

Macroeconomic policy priorities for the new government

Saturday, Mar 7, 2026

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Highlights:

- *Bangladesh growth slows sharply; poverty, unemployment, inflation rising*
- *Iran war threatens Bangladesh energy security and macroeconomic stability*
- *Priority reforms: fiscal stability, balance of payments sustainability, banking recovery*
- *Raise tax revenues to 10% GDP; reform state-owned enterprises*
- *Cut energy subsidies; boost spending on health, education, social protection*
- *Fix banks' bad loans; attract capital, strengthen export growth*

Bangladesh is facing a precarious economic situation. GDP growth rate has plunged to a mere 3.5% in FY2025. Poverty is rising. Open unemployment among educated youth exceeds 10%. Underemployment is persistent. And inflation is adamantly high at 8.8% at a time when global inflation is low and at around 2-3%. On top, a prolonged war in Iran presents a severe threat to energy security that could jeopardise macroeconomic stability.

Against that backdrop, what are the key macroeconomic policy priorities? The main objective of macroeconomic policy reforms should be to secure macroeconomic stability that is consistent with the restoration of the growth momentum. Related to this objective, the top three macroeconomic reform areas concern: first, navigate the perilous fiscal situation to the path of sustained fiscal progress; second, ensure that the balance of payments stability is consistent with rising GDP growth; and third, ensure that the fragile banking sector's health is restored to support the increase in GDP growth, employment and income.

This is admittedly a tall order. But reforms in all three areas are essential.

Fiscal Reforms

The perilous fiscal situation is indicated by the fact that presently, the government is borrowing funds from the banking sector to meet its current expenses. How can this fiscal situation enable the financing of public investment and social protection transfers to promote GDP growth, job creation, and poverty reduction? Reforms are needed on both the resource mobilisation front and on the expenditure front.

Public revenue mobilisation strategy: Regarding resource mobilisation, there are two main instruments. The most important thing is to deploy the tax instrument in a way that raises a higher share of GDP as revenues, away from 6.5% of GDP now to at least 10% over the next three years, while also being equitable and business friendly. The primary focus of tax reform should be modernising the tax structure by moving away from trade and other indirect taxes to income and expenditure-based taxes. Much has been written on this subject including by

me, which show that these proposed tax targets can be achieved.

The second instrument is the reform of state- owned enterprises (SoEs). The government has invested heavily in the SoEs. The book value of these assets is close to 20% of GDP. Presently SoEs on aggregate earn a mere 0.3% rate of return on these assets. A recent PRI study suggests that through a combination of corporate governance and pricing policy reforms, the financial performance of SoEs can be turned around to yield at 8-10% rate of return on assets as found in several neighboring Asian countries. This reform would yield profit revenues of 1.6-2.0% of GDP instead of requiring huge transfers from a fiscally constrained Treasury to keep the SOEs floating.

Public expenditure reforms: Presently, the two largest current spending items are interest on public debt and subsidies amounting to 2.4% of GDP each. In the short term there is limited scope of cutting interest costs, but much can be done to reduce subsidies. The biggest source of subsidy is the energy sector caused by mismanagement, especially power. The power sector reforms must address the problems at the source that entails re-negotiation of high cost IPPs, improved primary fuel policy, deregulation of the oil market, and power and oil sector corporate governance reforms. The target should be to limit energy subsidies to 0.3% of GDP. Regarding other subsidies, the subsidy on exports and remittances should be eliminated because with a competitive market-based exchange rate, these subsidies are unjustifiable. Remaining subsidies on food and fertiliser should be restricted to 0.2% of GDP. With this reform, some 1.9% of GDP can be saved to divert to other critical areas.

Owing to budget constraints, total development spending has been cut back to a mere 2.7% of GDP in FY2025. High priority public spending like health, education, water resources, and social protection have suffered tremendously. In FY2025, Bangladesh spent a mere 0.3% of GDP on health, 1.7% of GDP on education, 1% of GDP on water and 0.7% of GDP on social protection excluding civil service pensions. Much of the resources mobilised through revenue reforms and savings from subsidy cutbacks must be recycled to increase spending on health to at least 1% of GDP, education to 3% of GDP, water to 2% of GDP and social protection to 2% of GDP over the next three years.

Balance of payments sustainability: Significant progress has been made over the past 18 months towards restoring stability in the balance of payments. Current account deficit has

been lowered sharply, net private capital outflows have been reduced, and public capital inflows have increased. As a result, there has been a modest recovery of foreign reserves. This progress, however, is fragile and not sustainable because this is not consistent with recovery of GDP growth. Much of the reduction in current account deficit has been achieved through import cutbacks, primarily due to the slide in private and public investment rates and GDP growth rate. Exports grew modestly in FY2025 to 7% but declined to -3% in the first eight months of FY2026. Remittance has surged, mostly due to the diversion of funds from the subdued Hundi market. Similar rapid growth over the medium term is not likely. Finally, along with reserve build up there is a surge in foreign borrowings, which increased from USD 104 billion in FY2024 to USD 113 billion in FY2025 and is projected to grow to USD121 billion in FY2026. Associated debt servicing has also climbed rapidly.

As GDP growth is restored, imports will rise rapidly. To accommodate this while keeping the balance of payments and reserve level stable, exports growth must be targeted to grow at 8-10%, instead of negative 3%. This will require export diversification supported by a whole host of reforms including trade policy reforms to eliminate the anti-export bias of trade policy, a competitive exchange rate policy that avoids a real appreciation of the exchange rate, lowering the cost of trade logistic, and smooth supply of energy.

On the capital account, much more reliance is needed to encourage the flow of FDIs through a massive deregulation drive that secures sharp improvement in the investment climate.

Banking reforms: A banking sector with a 36% non-performing portfolio is a perilously sick sector that must be quickly revived to avoid financial collapse. Good practice international experience with the banking crisis suggests two critical and immediate measures: find sources of fresh capital, and ensure that revived banks are set on a course of financial sustainability.

Where can Bangladesh get this new capital? The typically easy solution is transfers from a financially healthy Treasury. Unfortunately, this is not a feasible option for Bangladesh because the Treasury cannot even meet its own current spending. Additional borrowing from Bangladesh Bank to finance the recovery of the ailing banks will simply cause inflation to accelerate. The current approach to keeping the near-dead banks alive by periodic injection of liquidity by the Bangladesh Bank is a temporary medicine that cannot be sustained without

fueling rapid inflation. The feasible choices are long-term loans from multilateral institutions; and attracting foreign/domestic private investors through strategic and transparent sale options. The terms and conditions of such transactions must be publicly disclosed along with a credible plan to restore the health of these banks.

Until such time that this plan takes effect, two measures can be taken to contain the downward spiral of the banking sector. First, all banks who do not meet the Basel 3 prudential norms must be stopped from engaging in new lending activities. These banks will function as narrow banks that can mobilise deposits and operate in T-bill purchases to finance their borrowings and expenses. Second, all banks must be required to pay utmost attention to the recovery of past loans. Lending can resume when banks are able to meet Basel 3 requirements based on loan recovery and new capital injection by owners.

Along with these urgent measures to arrest the slide in the banking sector, longer term regulatory and institutional reforms aimed at preventing similar crises in the future must be pursued in earnest. These reforms should balance Bangladesh specific political economy considerations with the lessons of good practice international experience.