



Giving credence to notion of 'Bangladesh surprise'

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In the past year, the economy continued its march on a high growth trajectory, albeit with some emerging vulnerabilities, along with opportunities across the domestic and global economy to continue to give credence to the notion of a “Bangladesh surprise”.

Economic growth accelerated in FY 2018 to a record 7.9 per cent, broadly based on a strong agricultural sector rebound, large-scale manufacturing growth of about 14 per cent p.a., growth of domestic trade and a moderate recovery of export growth. Growth of major manufacturing sectors such as garments, textiles, food processing, pharmaceuticals, and leather were the main drivers. Although still incipient, there are emerging signs of diversification in production and exports as Bangladesh is now exporting over 1600 distinct tradable products.

In other important ways too, 2018 was a milestone for Bangladesh. At the time of independence in 1971, Bangladesh was famously declared to be “the test case for development”. Forty-seven years later, Bangladesh has now officially started the United Nations’ graduation process out of the least developed category towards becoming a developing country in 2024. Bangladesh has been a lower-middle income country under World Bank classification since 2015. The newly released World Bank’s Human Capital Index



2018 report also showed Bangladesh to be among the best-performing South Asian countries well ahead of India and Pakistan by various measures of human development.

For the past 25 years or so, prudent macroeconomic management has been Bangladesh's strong point. That came under pressure in FY 2018, from emerging macroeconomic imbalances. Growth has been led by high consumption by both private and public sectors combined with an increase in public investment. This meant that national savings rates fell by 2.2 per cent of GDP and the savings-investment gap increased significantly by almost 3.0 per cent of GDP which resulted in a record setting current account deficit. Without the strong remittance inflows in FY 2018, the savings-investment gap would have been significantly larger. Slowing export growth, an increase in oil prices by nearly 35 per cent in the last few months and a high demand for imports has meant that, in dollar terms, the trade deficit stood at \$18 billion while the current account deficit was just short of \$10 billion – at about 3.4 per cent of the GDP. The need to finance this deficit coupled with central-bank intervention to support the Taka for much of 2018 put reserves under stress and is likely to do so again in the future. But the good news is that this current account deficit also indicates that we are finally investing more (e.g. on several mega infrastructure projects) than we save – a rarity in the past 18 years – leading to higher productivity and growth in the future.

Internally, growth also created fiscal pressures. As it was primarily driven by domestic demand, a combination of strong consumer demand, and expansionary government expenditures, the fiscal deficit increase to high 4.9 per cent of GDP, mostly financed through expensive non-bank savings certificate sources. As a result of this policy, interest payments in the budget have been rising rapidly – by 35 per cent in FY 2018. These payments now account for about 12 per cent of all public expenditures, a higher share than that for all sectors save education and transport and communications.

On the monetary side, the year was marked by tight money supply growth of 9.2 per cent. Even so, a decline in both net foreign assets and government borrowing meant that private credit growth grew robustly at about 17 per cent over the year. This outpaced deposit growth in banks and some banks, mainly state-owned ones faced a marked rise in non-performing loans and a significant liquidity crisis ensued in the first half of 2018, which shows no signs of abating until now. The central bank responded by taking a much more accommodative monetary stance in the last quarter by reducing the cash-reserve ratios and repo rates, more

than doubling the ceiling on government deposits in private banks, and using banking system for the financing of government deficits. The central bank also allowed a moderate depreciation of the Taka in the second half of the year and used this opportunity to rebuild reserves.

In the near term, these rising macroeconomic imbalances and financial sector stress, and a difficult external environment have exposed vulnerabilities challenging future growth prospects. These need to be addressed so that growth does not falter. In the medium term, Bangladesh can use these challenges as opportunities to implement a long overdue structural reforms to improve the investment climate in the country. Issues such as regulatory red tape, poor trade logistics and infrastructure, difficulties in finding land, all combine do discourage investors. Bangladesh's own GDP statistics show that the transport sector growth considerably lag behind overall GDP growth, while the power sector just keeps pace. It has become clear that Bangladesh must diversify its exports and economy to sustain export and overall growth rates. This requires addressing the high anti-export bias in the tariff regime and exchange rates, proactively in inviting FDI to help develop new products and connect to new markets and supply chains. That calls for improving infrastructure, trade logistics, and more broadly the investment climate.

Dark clouds in the global economic outlook: The global economic outlook is facing mounting uncertainties and vulnerabilities. Declining policy coordination among the advanced economies and the fraying of international trade relations are contributing to the deteriorating international climate and the softening of growth prospects. The IMF's World Economic Outlook (WEO) October 2018 report projects global growth for 2018-19 to remain steady at its 2017 level at about 3.7 per cent per annum (Table 1).

❑ Growth has also become uneven with major economies such as Argentina, Brazil, Iran, Italy, Turkey, and South Africa facing significant macroeconomic problems and low growth. Downside risks to global growth have risen and the potential for upside surprises has receded in the past six months. Suppressed activity in early 2018 in some major advanced economies, the negative effects of the trade measures implemented or approved between April and mid-September, as well as a weaker outlook for some key emerging market and developing economies arising from country-specific factors, tighter financial conditions, geopolitical tensions, and higher oil import bills are pointed out as the factors for this

slowdown in growth.

Several downside risks for the world economy such as rising trade barriers, reversal of capital flows to emerging market economies with weaker fundamentals, and higher political risk have all become realities to varying degrees. While trade growth was finally overtaking output growth, as it should be, a predictable slowdown is worrisome on this front. However, before we make too much of this, it is worth considering that Bangladesh exports is miniscule compared to the size of the global export market. Hence, in principle, a global slowdown is not necessarily cause for our export slowdown.

The escalation of the trade war between the US and China is seen to be one of the main causes of the slowdown in world trade and now projected to decelerate in 2018 and 2019. Since January, a sequence of US tariff actions on solar panels, washing machines, steel, aluminum, and a range of Chinese products have complicated global trade relations. The World Trade Organization (WTO) has warned that such escalation of trade war can pose great global economic risk as it could threaten millions of jobs. The WTO economists predict that a complete breakdown of international trade cooperation would lead to a sharp rise in tariffs, reducing the global economic growth by 1.9 per cent. The repercussion would cause significant disruptions for the firms, workers, and societies as they struggle to cope with the new reality. WTO's chief, Azevedo has stressed, "Potentially millions of workers would need to find new jobs; firms would be looking for new products and markets and communities for new sources of growth." He also called for political solutions and urged the leaders to work towards them at the G20 summit in Argentina at the end of this month. However, the recent concluded agreement between the United States, Mexico, and Canada to forge the United States Mexico Canada agreement on some bilateral trade issues has been a step forward as have been discussions to continue with the transpacific partnership without the US and the nearly concluded Regional Cooperation and Economic Partnership (RCEP) agreement. However, at the end these are relatively fragmented initiatives and trade tensions show no signs of abating.

Bangladesh's accelerating growth performance: Despite the global economic uncertainty, Bangladesh economy has been growing steadily clocking at more than 7.0 per cent GDP growth rate for three consecutive years (Table 2).

The latest official statistics on national accounts for FY2018 estimated by BBS reveals the GDP growth rate for FY 18 to be 7.9 per cent, the fastest growth in last three fiscal years. This growth has also been well balanced across the sectors. Impressive performances in agricultural crop, livestock, and fisheries sectors all added up to a healthy 4.0 per cent plus growth rate. Bumper harvests of Boro, maize, wheat, vegetables, pumpkin, groundnut in the northern region of the country certainly contributed to this growth. Increase in fish and livestock production is also credited for this healthy growth in the agricultural sector. ✖

Backed by this strong agriculture performance, the industry sector led growth, contributing to more than half of annual growth. In particular, the large-scale manufacturing sector's healthy growth of 14 per cent contributed to a third of overall economic growth. Growth of the garments, jute textiles, food processing, pharmaceuticals were the main drivers. Rise in export growth (8.0 per cent) in RMG sector, improved energy supply and relatively stable political situation helped the increase in output of the large and medium industries (20 per cent in the first four months in FY 2018/19) in the manufacturing sector. The power sector growth of more than 10 per cent was another important boost to growth. Within industry, however, the construction sector had a relatively subdued growth of about 7.0 per cent.

Growth in the service sector slightly dipped in FY 2017-2018 mainly due to quite slow growth in the real estate sector, which is consistent with the subdued growth of the construction sector. Transport and communications growth have also been mediocre and show a slight dip. Wholesale and retail trade, the Banking sector and Public Administration and defense all grew robustly above overall GDP growth rates.

Savings-investment balance: Overall, the investment rate stood at 31.2 per cent of GDP reflecting mainly the sharp rise of public investment in recent years to nearly 8.0 per cent of GDP (Table 3). On the other side of the coin, however, consumption driven increase in growth rates have translated into a lower savings rate. Gross national savings have declined from 29.6 per cent of GDP in FY 2017 to 27.4 per cent in FY 2018. This decline in the savings rate accompanied by an uptick in investment rates has meant that the savings-investment gap now stands at 3.8 per cent of GDP, i.e. more than 3.0 per cent point larger than the past year. It is the rise in public investment (mega projects) that has contributed to this savings-investment gap. The rising negative gap between savings and investment is also reflected in the current account deficit. The good news is that it signals an end to the many years of

under-investment of the past when the economy showed persistent current account surplus. If the investment spurt leads to higher productivity, income, and growth in the future, the savings-investment gap could eventually peter out.

✘ The rise of investment rates, especially public investment rates in Bangladesh are a significant positive development and brings its policies closer to the high-growth East Asian economies. Public investment has been closely associated with the acceleration of GDP growth rates in recent years (Fig.1). Seven mega development projects by the government are well underway this year

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✘ The projects — the Padma Bridge, Paira Sea Port, the coal-fired large power projects of Matarbari and Rampal, Metro Rail and LNG terminal, and over the long term the Rooppur Nuclear Power project – are expected to have significant returns and positive impact on future economic activity if they are implemented with care, avoid cost and time overruns, and, most importantly, have environmental risk safeguards and third party validators in place. Furthermore, the government has recently allocated Tk. 34.33 billion for three more mega projects which include Karnaphuli tunnel (19.05 billion), Dohazari-Gundhum rail line (14.50 billion) and Bangabandhu rail bridge on Jamuna (780 million). The progress in physical completion of these projects is expected to boost investor confidence. Reflecting the robust investment rates and domestic demand trends, development agencies are projecting a strong growth for 2018/19 also. The key development partners (e.g. WB, IMF, ADB) are all projecting 7.0 per cent or higher GDP growth for FY 2019 (Table 4). This also is a minor watershed in Bangladesh's growth history as it is the first time that these agencies have projected GDP growth to be higher than 7.0 per cent.

The main policy challenge lies in the efforts to stimulate private investment rates, which have been relatively stagnant for the past few years. In FY 2018 this pattern was continued, and private investment rates grew by only 0.06 per cent of GDP. With elections knocking at the door, anecdotal reports suggest many investors are on a wait-and-see mode, as they are hold back new investment until they can see how the political situation settles. It will be important for private investment to get a boost in order to attain the coveted 8.0 per cent GDP growth at the end of the 7th Plan period.

Slowdown in job growth: A well-functioning labour market that provides workers increasingly productive jobs in a smooth and flexible manner is essential for growth and poverty reduction. It is important for poverty reduction for most people because income earned from employment is their principal source of livelihood and wellbeing. And it is important for growth because labor productivity – a key part of total factor productivity – is the key driver for incomes and economic growth in the long run. Further, workers' earnings provide most of the demand for output in the short run. That is why the most awaited economic report every month in advanced economies like the United States is the monthly report on job growth, unemployment patterns and wages and productivity growth. While more high-frequency data need to be collected for labour markets, the BBS has improved data collection in this regard with the publication of the Quarterly Labour Force Survey (LFS) of 2017 closely following the heels of the 2013 and 2010 surveys. But as the discussion below suggests, much more needs to be done in collecting labour market data.

By adopting a labor-intensive and manufacturing-export oriented growth strategy, Bangladesh has been an impressive performer among developing countries in creating jobs which grew at a rapid rate of about 2.4 per cent until recently. As a result, currently the economy has been able to provide almost 61 million workers with jobs at present. Furthermore, most of the job growth between 2003 and 2013, 10 million out of 14 million, has taken place in higher productivity manufacturing and construction industries and services. This drawing of the workforce out of agriculture had led to a significant rise in rural real wages and incomes and lowering of poverty. Socially, the 2-3 million female workers employed in most ready-made garments manufacturing has been critical in raising female rights and empowerment and its many associated benefits.

But significant challenges are looming. Bangladesh needs to generate close to 2.0 million jobs every year to accommodate new entrants to its labour force. Further, 40 per cent of workers are still in agriculture where the share of GDP is only 15 per cent. About 85 per cent of the workers are engaged in informal jobs, 2.7 million unemployed and another 6.6 million underemployed.

In this backdrop, a serious development is the halving in employment growth between 2010-2013 and 2013-2017 from 2.4 per cent to 1.2 per cent p.a. It is worth noting that the LFS of 2017 which provides these results will need scrutiny, but the initial findings are

dramatic. In urban areas and industry, job growth has slowed down from about 8.0 per cent p.a. in the first period to about 1.0 per cent p.a. in the most recent period. Even more dramatic, according to BBS, total employment in the manufacturing sector between 2013 and 2017 fell in absolute terms from 9.5 million to 8.7 million. This suggests that, despite adding more than Tk 450 billion-worth of output (in real terms using 2005-2006 prices), employment shrank by close to 1.0 million. Such developments are corroborated by trends in relative wages — which show that manufacturing-agricultural or urban rural nominal wage premiums are only about 38 per cent. Real differences will be considerably less. If correct, then it will suggest a slowdown in urban development and structural transformation of the economy. Clearly, more policy and research attention are needed on this issue.

Prices are stable but under pressure: Overall year-end inflation rates in June 2018 remained below 6.0 per cent and at 4.0 per cent or less for non-food prices – close to targets set by the Bangladesh Bank. The taming of inflation in Bangladesh since 2011 represents a success story for Bangladesh Bank and the Government. At the close of FY 2011, inflation had reached an all-time high of 11 per cent plus, making it the highest among the South Asian Countries. Thanks to the adoption of a strong monetary stance by Bangladesh Bank inflation rates were brought down to a more desirable level of 6.0 per cent and even lower by FY 2015. The strong management over prices have continued over 2017-18, despite pressure on food prices.

✘ While average inflation rates edged up during the first quarter of calendar 2018, it edged closer to the target of 5.5 per cent by Bangladesh Bank by September (Table 5). The slightly higher than targeted inflation broadly reflected the food related domestic shocks and higher global commodity prices. The twelve-month average food inflation reached 7.3 per cent in April, the highest so far in the year, from 6.0 per cent recorded in June 2017. Food imports and better harvests however reduced prices towards the middle of 2018.

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Point-to-point non-food inflation, which had increased to its highest level in the last two years in 2016 (Fig.2), fell through most of 2017. Since January 2018 however, the price rise of clothing, footwear, furniture and household equipment and transport increased non-food inflation rates generally and particularly in urban areas in the last two quarters since March

2018. The uptick may have also reflected some spillover from exchange rate depreciation in recent months as well as the more accommodative stance of monetary policy since April 2018 when they lower cash-reserve ratio and the reverse repo rates.

Given that no large domestic or external shocks are foreseen, BB projects average inflation to be around 5.5-6.0 per cent by the end of 2018. Nevertheless, the gaining strength of international commodity prices, the depreciation of taka and the recent expansionary monetary policy and FY 2018 fiscal stance may put inflation at a vulnerable state in the near future. Bangladesh Bank will need to be vigilant about managing inflation rates as it has done ably in the last few years.

Food inflation – especially inflation in rice prices – will have to remain a careful watch over the coming year. Although point to point food inflation has continued to decline, inflation risks in the first quarter of FY19 from higher global commodity prices and exchange rate movements cannot be ignored. 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.



The recent increase in rice prices underscores this. Prices of all types of rice, including coarse rice took a sharp upward movement during the second half of 2018 (Table 6). While Najershail/Minikat experienced a sudden jump from Tk. 58.60 per kilogramme (kg) in June 2018 to Tk. 62.05 per kg in the next month, Irri/Boro showed a smaller jump from Tk. 45.05 per kg to Tk. 45.92 during the same period. The trend continued in the following months with price of Irri/Boro reaching a high Tk. 49.50 per kg by the end of September 2018. Despite having adequate supply of rice, good harvest in the last Aus, Aman and Boro seasons and high rice import, the price of rice kept escalating.

Exports sluggish but picking up: Export growth has been tepid since FY12, with an average of around 7.0 per cent growth over these years. However, export has experienced a slight increase in growth of 5.3 per cent in FY18 compared to last year's growth of 1.7 per cent. Negative strains from the Rana Plaza episode, a fall of the euro against the US dollar, uncertainty surrounding Brexit and the Eurozone crisis are some of the main factors that

contributed to a slowdown in export growth. Moreover, a significant appreciation of the Real Effective Exchange Rate (REER) over the past five years seemed to have a debilitating impact on export competitiveness.

A pickup in exports is also being observed with growth of 14.8 per cent in the first quarter of FY19 compared to that of last fiscal year. The Export Promotion Bureau has set a modest target of 6.3 per cent export growth for FY18-19, amounting to \$39 billion worth of exports over the fiscal year. If the July-September FY19 results could be maintained for another few months, the modest export target would need to be revised upward in January 2019.

Product diversification of our export basket shows little movement in FY2017-18. To be fair, in FY2017 we exported a little over 1654 distinct products (at HS-6 digit level), with 216 products in RMG export and 1438 products in non-RMG. After readymade garments, jute and jute goods, footwear and leather goods, we are yet to find emerging products with staying power. It would make sense to target some progress in export diversification that would aim at reducing export concentration. For that to happen, Non-RMG exports will have to be given the same export regime as RMG (e.g. duty-free imported inputs).

Unfortunately, the non-RMG exports performed worse than RMG exports which grew at about 7.0 per cent per annum. Consequently, export concentration in RMG increased to 84 per cent as export diversification stalled. Bangladesh has yet to find emerging products with staying power.

Government will need to take a concerted multi-pronged approach towards diversification. Such an approach will need to have the following elements:

First, the anti-export bias of the tariff regime will need to be sharply reduced. The current protective tariff protection – very high in comparison to the export-powerhouse East Asian economies – makes domestic sales far more profitable than exports. This tariff created bias, creating a disincentive to exports, needs to be rationalized. This measure can be supplemented by providing the non-RMG exports of 1438 HS-6 products and the 4100 exporters the same duty-free import facility as the 4300 RMG exporters of 216 RMG products. A careful application of digital technology can solve the problem of leakages from bonded system that concern policy makers.



Second, closely related to earlier point, a proactive real effective exchange rate management will be needed to make exports competitive. The nearly 50 per cent appreciation in this exchange rate in the recent past has significantly eroded Bangladesh's competitiveness.

Third, partnerships with foreign investors who are well connected to foreign market and value chains should be encouraged. Without FDI, the impetus to accelerate both RMG and non-RMG export growth will be absent. FDI not only brings capital and helps job creation, it also provides market access, technology, and advanced management practices.

Fourth, improvements in the investment climate regime through cutting regulatory red tape, providing adequate infrastructure and logistics support will be necessary. The weaknesses in Bangladesh's investment climate have been pointedly highlighted in both the World Economic Forum's World Competitiveness Report and the World Bank's Doing Business Report of 2018. Bangladesh's trade infrastructure (e.g. ports, road and rail transportation, and customs administration) must be modernized to infuse export dynamism that has been missing in the past. Here, again, Government should seek opportunities to invite FDI and form public-private partnerships to develop and manage the trade infrastructure.

As the global economy shows signs of strengthening and trade flows are gathering momentum, Bangladesh can look forward to see a rebound in its exports. But this trade recovery still remains fragile, and cannot be taken for granted. Related to this an over-valued taka remains a concern not only for exports but also for remittances. Furthermore, total reliance on unskilled labor-intensive exports can prove to be self-defeating in the long run when the reliance on unskilled labour in the context of rapidly changing technological innovations and increased industrial automation (a la 4th Industrial Revolution) can prove to be an unviable option for export-oriented industrialization of the future. While opportunities are still there for Bangladesh to continue to focus on labor-intensive products like RMG and footwear in the near to medium-term, how long that competitive advantage will last is difficult to predict.

Over the longer run, it will be necessary for Bangladesh to position itself to take advantage of new opportunities resulting from technological changes and innovations. That means more

resources should be directed towards improving education quality and outcomes, vocational training, and skill development, including the reskilling of the labor force where necessary, to enable the country to take advantage of newly emerging opportunities. Bangladesh is behind our comparators in skill development, spending only 2.3 per cent of GDP on education compared to the international average of 3.5 per cent. Therefore, to face the challenges of the future, Bangladesh not only needs to focus on today's jobs but also on developing skills for tomorrow's jobs.

A good model to follow here is Vietnam. Despite the slowly recovering global economy after the 2008 financial crisis, one of Bangladesh's chief competitors, Vietnam, has shown quick progress in export competitiveness over the past few years. Apart from high growth of exports, they have managed to have a well-diversified export basket, unlike Bangladesh.

Import surge: A surge in imports is observed in FY18, reaching as high as over 25 per cent growth. The increase in demand for imports has been triggered by the economy's overall growth which has gone up over 7.0 per cent this fiscal year. The impetus comes from implementation of various infrastructure mega-projects which inevitably led to an increase in imports for machineries and other capital goods. Almost half of the import payments were spent on intermediate goods which comprise of key raw materials for manufacturing and exports sector. In FY18, import of rice was expected to increase as a consequence of the floods of 2017. According to the Ministry of Food, Bangladesh imported more than 1 million tonnes of rice in the July-October period of FY18.

However, it is not the sharp trade deficit that is of relevance as trade deficits are often pro-cyclical, moving in the same direction as the GDP. Rather it is the current account balance that Bangladesh should be wary of. Moreover, if the current trend of imports outpacing exports perseveres, the current account deficit also widens without sufficient capital inflows in the financial account of the balance of payments, we could see some drawdown in foreign exchange reserves in the coming year.

While exports also grew, it was at a much slower rate and as a result the trade deficit reached over \$18.3 billion. However, it is not the sharp trade deficit that is of concern by itself, as trade deficits are often pro-cyclical, moving in the same direction as the GDP. The current account balance is of some concern. If the current trend of imports outpacing exports

perseveres, and the current account deficit also widens due to remittance flows slowing down and inadequate capital inflows in the balance of payments, Bangladesh could see some drawdown in foreign exchange reserves in the coming year and increasing pressures on the exchange rate. In the event, healthy increase in remittance flows to \$15 billion this year contributed to limiting the current account deficit at US 9.8 billion or 3.4 per cent of GDP. However, as mentioned before, the emergence of a current account deficit of 3.4 per cent of GDP also signals that the economy is finally investing more than it saves - reversing many years of under-investment when the current account was in surplus.

Remittance reversal: The recovery of remittance inflows in FY 2018 has helped the country contain the current account deficit (Fig.4-5).



Analysts claim that the central bank's role in encouraging expatriates to remit funds through official channels is one reason for the rise. However, the depreciation of the Taka exchange rate is likely one of the main reasons that pushed up remittance. Bangladeshis living abroad are remitting more money through the formal channel as their families/relatives are now getting a better rate against the dollar. The slump in the previous year FY17 was due to lingering weaknesses in the Gulf Cooperation Council economies- consisting of some of the top destination countries for Bangladeshi migrant workers- because of the low oil prices and burgeoning fiscal deficits. But a modest appreciation of oil prices in the global market has contributed to the reversal of remittance from negative to positive for Bangladesh.



Foreign exchange reserves: Foreign Exchange Reserves stood at \$32.9 billion as of June 2018 and underwent a modest 1.8 per cent decrease compared to last year (Fig.6). The import coverage of the reserves was 7 months compared to last year's 8.3 months. Although it is not yet alarming, if import coverage falls further, the Bangladesh Bank will need to consider options between protecting reserves and avoiding instability of the Taka.



Exchange rate challenge: There is wide consensus among economists that proper management of the exchange rate is critical for ensuring export competitiveness and a superior export performance. In an economy where export is a key driver of growth, misalignment of the exchange rate will be harmful for economic growth. In particular, if the exchange rate, nominal or real, appears over-valued, it serves as a major disincentive to exports by stifling profits in an environment where profits are razor thin any way (Fig.7).




Getting Tk.79-80 per US dollar of exports for almost five years while global competition has depressed export prices has shaved a good chunk off the already razor thin margins that exporters eke out on the world market. The average exchange rate in FY 2017-18 is \$82.2. There has been a depreciating movement of the exchange rate since last year which is of course a welcome relief for the exporters. Since the 2006, the REER is found to be on an upward trajectory, only changing direction this past year. Given the significant appreciation of REER, there's scope for further adjustment of the exchange rate to keep exports buoyant in the future.

Expansionary fiscal policies: The fiscal performance of the Bangladesh economy in the last two years has been marked by the Government's ambitious increase in public expenditures on the Annual Plan and rising public investment. Over the last three years total public expenditures increased by 3.6 per cent points of GDP, while public development expenditures increased by 2.6 percentage points of GDP. This suggests that development and capital expenditure share in the budget has increased. Given Bangladesh's huge infrastructure requirements, capital expenditure increase is welcome. But expenditures on other items have increased even more suggesting there is room to improve the allocation of expenditures. Nevertheless, the perennial gripe about the quality of public expenditure and leakages from it does not seem to go away.


On the reverse side, revenue increase has been markedly lower, growing by only 2.1 per cent of GDP. Actual revenues were 9 per cent less than budget targets (Table 7) and as a result the Government deficit in FY 2018 increased to 5.0 percent, a marked rise (Fig.8). Such high deficit financing in FY 2018 meant that Government's interest payments grew exponentially crowding out fiscal space for other high priorities. In FY 2019 an even more expansionary stance has been taken in that the budgeted deficit is 4.9 per cent of GDP based on an assumption of 32 per cent increase in revenues. However, the FY 2018 and past years

of budget implementation experience suggest that such an assumption is highly unrealistic.

The implementation of the FY 2018 budget improved on the expenditure side, but not in the case of revenues. Overall revenue receipts and tax revenue receipts fell short of their respective budgetary targets by 10 per cent and 9.5 per cent respectively in FY '18. Tax revenues fell across the board for VAT, income taxes, but were particularly significant for international trade taxes (short by 12 per cent) and for property taxes by nearly 25 per cent of targets. Both the domestic and import based revenue growth was lower than the previous year. Capacity constraints, complex procedures for tax collection and monitoring, lack of investments on development projects are some of the reasons for the slow progress on the part of NBR. However, liquidity crunch of the banking sector during the last fiscal year, along with weak financial performance, defaults on loans and diminished capital market confidence resulted in lower profit margins for the banks and corporates. With reduced profitability, businesses end up paying lower taxes.

On the expenditure side, wages and salaries that take up nearly a quarter of operational expenditures, stayed on budget but undershooting slightly. In other positive developments grants to other government agencies, 13 per cent of the budget, stayed on target while subsidies to other government corporations, that account for 9.0 per cent of current expenditures were below budget targets by 10 per cent. 

Bangladesh runs some of the developing world's largest social assistance programmes. However, in FY 2018 social assistance and especially for employment and works related expenditures, that account for 17 per cent of the budget, massively underachieved their targets by nearly 40 per cent. It is difficult to evaluate the welfare implications of this without further information. If this reflects that there was less need for public works employment, then it is a positive development. If on the other hand the needy were deprived of the benefit of public employment support, this would be a welfare loss.

 Annual development expenditures showed a strong implementation relative to previous years and was almost on track – just 3.0 per cent short of target. Annual development expenditures stood at 6.7 per cent of GDP barely 0.2 per cent less than what had been budgeted. Capital expenditures within the plan were also implemented robustly and those reached 5.0 per cent of GDP. The implementation was the strongest ever in terms of

magnitude and achievement. The implementation of the mega projects undoubtedly has helped to achieve this.

Among the five major sectors of annual development programme (ADP), transport and communication are receiving the largest allocation for the past few consecutive years, due to Padma bridge and metro-rail projects. The second largest allocation goes to the power sector where Bangladesh has made commendable progress in electricity generation during the last eight years (2009-2017). Spending on the social sector including education and healthcare facilities have trended modestly downward, which is not a good sign (Fig.9).

❑ Nevertheless, the ADP utilization rate as of FY18 is 94 per cent of the revised ADP allocation, which is the highest compared to the previous three years, displaying the current government's diligent endeavor of rapidly creating the physical and social infrastructures for achieving the goal of an upper-middle income country by 2031 and high-income country by 2041 (Fig.10).

The overall budget deficit came down to 5.0 per cent of GDP. Most of the year, the government financed about 40 per cent of the deficit using a significantly higher inflow of development lending – which quadrupled as a share of GDP compared to the year before. Within domestic financing sources borrowing from non-banking sources such as the national savings certificates accounted for more than 40 per cent of the deficit. Thus, although the government resorted to borrowing from Bangladesh Bank in the last quarter, overall borrowing from the banking system overall was less than 1.0 per cent of GDP.

❑ The Budget for FY 2019: (Fig.11) continues to be ambitious The FY 2019 budget proposes to finance 64 per cent of the expenditure through NBR tax revenue, however, the budget did not have any directive towards strengthening revenue collection. In addition, corporate tax rates on listed banks and insurance companies have been reduced from 40 per cent to 37.5 per cent, and on non-listed ones from 42.5 per cent to 40 per cent. Although the total revenue as of ratio of GDP is 11.6 per cent and tax to GDP ratio 10.4 per cent during fiscal year 2018 revised estimates, Bangladesh seems to be in trouble in the coming years with inadequate revenue generation, higher expenses, and loss of preferential treatments.

Overall public expenditures are projected to increase by 22 per cent this fiscal compared to

the actual one in FY 2018. Recurring expenditures are particularly increasing by 30 per cent compared to the turnout while the development budget is increased by 17 per cent. As a result, the share of ADP has decreased to below 40 per cent. Broadly speaking, the trend says that the government consumption is rising.

It is noteworthy that interest payments on government debt is very high, accounting for 20 per cent of the recurrent budget or 12 per cent of the overall budget. Comparatively, payment for government operations aside from salaries but including transport and travel, account for less than 10 per cent of the recurrent budget or 6.0 per cent of the whole budget. Interest payment on debts are currently just a little less than transport and communications expenditures, twice of what is spent on agriculture and health sectors and higher than aggregate government spending on all sectors except education.

Given the high share of interest payments in current expenditures is not surprising that critical function of the government, maintenance of infrastructure and assets gets very little space in the market budget. In the FY 2019 budget for instance, spending on supplies and materials and transport is less than 11 per cent of recurrent expenditures, which means it is less than 1.0 per cent of GDP.

Coming to the development expenditures, among the five major sectors of annual development programme (ADP), transport and communication sector is receiving the largest allocation for the past consecutive years, due to Padma bridge and metro-rail projects. The second largest allocation goes to the power sector where Bangladesh has made commendable progress in electricity generation during the last eight years (2009-2017) with close to 80 per cent of households having access to electricity, though Bangladesh's per capita electricity consumption is still 1/10th of world average. Spending on the social sector including education and healthcare facilities have trended modestly downward, which is not a good sign. Nevertheless, the ADP utilization rate as of FY18 is 94 per cent of the revised ADP allocation, which is the highest compared to the previous three years, displaying the government's resolute endeavor of achieving the goal of an upper-middle income country by 2031 and high-income country by 2041.

The last point concerning the budget that we will make here is that although annual development expenditures and capital expenditures are increasing, it was very important to

ensure that development projects do not have significant cost and time overruns, or procurement mismanagements. If there are cost and time overruns, or excessively large procurement costs, then returns to those expenditures will decline accordingly and future GDP growth will be adversely affected.

Regarding financing in the FY 2019 budget, the government is assuming similarly high rates of external lending to finance deficits as in last year when 2.1 per cent of GDP came by debt financing. Given the size of today's economy these are very large numbers, about USD 5.0 billion and presumes a high implementation capacity. On the positive side the government appears to have realized that taking recourse to nonbanking financing is expensive and could lead to adverse debt dynamics. Thus, early on it is decided to take greater recourse to banking finance. This of course will raise its own set of issues if it results in the crowding out of private investment.

Monetary policy has been on a tight-rope walk: Monetary policy was extremely tight in FY 2018, though not by design. At year end in June 2018 broad money growth stood at 9.2 per cent over the year significantly less than the programme target of 13 per cent. A sharp decline in the net foreign assets in the first three quarters of the year, used to finance the large current account deficit and to defend the Taka earlier in the year, was one factor in containing monetary growth. In the last quarter, after the Taka became more flexible and not defended, net foreign assets recovered at year end having declined by less than 1.0 per cent. By August of 2018 net foreign assets recovered in Taka terms.

The second factor was that the banking system's lending to the government was also significantly less than originally programmed as the government took recourse to nonbanking sources of finance, the national savings certificates in particular. As of June 2018, claims on government credit from banking sector registered a negative growth of 2.5 per cent, compared to the Bangladesh Bank projection of positive 12.0 per cent growth. The growth remained negative throughout the first half of 2018 as the government was mopping up too much money from the proceeds of the larger than planned sales of national savings certificates (NSCs).

Riding on the high difference in interest rates between bank deposits and NSD certificates, the government has surpassed its annual non-bank borrowing target by a big



margin in fiscal year 2018 – but at high interest cost and rising future liability to the exchequer as discussed earlier.

The negative growth of net foreign assets and the government borrowing from the banking system created the space for a robust growth of credit to the private sector to 16.9 per cent by year end just surpassing monetary targets (Fig.12). Higher import payments, particularly for trade financing, may have contributed to private credit surpassing Bangladesh Bank's target growth rate.

Things changed dramatically on the credit front. Credit growth as of August 2018 was nearly two percentage points lower than the central bank's target for the first half of the current fiscal year. Public sector enterprises had a robust growth of 12 per cent by year-end. Private sector credit growth on the other hand dropped to a 21-month low to 15.2 per cent in August 2018, primarily owing to central bank's newly set lower loan-deposit ratio. The clear indication of a liquidity crisis in the banking system, portrayed by banks' efforts to adjust their loan-deposit ratio, has contributed to the slow disbursement of loans to the private sector. Credit growth has almost ground to a halt as banks have become reluctant to provide loans ahead of the national election fearing diversion of loans to political campaigns.

The rapid credit growth of the past year combined with a fall in deposit growth rate over 2017 led to a liquidity crisis. In response the central bank lowered ceiling for the advances to deposit ratio from 85 per cent to 83.5 per cent. As liquidity tightened deposits and lending rates started rising in response.

Non-performing loans and liquidity constraints in banking sector threaten stability: However, the other serious factor driving liquidity shortages with concerns about the health of banks as it became clear that nonperforming loans were rising significantly. The banking sector has been passing through a troubled period. The sector is still struggling to recover from the recent setbacks caused by large financial frauds in several state-owned and private commercial banks. The problem seems to be compounded by recent changes in the tenure and family membership of bank boards. This reflects severe weak regulation and governance in the banking sector and means that family ownership will have greater control in banks with the possibility of erosion of corporate governance. Banking supervision, which had improved significantly over the past two decades, is showing signs of deterioration.

Though the Bangladesh Bank had adopted a flexible loan-rescheduling policy in December 2013, it did not bring the positive outcome as intended. The questionable quality of the loan portfolio, inefficient fund management, obligatory financing towards priority sectors and the reluctant quality of the regulatory standards have raised serious questions regarding the health of the banking sector in the past. However, no notable actions have been taken to recuperate from the damages made.

✘ The ripple effects are quite visible now. As of June 2018, the gross non-performing loans of the overall banking sector increased to 10.41 per cent, from 10.1 per cent recorded a year earlier (Table 8). The banking sector is bleeding from bad loans and affecting the banks' profit margin, scope of business expansion and the plan for job creation.

The state of state-owned commercial banks (SCBs) is distressing, and there is no relief in sight. Since the government owns the banks, the bank managements have no stake in the efficiency or profitability of operations. Any government is only a transitory owner with little or no immediate risk. It also has little incentive to manage these banks on a commercial footing because either the losses can be passed over to the citizens through treasury financing based on tax revenues or as continued accumulation of bad loans (i.e. NPL). Instead, there is a strong incentive to use these banks as instruments to finance politically-motivated projects or to distribute political patronage.

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 (SCB) held around 28 per cent by end June 2018 (Table 8).

An internal report on the state of SCBs reveal that the top 20 borrowers held as much as a third of these bad loans. When there is such a concentration of bad loans with big borrowers, recovery becomes nearly impossible, and loan rescheduling or restructuring becomes a fait accompli. Demands on recapitalisation year after year out of the public exchequer then becomes inevitable - a clear case of throwing good money after bad. That resource could be better used to beef up our health and education system. Flexible measures, including loan rescheduling or restructuring policy favoring powerful people and lack of punishment for fraudulence in banks should set off alarm bells in the banking sector.

The practice of loan rescheduling has in-fact went up heavily in the banking sector in the second quarter of 2018 in line with the rising default loans. Between the months of April and June, default loans amounting to Tk 58.79 billion (US\$ 0.7 billion) were rescheduled, in contrast to Tk 14.58 billion (US\$ 1.7 billion) three months earlier (Bangladesh Bank).

Despite huge loan rescheduling, NPLs of the overall banking sector still hovered around 10 per cent at the end of fiscal year 2018. Needless to mention, because of higher provisioning requirement against default loans, lower interest rates and slow credit growth banks have started witnessing tumbling profits near the third quarter of 2018.

Enforcement of laws is extremely important to control the default scenario in the country today. To play the larger role of contributing towards a stable and sound macroeconomic foundation in Bangladesh, there is no option but for the banking sector to go through the path of stricter policy, legal measures, and improvement of governance.

Epilogue and future outlook: Though some vulnerabilities have emerged in the macroeconomic landscape, what could be handled by resolute policies, the overall economy remains strong with decent prospects for high and inclusive growth. Not surprisingly, international analysts are describing Bangladesh as the “poster-child” of development, a significant upgrade from the 1970s ubiquitous stamp of “a test case of development”. But vulnerabilities need to be addressed so that growth does not falter. In the medium term, Bangladesh can use these challenges as opportunities to implement long due structural reforms to improve the investment climate in the country. Issues such as regulatory red tape, poor trade logistics and infrastructure, difficulties in finding land all combine to discourage investors, leaving Bangladesh with an unenviable ranking of 177th in the World Bank’s Ease of Doig Business Index.

Unlike in past centuries, many developing countries in the 21st century are experiencing high growth, as a consequence of trade integration with the world economy. Growth is no longer limited to the infusion of labor, capital, and technology. Strategic trade integration with the vast global markets provide the new impetus to high growth of 7-8-9 per cent per annum on a sustained basis for developing countries. The opportunity is waiting for Bangladesh to seize and give credence to the notion of “Bangladesh surprise”. But, first Bangladesh must diversify its exports and economy to sustain export and overall growth rates. This requires

modernising its trade regime, addressing the high anti-export bias in the tariff structure and exchange rates, proactively inviting FDI to help develop new products and connect to new markets and supply chains. It will also require improving infrastructure, trade logistics, and more broadly the investment climate.