



Recovery under strain

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Reflections on the State of 2014 Economy

The yearlong calm that we experienced during 2014 has been ruptured by recent events that put a damper on the long awaited recovery. In the fiscal year 2014-15 the economy was expected to grow at a respectable pace though not nearly as high as the planned 7.3 per cent for the current fiscal year. What is most worrisome is that investment appears to have become one of the casualties in this predicament. Needless to say, political stability is a sine quo non of private investment.

Another disappointment so far has been the export sector whose performance is entirely driven by the readymade garment sector. This happened when many analysts hoped that the Rana Plaza episode and hartals were behind us. Non-RMG exports have been and continue to

be laggards, except footwear exports, with the result that our export basket continues to become even more concentrated on one product. The hope is, according to industry insiders, garment exports will see a pick up in the first half of 2015. The next few months will show if that will materialize.

Then again, there is the pick up in imports of the first quarter (July-Sept) of FY2015. Capital machinery imports are up 53% signalling an uptick in investment while intermediate goods imports are also up a respectable 15%. Is this a favourable sign of an investment turnaround?

The recent sharp fall in the price of petroleum since June 2014 could mean significant terms of trade gain for Bangladesh which could free up foreign exchange resources for other essential imports. But without an import rebound this bonanza will remain untapped.

The global outlook for 2015 gives mixed signals for the Bangladesh economy. The strongest rebound in growth came from the United States, the aftermath of the economic crisis continues to haunt the euro area, and growth in Japan is and will remain modest. Growth elsewhere, including in other Asian advanced economies, Canada, and the United Kingdom, is projected to be solid. Global trade, according to IMF, is projected to pick up ahead of GDP as the global recovery strengthens as trade growth typically outstrips output growth in an expanding global economy. Given a weak recovery next year, the difference between trade and GDP growth is projected to remain below recent pre-crisis averages. Nevertheless, a 5% projected trade growth is expected to provide the tailwinds necessary to give Bangladesh exports the needed shot in the arm in 2015.

As compared to FY2013, the higher expected GDP growth in FY2014 is mainly due to higher growth in Agriculture, Construction, Education, Health and Social Works. With the current state of political tension, and hoping it will taper out by the end of this fiscal year, the projected growth rate (PRI estimates) in keeping with the rebased GDP for FY2015 stands at around 6.4%.

The FY2015 budget has set a very ambitious 7.3 per cent growth target. Given an average incremental capital output ratio (ICOR) of 4.5 for FY2012-14, achieving this would require the total investment to GDP ratio to rise by over 5 percentage points—from 28.7 per cent in FY2014 to 33.8 per cent (new 2005/06 base). If the ICOR and GDI ratio are to be accepted,

then the targeted growth rate of 7.3% appears to be highly implausible as the GDI ratio cannot be raised by 5% in a year.

The inherent strength of the economy lies in its macroeconomic balance. The economy continues to have sound macroeconomic fundamentals needed for a take-off into higher growth trajectory. Sound macroeconomic management for prolonged period has yielded (a) higher average growth every decade, (b) low volatility of growth rate, (c) sustainable fiscal deficits through prudent expenditure management in the face of low revenue yields, (d) low internal and external public debt, and (e) stable balance of payments and exchange rates leading to accumulation of comfortable foreign exchange reserves, to name a few.

The less said about the financial sector the better. There are major problems in financial intermediation stemming from deep-rooted ailments in the banking sector – scams, insider lending and non-performing loans, predominantly in state-owned banks. The equity market which remains shallow has been only marginally helpful during 2014 in mobilizing investible resources for fast-growing manufacturing and service sectors.

The political turmoil that plagued the country in FY2014 adversely affected business sentiment and confidence, in addition to affecting consumer confidence. Revenue collection became a casualty. This was clearly reflected in the revenue performance for the year which slowed down considerably, both for domestic-based and import-based taxes. There was a huge shortfall in revenue from targets. Almost 80% of the shortfall came from domestic based taxes, which reflects the slowdown in economic activity and the decline in consumer and business confidence. The NBR revenue growth target has been set at a modest 13.7% in FY2015 which seems to be a prudent move considering the poor revenue performance in FY2014.

The political instability in the country affected official development assistance as well. Slowdown in project implementation adversely affected the inflow of foreign funds into the country. In FY2015, the government seems confident in its fiscal management abilities and has set the budget deficit target at 5% of GDP, despite a seemingly modest revenue target. It is expected that the inflow of foreign financing of the budget deficit would be about 1.8% of GDP in FY2015, which may materialize if the political situation in the country remains stable.

Inflation is moderating, but much slower than one would like. Food inflation, which is more responsive to international price movements, remains stubbornly high though non-food inflation has declined significantly in response to monetary tightening directed towards achieving an annual inflation rate of 6.5% for FY2015. Despite efforts by the Bangladesh Bank, private credit growth, stifled by political uncertainty, barely rose from its lows of 11% throughout the year.

With a view to keeping inflation under control, the central bank has continued its tempered monetary policy stance which is in part the result of restrained growth of private credit, the larger component of domestic credit. It still seems highly unlikely that the private credit growth target of 16.5% by end December can be met.

The Taka-US Dollar nominal exchange rate remained stable in the second half of FY2014 but BB's interventions in the foreign exchange market have not prevented the loss of external competitiveness as the Real Effective Exchange Rate (REER) index showed signs of appreciation due to the protracted higher domestic inflation compared to that of major trading partners, such as EU, North America, China, and India.

Overall exports might have suffered due to a number of reasons: (a) modest appreciation of the Taka, (b) lagged effect from the political turmoil of last year, (c) the image crisis suffered by RMG exports following the Rana Plaza collapse and Tazreen fire incidents, (d) the hike in labour wages, and (e) cancellation of orders by buyers from firms operating in shared buildings (30% of RMG firms operate in shared buildings). There is speculation that some buyers did switch to alternative RMG producing countries like Vietnam and India due to the non-compliance with safety standards by many Bangladeshi firms.

The current account balance of Bangladesh has been positive for most of the years since 2001 due to the superior performance of exports and significant inflow of remittances. A positive balance however also signifies under-investment in an economy like Bangladesh which needs to invest heavily on building human capital and infrastructure.

The improved performance in FY2014 of foreign exchange reserve developments, standing at USD 22 billion as of end 2014, may be attributed to the positive impact of recently announced 6-month monetary policy statement, improved remittance inflows, increase in

export as well as a decline in imports (over the past year).

However, reserve buildup is not without its associated costs: First, return on foreign exchange reserves is generally much lower than return on domestic assets in developing countries, and, in case of Bangladesh, it is estimated at less than 1%. Second, a rapid reserve buildup also complicates monetary management for the central bank, as in the case of Bangladesh, for every dollar increase in reserves, Bangladesh Bank injects more than Tk. 77 of high powered money into the banking system. When reserves accumulate at a faster pace than envisaged under the monetary programme underpinning the Monetary Policy Statement (MPS) of Bangladesh Bank, both reserve money and broad money would tend to exceed their targets established under the MPS. This would lead to tensions in monetary management and can potentially undermine the inflationary target of the central bank and the government. Fortunately, monetary expansion was curbed by the slack in private credit growth despite sufficient liquidity.

On the trade policy front, the two main policy changes coming from the FY2015 budget were (a) reduction of supplementary duties on over 700 products or tariff lines, and (b) reduction of input duties for selected locally produced consumer products and medicines. These notable tariff and para-tariff adjustments had the effect of reducing protection on a wide range of domestically produced consumer goods. Simultaneously, a number of high profile sectors were identified for protection support (raising profitability and protection levels) primarily by scaling down customs duty on inputs which are basic raw materials and intermediate goods. These sectors include Alopethic and Ayurvedic medicines, poultry and livestock industry, paper, ceramics, furniture, plastic, baby diaper, and electrical goods.

The problem here lies with granting discriminatory effective protection levels to different industries or products as a result of a protection policy relying on non-uniform tariffs. Consequently, these discriminatory tariff adjustments become subject to lobbying by particular business quarters making it difficult for policy makers to come to a judicious assignment across all sectors.

In terms of FTAs, the challenge for Bangladesh lies in gearing up its economic diplomacy in order not to be left out of some of the emerging mega trade and investment partnerships such as RCEP (Regional Comprehensive Economic Partnership), TPP (Trans Pacific

Partnership), and a few other notable ones. Because, just as China will lose out when TTIP (Trans Atlantic Trade and Investment Partnership) and TPP are functional, Bangladesh will lose by being left out of the free trade and investment arrangements that will be exclusive to members of the mega partnerships. However, properly positioning itself for a possible FTA deal with ASEAN+ and under the larger umbrella of FTAAP (Free Trade Agreement of Asia and the Pacific) sometime in the future would remain an option for Bangladesh to pursue.