workers, banking support for mobilizing remittances, fiscal incentives (tax free remittance inflows) and a favorable exchange rate. These have paid off handsomely. In FY2012 official remittances reached an all time high of US\$ 12.8 billion. This is now the second highest source of foreign exchange earnings after RMG. The prospects for remittances remain bright as evidenced by further growth of remittances in FY13. As of October 2012, \$5 billion of remittance have flowed in during the first 4 months of FY12. At this rate of inflows, FY13 remittance figures could top \$15 billion, a growth of 17% over the respectable sum of \$12.8 billion in FY12. This is a remarkable achievement and has been a life saver for Bangladesh in terms of both supporting the balance of payments, but more fundamentally in terms of providing a massive safety net for a large segment of the population.

Those who are keen to distinguish between net and gross earnings of foreign exchange might be exhilarated by the fact that remittance of our migrant workers continue to exceed net foreign exchange earnings from RMG, which have to rely on substantial imports. But while RMG exports create 4 million jobs and support as many as 25 million people directly or indirectly, remittance has helped reduce consumption poverty, according to recent World Bank research on the poverty reduction implications of remittance. The challenge to transform much of the remittance inflows into investment in human and physical capital has surprisingly not received the high priority it deserves in policy circles. Nevertheless, for the past six months, remittance inflows have boosted official foreign exchange reserves which rose to \$12.3 billion which can support 3.8 months of prospective imports of goods and non-factor services in the current fiscal year – still below the 4 months required to describe it as a comfortable reserve situation.

✘ RMG exports face temporary hurdles but prospects abound

Adverse global developments have clobbered our exports recently, both RMG and non-RMG.

Yes, these are tough times for economies dependent on trade in general, and exports in particular. Regardless, this should not give scope for export pessimism. Global economy will have its ups and downs, but our export markets will continue to expand. With product and geographical diversification of our exports, vulnerability from occasional external demand shocks will be minimized.

In the medium-term, we see tremendous prospects for expansion of RMG exports in growing markets beyond Europe and North America. Now that Bangladesh has become the No.2 exporter (on a single country basis) of RMG after China, other countries are taking serious note, so that McKinsey & Co. in its 2011 report concludes that “Bangladesh will be the number one sourcing hot spot in the next 5 years”. Japan, and the emerging market economies of China, India, Brazil, Russia and South Africa, together could soon replace our traditional destination markets.

It is hard to ignore the potential developments in Japan, which could soon become a major destination of RMG exports. Effective in 2001, under the 99% initiative, Japan has liberalized imports of industrial products (HS-25 and above) from all LDCs, offering duty free and quota free (DFQF) access. This preferential access includes textiles and clothing, but excludes non-manufacturing products. The 99% initiative also includes 8 items of raw hides and skin and leather, 123 items of textiles, 4 silk items, 2 categories for pearls, precious stones, metal coins, 1 category of optical, photo, technical apparatus for duty free and quota free export.

Japan’s apparel market is the second largest in the world, behind only the USA in terms of sales volume and it has become the third largest importer of knitwear in the world. According to a recent policy called “China Plus One”, Japanese RMG buyers intend to relocate about 30% of their orders from China (China is the largest RMG exporter to Japan with US\$25 billion, around 80% share) to other locations. Possible source countries include Vietnam (15%), Bangladesh (10%), and Cambodia (5%). Bangladesh is the 6th largest supplier of Japan’s clothing import with share of around 1.1%. It has good prospects of attracting higher export orders as Chinese garment products become costlier by the day. Export of woven garment products and knitwear items to Japan grew nearly 63% to \$403.65 million in FY12 (EPB). Bangladesh apparel exports are expected to top \$2.5 billion in 3-4 years if the China Plus One policy takes effect.

True, the global outlook for trade growth in 2013 is muted, yet, the fact that Bangladesh is slowly gaining a larger share of the RMG exports market suggests continual and robust export growth provided trade logistics are functioning and domestic capacities are being expanded. Alongside the likes of China and Vietnam, “Made in Bangladesh” has become a known and dependable brand for readymade garments all over Europe and North America, in big name departmental stores from Blumingtondale to WalMart to Marks & Spencer, and a variety of smaller outlets across the continents. Korea, Taiwan, Hong Kong, all created beachheads in developed markets starting with textiles and then moved on to more technologically sophisticated products. Now, the world of export opportunities has opened up for Bangladesh. Is Bangladesh ready?

That said, as RMG buyers around the world take a closer look at Bangladesh, there is deep concern with regard to compliance standards and labor relations. The recent fire incident in a garment factory in Ashulia should be a wake-up call for the entire industry that leaves no room for kicking the can down the road any more. By all accounts, the country’s existing labor laws and courts do not provide adequate protection to workers’ rights. A combined effort of all stakeholders is necessary to make the labor justice system effective. To be sure, there are economic costs to meeting compliance requirements and also improving well-being of workers (e.g. through worker safety and scope for collective bargaining) by instituting proper workplace environment and raising wages commensurate with productivity. Bangladesh RMG being a supplier in the global marketplace, in all fairness, the onus of additional compliance costs ought to be shared by buyers and suppliers if we wish to see an early resolution of the problem. On its part, the Bangladesh Garment Manufacturing and Exporters Association must take steps to ensure fair employment practices and safety standards of all member enterprises so that they all are in compliance with the international safety standards.

Trade Policy losing direction?

A substantial portion of trade policy for the coming year (2013) has been formulated under the June 2012 budget, stemming from the proposals regarding adjustment of trade taxes. These adjustments affect profitability of import substitute production on the one hand and export competitiveness on the other with serious implications for trade as well as growth prospects. The budget essentially perpetuates the previous tariff stance with the singular

statement of support to domestic (import substituting) industries. It seems we have kissed trade liberalization goodbye for an unknown objective. Is it sound policy in light of global competitive challenges and Bangladesh's goal of attaining higher growth and reaching middle income status by 2021?

A single message of trade policy that stands out in the budget statement is that the changes are done to assist local industries. Indeed, that might be so, at least for the time being. But just as a pampered child often becomes unfit to face the real world, industries propped up by high protection for too long are likely to face eventual decline as greater global competition is unleashed in coming years. Like before, there is no announcement regarding how long such industry assistance through protective tariffs will continue. And the measures tend to be ad hoc in nature, without any background research about how much protection is justified, and for how long. Also, since protection is not uniform, we find no rationale for the variable rates of protection given to different products. For example, nominal protective tariff on biscuits works out to 200% — which is tantamount to a de facto ban on biscuit imports. So, while the benefits of protection are inequitable, it is consumers who end up paying the protection tax, indefinitely. This can hardly be justified under any policy principle.

✘ A review of tariff trends for the past two decades (Fig.11) gives an idea of trade liberalization trends. What is evident is the gradual decline of average tariffs until about FY09, following which there is an uptick that continues to the current budget, thus reversing past gains. Though average customs duty (CD) has been on the decline, para-tariffs have emerged as a rising component to push up average Nominal Protection Rate (NPR), which is now estimated at 28.9%, about the same as it was in FY01 (Table 5).✘

The new story is about para-tariffs – import taxes and levies other than custom duties – that have slowly emerged as a dominant set of trade taxes since the middle of the past decade. Supplementary duty (SD) and regulatory duty (RD) seems to have become standard instruments for raising revenue or offering protection to domestic import substituting industries, so much so that in FY2013, its share in average NPR has, for the first time, exceeded that of CD (52% of 28.9% in Fig.12).

✘ Though SD was introduced in 1991 under the VAT Act, and was meant to be a trade-neutral tax. However, increasingly, it has come to be applied in a non-neutral fashion, i.e. it is not

applied equally on imports as well as domestic sales. Indeed, it has become an expedient instrument of protection through its differential application (higher rates on imports; lower or zero rates applied to import substitutes). Likewise, RD is now seen to be used on an ad hoc basis every year, only on imports, aimed primarily to raise protection to domestic industries, though NBR hopes it will generate extra revenue. The fact that there is hardly any objection from the producer community against these applications testifies to their favorable impact on protection. So far, such rampant use of para-tariffs seems to have escaped attention of WTO Trade Policy Review, since cross-country tariff comparisons available in UNCTAD's COMTRADE database do not have information on para-tariffs. However, information on para-tariffs are being compiled and could soon become an irritant in multilateral trade discussions.

#### Trade Policy and the Export Diversification challenge

Generally speaking, policies and institutions that favor export expansion will also be conducive to export diversification. Bangladesh is probably a unique case where this proposition might not hold. This is because the high reliance on RMG exports has put in place institutions and policies that give high priority to this sector resulting in an asymmetry of policy support that accentuates the existing uni-product export concentration, on the one hand, and also hinders the emergence and growth of non-RMG exports. Given the size of the global market for textiles and clothing, Bangladesh's strong market position in RMG is unlikely to diminish anytime soon. Given that (a) China is moving away from basic garments to high-value products, (b) Japan, the second largest apparel market in the world, has opened up to Bangladeshi garment exports, and (c) emerging markets are becoming significant buyers of Bangladeshi garments, McKinsey & Co. project that Bangladesh RMG exports will approach \$30 billion by 2015, and \$45 billion by 2020. Nevertheless, the case for diversifying Bangladesh's export basket in the interests of reducing vulnerability from industry-specific shocks cannot be ignored.

The focus of current policies seem to be more on product diversification, and the approach taken is to pick winners, i.e. select "thrust" sectors and promote them with all sorts of incentives in the hope that they will be the RMGs of the future. If we recall, this is not how RMG emerged as the leading export item of Bangladesh; nor, for that matter, was ship-building – a recent success. With the advent of MFA, the right policies were formulated to give RMG production a free trade channel, i.e. by providing duty-free inputs through bonded

warehouse and back-to-back LC system. With success, ship-building received duty-free bonded import facility almost instantaneously. International experience suggests that, in a high tariff regime, export success cannot come through subsidies provided to “thrust” sectors. It could, however, come through providing RMG-like free trade channel to existing and potential exports. That is the big policy challenge.

While there is no magic recipe to promote diversification, a broad array of policies might be needed to create and sustain new export products. The important point to note is that the diversification challenge might be unique to each country context though some commonalities can always be identified. The Bangladesh context, for one, might call for some customized approach to addressing the problem, namely:

- \* First, exports need imports. So the import regime must be made seamless to facilitate duty-free imported inputs into exports. Why duty-free? Exports, to be competitive in world markets, must be provided with world-priced inputs. Duty-free makes imported inputs bought at world prices;
- \* Second, the incentive structure for exports must be set right (i.e. removing anti-export bias) by ensuring that relative incentives for export and import substitute production are about the same;
- \* Third, lowering the costs of trade-related services (improved trade and transport logistics, and, of course, energy infrastructure) is critical for ensuring export competitiveness;
- \* Fourth, proactive policies, such as helping exporters upgrade existing products, break into geographic markets, and launch and consolidate new line of business abroad, might be critical in view of serious governance deficiencies.
- \* Finally, managing the exchange rate is critical for ensuring competitiveness of all exports.

Exchange rate management: Exchange rate is a critical determinant of export incentives and as such sound exchange rate management is very important for maintaining export competitiveness, particularly for non-RMG exports. RMG exports are partly shielded from exchange rate movements because of the special import credit system (back-to-back LC) that covers import costs from export proceeds so that any nominal exchange rate depreciation affects costs and returns proportionately.

✘ Bangladesh adopted a market-based exchange rate regime with effect from May 2003. By adopting a market-based exchange rate management and combining this with a prudent

monetary and fiscal policy management over the longer term, Bangladesh avoided an appreciation of its real effective exchange rate (Fig.13). There were slippages in the short term. For example, a look at the trends in the Real Effective Exchange Rate (REER) shows real appreciation of about 9% between FY03 and FY06. Thereafter, this trend was reversed through real depreciation for the next five years until FY12. Since January 2012, monetary tightening has helped stabilize the nominal exchange rate while moderating inflation, thus keeping the REER from any real appreciation. As a long-term strategy for export diversification, the appropriate exchange rate management would be to avoid rigidity or real appreciation of REER; a moderately depreciating REER would work better to sustain competitiveness of exports, particularly non-RMG exports.

### Economic Outlook for 2013

While the economy is in the grip of Hartals, in comes the global rating agency Moody's with a positive report card on the Bangladesh economy and its prospects. Restoration of macroeconomic stability following fiscal and external pressures in the beginning of the year, and build up of foreign exchange reserves through consistent current account surpluses, has helped to shore up Bangladesh's credit stability, over and above the fact that Bangladesh continues to be a less indebted country by World Bank criteria with extremely strong external debt servicing capacity. "Steady growth trends, a more positive outlook for the external sector, stabilizing exchange and interest rates, and the recent momentum in reforms are positive", states Moody's before warning that continued labor unrest and the possibility of a messy transition to parliamentary elections in 2014 could derail the smooth progress in reforms. But banking loan scams and the Padma Bridge financing controversy were not ignored either as indicators of governance failures. Perhaps what they missed out was the economic ramifications of the unique Bangladeshi political phenomenon called Hartals.

Moody's report card notwithstanding, at the close of 2012, dark and ominous political clouds hang over the lives of our citizens. The big question that is in everyone's mind: is this going to be a repeat of 1996 which had 200 days of Hartals? ...or of 2007, which ushered in a non-political government with all the uncertainties? Either way, politics and the Bangladesh economy are too intricately connected for the economy to be unaffected by developments in the corridors of power. Production and investment decisions at the highest as well as at the grassroots level are being influenced by the political environment. Work stoppages and

frequent obstruction to the movement of goods and people – by resorting to extreme form of violence like indiscriminate torching of vehicles and deadly assaults on ordinary folks – take a heavy toll on the economy, as potential investors, domestic or foreign, hold back their decisions. In the end, it is the poor, the daily wage earner, whose family quietly suffers when they have to skip a meal or two, before going to bed. The plight of the elderly and the sick is no better. We did not hear of those souls who died as they could not get to the hospital or to the nearest doctor. Such is the human cost of Hartals, on top of the economic costs which are dragging the economy to the brink of a precipice. Can we come out of it in 2013?

All in all, 2012 will be remembered as a year in which macroeconomic stability was restored from a potential slide in monetary, fiscal and exchange rate developments that threatened the economy early in the year. But uncompromising political posturing by leading political coalitions threatened to shatter the equilibrium and take the economy on a downward slide. Needless to say, 2013 will be a year of heightened political tensions, as 2014 elections draw near. In these circumstances, projecting growth performance for FY13 (done in Table 2) is a formidable task. In the unlikely scenario that political confrontations end with 2012, the projected growth rate of 6-6.5% for FY13 could still materialize. If political turmoil continues unabated, below 6% growth is a stark possibility which would then make improbable the achievement of growth targets set in the Sixth Plan. With the prospects of 7%+ growth receding, attaining 8-10% growth by 2021 and crossing the coveted middle income country threshold could also become improbable.

How does 2013 look in the context of global developments? It all depends on the resolution of two evolving global challenges: the “fiscal cliff” in the USA and the debt-ridden crisis in the Eurozone. As of this writing, the two political parties in Washington have yet to reach a mutually acceptable package of tax and spending adjustments that will meet the criteria of a “balanced” approach to a resolution of the crisis. Going over the fiscal cliff would throw the slowly recovering US economy back into a recession with adverse global consequences. The best scenario is that shortly before the deadline of 31 December, they will come up with the requisite statesmanship needed to resolve the crisis, to sustain the US recovery. The worst scenario is that they might have to kick the can down the road again by some legislative brinkmanship that will create more uncertainty around the globe. As for the Eurozone crisis that recently came to a point where analysts were predicting its demise, the approval of the German-backed second rescue package for Greece with support from the European Central

Bank (ECB) and the IMF, signals progress towards a resolution. More promising development was the recent decision of the European Commission to establish a Banking Union to oversee lenders across the Eurozone under the supervisory control of the ECB. Clearly, this move is aimed at monitoring lending practices, banking defaults and winding down bankrupt banks. It is seen as a major first step towards a stable economic and monetary union; a union that EU leaders hope will ring-fence banks in trouble to prevent future crises. All that is positive news for Bangladesh as more than 50% of our exports are destined for the EU countries.

The world economy presents both opportunities and challenges. It is up to us to make the best use of both by getting our own house in order – economically and politically