

## State of the Economy 2015-Prosperity beckons: A call for greater readiness

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The Bangladesh experience this past year may be described as a mosaic of hope, despair, and the creation of momentous opportunities for shared prosperity in the years to come. After a tumultuous period of destructive violence that reached a point of no return by close of the first quarter of 2015, relative political calm has descended on the nation's body politic creating space for rapid economic progress and human development. It calls for increased preparedness to seize the opportunities and address the challenges that beckon us from the global as well as the domestic landscape. September 2015 saw the launch of the UN 2030 Sustainable Development Goals (SDGs) amidst celebration of the end of the Millennium Development Goals (MDGs), heralded as a success story of global multilateralism. Bangladesh came out with relatively flying colors in attaining most of the MDGs, finding it appropriate to make a stronger resolve and commitment in the pursuit of SDGs over the next 15 years.



In 2015 Bangladesh finally shed its label of a low-income country to cross into the category of Lower Middle Income Country (LMIC) according to the World Bank's classification. Two prospects and challenges beckon in this area: the pursuit of becoming an Upper Middle Income Country (UMIC) within the next decade and graduating out of UN's LDC status very likely by 2021. The latter prospect could result in substantial preference erosion in market access of our exports to some of our major export destinations thus calling for preparing a roadmap now to address this emerging challenge that is not so far off. In that context, fortuitously enough, 2015 saw the end of the 6th Five Year Plan (2011-2015) and the launch of the 7th Five Year Plan (2016-2020). Though missing some targets, the 6th FYP also had an

impressive array of achievements, not the least of which was the record of the highest average 5-year GDP growth (at 6.3%) of any previous Plan. The 7th FYP heralds the era of 7-8% “transformational” growth rate, the kind that lifted many East Asian countries from low-income to UMIC or developed country status in a generation. Bangladesh economy’s sustained macroeconomic stability continues to offer the basis for growth acceleration to move the economy on to a higher growth trajectory.

As the curtain draws on 2015, Bangladesh is clearly on the radar screen of economies with strong potential for accelerated growth and poverty reduction. That was not missed by our development partners (DPs). After a long lapse, DPs assembled at the Bangladesh Development Forum (BDF) held under the auspices of the Economic Relations Division of the Ministry of Finance and, in a rare display of unity of vision, expressed their willingness to deepen their engagement in the country’s development process by pledging “... to support the Bangladesh government in its efforts to work on the sustainable development goals, the seventh five-year plan and the strive to achieve the Prime Minister’s Vision of 2021,” (Janina Jaruzelski, head of USAID Bangladesh). All this augurs well for the country’s prospects for attracting FDI and for mobilizing resources for several key high priority infrastructure projects. Not surprisingly, the country’s credit rating by Moody’s and Fitch continues to hold steady at BB- bolstered not least by the accumulation of comfortable level of foreign exchange reserves which, at \$27 billion, now cover a record 7 months of projected imports.

At the regional level, a landmark agreement was signed in 2015 ushering in a new era of free movement of motor vehicles with passengers and cargo between Bangladesh, the two land-locked countries of Bhutan and Nepal, and India (having a land-locked region in the North-East). Once ratified by all parties, the BBIN MVA (Bangladesh, Bhutan, India & Nepal Motor Vehicle Agreement), as it is called, opens up numerous opportunities for Bangladesh in the form of increased connectivity, augmented trade, higher utilization of seaports, and potential revenue gains. With the potential of significantly reducing trade transaction costs in this sub-region this agreement paves the way for closer economic integration of a region that has hitherto remained disintegrated with fragmented road and rail infrastructure defined by political boundaries rather than economic necessities. This agreement could work as a catalyst not only for stimulating intra-regional trade and investment but could also foster better economic and political relations.

Global outlook and Bangladesh economy: Bangladesh economy continues to be progressively more integrated with the global economy through greater trade openness and selective opening of some capital account transactions. Therefore, global economic outlook and performance - output and trade growth — is playing an increasingly influential role in our own economic performance. That is why analysts of Bangladesh economy need to closely watch the information put forth by the International Monetary Fund (IMF) in its biannual publication of World Economic Outlook (WEO) in order to make judgments on trade developments as it might impact the overall economy.

Throughout 2015 the global economy continued to demonstrate weakness particularly in the Eurozone and emerging market economies on which so much of future growth was projected prior to the financial crisis of 2007-08. The US economy, the largest single-country importer of Bangladesh garments, continued to be the exception showing moderate growth in output and job creation. This scenario is validated by a familiar downward revision in IMF's WEO. Every year IMF revises their WEO growth projections downward in the October update relative to the April update and this year's outlook has been no different. Global growth for 2015 is projected at a modest 3.1 per cent, 0.3 percentage point lower than in 2014, by the latest IMF update of October 2015 and trade growth is expected to be 4.1% in 2016 whereas it was 3.2% in 2015 (see Table 1). What is new is that in the years prior to the financial crisis, global trade growth typically outpaced output growth. That phenomenon appears absent in 2013-15.

Growth in advanced economies is projected to increase modestly in the current and following fiscal years. This year's developments reflect mainly the modest recovery in the Euro area and a return to positive growth in Japan, supported by falling oil prices, accommodative monetary policy, and, in some cases, currency depreciation in emerging markets. However, the global growth outlook is generally weakening, with growth projected to decline for the fifth year in a row. This reflects a combination of factors: weakness in commodity prices, as well as geopolitical tensions and domestic strife in a number of countries. In particular, emerging markets remain vulnerable in the short term to further declines in commodity prices and sharp appreciation of the U.S. dollar, which could further strain corporate balance sheets in some countries.

The plummet in global oil prices, however, was a welcome news for oil importing developing

countries like Bangladesh. Bangladesh's annual import of oil stands at around 5 million tonnes in 2015. Though oil prices fell 40-50% last year, our oil import bill fell by only 14.5% in FY15 compared to FY14. Nevertheless, the retail consumers and the business enterprises of Bangladesh have not been benefitted despite the falling oil price due to government price setting. The net implication of not adjusting prices should be seen from the reduction in oil subsidies to the Bangladesh Petroleum Corporation, the exclusive oil importing government agency, which amounted to a saving of nearly Taka 150 billion for the public exchequer.

Global oil price outlook presents interesting variations. The World Bank (WB) estimates are a bit conservative with forecasted prices hovering under \$65/barrel in the next five years. In contrast, Economist Intelligence Unit (EIU) shows a forecasted price growth to \$93.8/barrel by 2018- almost equal to that of 2014. IMF estimates show significant rise in 2017, followed by steady growth in later years. Over time, if low oil price continues, the benefit of the price fall is likely to be passed on to consumers, especially if global oil prices fall further. Lower oil prices will reduce transport and production costs and, over time, food costs (since diesel is a major source of energy used in rice farming). To sum up, cheaper oil will trim down Bangladesh's macroeconomic risks at a time when exports and economic growth are softening.

Bangladesh growth outlook: Violent disruptions in economic activity in the first quarter of 2015 might have given the impression that Bangladesh may go a few steps backward. However, the economy appears to have picked up speed and stood on its feet for the better part of 2015 giving hope that economic progress has resumed. Bangladesh has maintained stable GDP growth of 6%+ over the past decade, no mean achievement for a country facing steep challenges on many fronts. Provisional estimates of GDP for FY 2015 stands at a remarkable 6.51 % compared to 6.06% in FY14. Based on estimates of gross domestic product at current prices Bangladesh is currently the world's 44th largest economy, climbing up 11 notches from the previous year, due to consistent growth over the years, according to the IMF and the WB.



International agencies like the WB, IMF, and Asian Development Bank (ADB), all need to make projections of GDP growth in order to plan their activities for the upcoming year, and to

make international comparisons in global growth outlook. These projections are made on the basis of partial information and many assumptions that might or might not hold in the coming year. Make no mistake, BBS alone has the informational wherewithal to compute GDP growth for a specific year. At the end of the day, it is the BBS estimate that stands the test of time and is used by all concerned – however flawed these estimates might be. Herein lies the rationale for building capacities at the BBS. Stronger is the BBS as an institution, the more credible are the GDP growth estimates coming out of BBS.

GDP growth projections for the fiscal year 2016 is presented in Table 2. All the international agencies are modestly upbeat about the outlook for next year. In its State of the Economy report published annually in the Financial Express, PRI has also been making growth projections which are judgmental based entirely on our assessment of available information on current economic trends and the outlook for political stability. With the current state of political stability and the expectation that it will remain that way, and keeping in line with the Seventh Five Year Plan strategy for accelerated growth, the projected growth rate (PRI estimates, Table 3) for FY 2016 stands at 6.85%. This estimate is also premised on the assumption that BBS provisional estimates of sub-sectoral growth rates for FY2015 will hold in the final estimate. Agricultural growth rate is expected to increase slightly from 3.04 per cent in FY15 to 3.19 per cent in FY16 primarily in favor of nutrition and protein rich ‘livestock-poultry-fish’ sub-sector and commercial crop sub-sector. Industry’s share in the economy, which hovers at around 30%, is expected to experience a modest growth from 9.6% to 10.02% mainly due to a more business conducive environment. Service sector performance overall has been fairly robust and is expected to continue that way in light of an improved agriculture and industry performance.



Growth in Bangladesh is largely driven by investment which in turn must be financed through savings, domestic and foreign. An adequate rate of national savings is essential to achieving higher investment and consequently higher economic growth. While the national savings rate is hovering around 29- 30.5% for the last three years, the positive saving-investment gap, which has narrowed from 2.14% in FY13 to 0.15% in FY15, remains a concern. If the data is correct, that is a sign of under-investment. While total investment remains stable at around 28-29% of the GDP (Fig.1), private investment has been stagnant during the last five years

remaining around 22% between FY13 and FY15 and public investment growing from 6.55% to 6.9% in FY15. Considering the gap between national savings and investment private investment in Bangladesh may be underestimated and public investment over-estimated. Reversing the stagnant private investment trend will be a key challenge for realizing the growth target of 7% in FY2016 envisaged in the 7th FYP.



Raising the level of investment higher than 30% of the country's GDP remains a challenge and is critically needed for attaining its overall planned targets in different sectors given an estimated Incremental Capital Output Ratio (ICOR) averaging at 4.3 during the 7th Plan period. Indicators of investment climate for Bangladesh suggest that the cost of doing business is substantially higher than in competing countries. The need for improving the investment climate is obvious and requires concerted actions involving further business deregulation, financial sector reforms, tax and legal reforms, and better governance.

**Fiscal Developments:** The political violence and disruptions in economic activity during the first quarter of 2015 made a considerable dent in business morale as well as consumer confidence, leading to a decline in aggregate demand (domestic plus imports) in the first half of 2015. In terms of fiscal policy, the impact was most strongly felt in National Board of Revenue (NBR) revenue collection for FY15 which fell short of the target for the third consecutive year. The shortfall in revenue collection had a sequential impact on government expenditure and also the composition of budget deficit financing. The positives for the last financial year were the ADP utilization rate which continued to rise in spite of disruptions early on and the prudent fiscal management of the government in containing the fiscal deficit to 3.6% of GDP despite the weakness in revenue collection.

The NBR revenue target for FY15 was set at BDT1497.2 billion, which was 34.4% higher than the actual revenue collection in the previous fiscal year. Many analysts commented that the target was overambitious and NBR would be unable to achieve it since revenue growth had never reached 30% in recent years. Despite all efforts, the NBR revenue shortfall in FY15 amounted to a staggering BDT130.2 billion, the only saving grace being the better performance relative to BDT162.5 billion shortfall recorded in FY14 (Fig.2). A closer look at the revenue composition shows that the bulk of the shortfall came from domestic based

taxes, with income tax and VAT-domestic making up almost 90% of the shortfall. This is attributable to the temporary slowdown in the economy and the decline in consumer morale during the disruptions in Q1 of 2015. Even when the political situation improved, consumers and investors were cautious in their approach and therefore the year end saw no marked improvement in collection from these sources. Import-based taxes were a solace to the NBR revenue collection efforts in FY15, as these were the only sources which not only achieved the targets but managed to surpass them. Amongst the three import-based tax sources, custom duty showed a commendable improvement in FY15 by surpassing the target. VAT-import and Supplementary Duty-import also surpassed their targets and managed to positively contribute to the revenue collection effort (Table 5). In the FY16 budget, the government has taken a more cautious approach by setting a NBR revenue target of BDT1763.7 billion which is 28% higher than the actual collection in FY15. This seems achievable given political stability so far as well as the restructuring of taxes on cigarettes which historically has been a major contributor to the government coffers.



The government expenditure was affected as a result of the shortfall in revenue collection which was reflected in downsizing of the Annual Development Programme (ADP) for FY15 which was revised down to BDT 750 billion and eventually amounted to BDT 685 billion at the end of the year. There were doubts during the year whether the government will be able to maintain the ADP utilization rate of 90% and above, which has been the trend over the last couple of years. However, the government managed to turn things around and spent 91% of the revised ADP budget, which was a commendable outcome. Perhaps buoyed by this success, the government set a massive ADP budget for FY16 budget at BDT 970 billion, which is 41% higher than the actual ADP in FY15. While this is a positive step towards the development goals of the government, the sectoral composition of the ADP raises some red flags. The government is focused on improving the infrastructure of the country as seen through the increased allocation to the Electricity and Transportation sector. However, the social sector, namely Education and Health has seen a decline in allocation or continues to stagnate. The allocation to the education sector has been on a decline for the third consecutive year, while the health sector has been stagnating at 6% of the ADP budget (Table 6). The government should perhaps reconsider their stance in these sectors since it is essential for attaining human development goals under the 7th Plan.



Despite all the shifts and cuts in finances and revenues, the government managed to keep the fiscal deficit at 3.6% of GDP, which was below the target of 5% of GDP. The composition of domestic sources of deficit financing was initially planned at 42% from borrowing from the banking system and the remainder through borrowing from National Savings instruments. However, owing to the political upheaval and the dip in consumer confidence, the sales of NSD instruments was very slow. Therefore, the government had to turn to the banking system and ended up borrowing 60% of the domestic financing from them. The main argument against excessive government borrowing from the banking system is the crowding-out effect on private sector credit. In FY16 budget, the budget deficit target has once again been set at 5% of GDP, out of which 2.24% of GDP is to be borrowed from the banking system. The reliance on NSD has declined in absolute numbers from BDT230 billion in FY15 to BDT 180 billion in FY16B. While this does put additional pressure on the banking sector it is a prudent move since there have been widespread discussions on the interest rate structure and term mismatch in the government saving instruments.



**Inflation and Monetary Policy:** At the close of 2011 Bangladesh inflation had reached an all-time high of 11% plus, making it the highest among the South Asian Countries. Thanks to the adoption of an appropriate monetary stance by Bangladesh Bank the inflation rate was brought down to a more desirable level in a span of three years (Table 7).



The shift in monetary policy stance till date remains a successful measure in cutting down inflation in Bangladesh. The downward trajectory of inflation in recent times can be attributed to favorable agricultural production, decrease in international commodity prices and minimum supply disruptions due to absence of natural or man-made calamities. The continuous improvement in domestic distribution system has further minimized supply disruptions contributing to containment of inflation. It is also important to note that the first half of FY16 has been blessed with minimum political turmoil making it easier for inflation to reach its targeted level within the desired period of time. The upsurge in point to point food inflation observed in early 2015 could be attributed to supply disruption caused by political

unrest and road blockades throughout the country during that period. High food inflation persisted for the following few months before changing course downwards. In Sept-2015, the point to point food inflation declined to 5.92% from a high of 7.63% recorded in the same month of the previous year (Fig. 4).



Following the decreasing trend in food inflation, the average general inflation settled at 6.24% in Sept-2015, being consistent with the inflation target of 6.2% for FY16. In contrast to the average general and food inflation, the average core inflation that counts for non-food and non-fuel inflation has inched up from 5.64% in Jan-2015 to 6.22% in September (Fig 5). In the latest Monetary Policy Statement (MPS), Bangladesh Bank has promised a “cautious stance” in order to address the continuous upsurge in core inflation. If the government allowed the local price of fuel oil to adjust in line with global market rates, then perhaps the inflation target for FY16 could have been reached by the end of 2015.



Although there is scope for inflation to decline further, Bangladesh Bank expects an escalation in the future if the economy targets a growth rate of 7% or above. It is extremely important that Bangladesh move out of the belief that higher inflation is required for higher growth. Higher inflation in a growing economy would soon affect the lending rate of banks and result in a case of perverse taxation leading to social inequality. The country's competitiveness will also be harmed as rising inflation will result in an appreciation of the real exchange rate. According to the latest MPS, “affording an inflation rate of 7% or 8% will be necessary to absorb the speeding up of employment, output, and wages”. Against this backdrop, countries like India and China should be taken as good examples of economies which have defied this concept by undertaking strong inflation controls. Bangladesh too should follow in their footsteps and reduce tolerance for higher inflation in the future.

Credit growth scenario: Domestic credit in Bangladesh has always been dominated by private sector credit claims. According to MPS 2015, the government is expected to borrow more money from the banking system in the ongoing fiscal year. However, when it comes to actual financing needs of the government, some discrepancies are always observed between the

projected and the real growth of public credit. In FY15, public credit registered negative growth of 2.6% whereas the original projection by the Bangladesh Bank was a positive 23.7%. The fall in public sector credit growth in the beginning of the year can be attributed to the slow implementation of government projects due to political unrest. Such volatility in the credit growth figures must soon be addressed by the Bangladesh Bank in order to have a more accurate and viable projection in the future.

In contrast, private sector credit growth has been relatively stable over the last few years. An exception would be the drastic fall witnessed in FY13, when private credit growth reduced to 10.8% from a high of 19.7% (Fig. 6). The growth rate has been slower since then. Part of this fall could be attributed to the limited interest in borrowing for new investments within the business community. From Dec-14 onwards, the growth rate has been stubbornly hovering around 13%. In addition, lack of electricity and gas supply, the major barriers to investment, are still prevailing making businessmen reluctant to expand their businesses. This has added to the plummeting demand for private credit. Likewise, the sluggish growth of RMG exports in FY15, a possible lagging effect of Rana Plaza episode, can also be held accountable for the slow but stable credit growth in Bangladesh.



According to the latest MPS, private sector credit growth of 13.2% in Jun-15, was adequate to support the output growth of 6.5%. Against this backdrop, a private sector credit growth of 15% should be sufficient to maintain the desired output growth of 7% for the current fiscal year (highlighted in MPS 2015). However, if the slow pace of credit growth persists then the prospect of reaching the projected credit growth by the end of FY16 may not materialize. It is therefore important that Bangladesh Bank takes appropriate measures to create room for private sector credit expansion in order to help the economy sustain the desired level of output growth.

#### External sector developments

**Current Account Balance:** After several years of surpluses over the past decade, Bangladesh's current account balance turned to a deficit of \$1.65 billion in FY15 (Fig.7) from a surplus of \$1.4 billion in FY14 owing to poor growth in exports of 3% being overshadowed

by a modest growth of 11% in imports. Other components of the current account have not fared well either, with increasing deficits in the services and income account, except for remittances. There is no cause for alarm about a negative balance in the current account as it is fitting for a developing country like Bangladesh to run substantial trade deficits as imports of capital machinery and intermediate inputs support investment and productive activity. As long as the current account deficit stays within 1% of GDP, its financing is quite manageable. During July-August, FY16, a modest recovery from the deficit was witnessed when despite a deficit in overall trade balance, services and primary income, inflow of wage earners remittances contributed to a current account surplus of \$800million.



Exports: FY15 ended with lacklustre export growth of only 3.4% (Fig.8), with RMG exports growing at 4% and non-RMG exports growing a mere 0.4%. This was clearly Bangladesh's worst record of export growth in the last 12 years. A modest pick up is observable in the first four months of FY16 with exports growing at 4.9% compared to a negative 1.0% during the same period of last fiscal year. The Export Promotion Bureau has set a target of 10.98% export growth for FY16 and in order to achieve it, exports would have to record an average of \$2.9 billion every month for the remaining eight months of FY16. This target is premised on past performance that will need a lot of favorable international developments to materialize.



The RMG sector, which recorded a paltry growth rate of 4% in FY15, is still recuperating from the blows it received due to the Tazreen fire and Rana Plaza tragedies. Though considerable progress has been made in improving compliance thanks to the pressures from Accord and Alliance and commitments under the EU Sustainability Compact, some remediation measures clearly need more time for completion. Meanwhile, though Bangladesh was not in the list of 122 eligible countries whose GSP was renewed by the US, substantial progress has been made in meeting the requirements under the United States Trade Representative (USTR) Action Plan so that a strong case is building up for renewal of GSP.

A careful analysis will show a number of factors that could be blamed for the lackluster export performance for much of 2015: (a) continued weakness in the economies of the

Eurozone - the destination of over half our exports; (b) stable nominal Taka/\$ exchange rate but significant appreciation of real effective exchange rate (REER) over the past three years that made our exports less competitive, at a time when most competing countries were depreciating their exchange rates; (c) rising domestic production costs due to wage increases and extra compliance costs in RMG industries; and (d) increased competition from Pakistan (received DFQF in EU), Vietnam (growth in US market), and India. However, a one-year lacklustre performance should not be taken as a doomsday scenario but accepted as a temporary setback from which to take lessons for future actions. Competitiveness of Bangladesh exports in labour intensive exports remains and will need to be complemented by supportive exchange rate management and improvement in trade facilitation. When export-led growth is the avowed strategy export pessimism has no place in our trade horizon. A turnaround in export performance is highly probable and distinctly feasible.

Export diversification, a vital component of our export-led growth strategy, has been a collateral victim of export under-performance. Constituting 18% of total exports in FY15, non-RMG exports continued to be outshined by RMG exports growing at a miniscule 0.4% (Fig.9 on page-3). If RMG export growth continue to outpace non-RMG export growth, the simple arithmetic of this trend suggests further mono-product concentration of our export basket. Out of the major non-RMG exports, footwear, jute goods, electric products and bicycles have been able to secure modest growth during FY15 unlike frozen food, agrifood products, raw jute, ceramics, and leather which posted negative growth during this period. With regard to export destinations of Bangladesh, as a single country, the U.S. accounted for 18 per cent of total exports while as a region the EU dominated with a share of 55 per cent in FY15 (Fig.10). Being reliant on a limited number of export destinations make developing countries like Bangladesh more susceptible to external demand (quantity) shocks. While a developing country cannot escape fully from the adverse effects of a global crisis, geographical diversification into emerging economies like Brazil, China, and India can help stabilize export revenues in times of crises in developed countries.



Imports: The relatively higher growth of 11.3% in FY15 imports (Table 8) gives a positive signal regarding forthcoming investment and economic activity, particularly when 78 per cent of these imports comprise capital machinery, intermediate goods, and raw materials and

a mere 14 per cent of total imports consisted of food grains and consumer goods. This is symptomatic of the fact that there is growing demand for capacity expansion and more productivity in the economy. Moreover, since imports support export production, a solid import performance gives a positive signal to export prospects in the coming months. Further, recent sustained pick up in production related imports (capital and intermediate goods) indicate potential uptick in industrial production (following the end of violent disruptions) which is supported by the Quantum Index of Industrial Production published by the Bangladesh Bureau of Statistics (Fig.11) showing a whopping 26% jump in industrial output between February 2015 and June 2015.



Services Trade Balance: Bangladesh has long been suffering from a services trade deficit in its balance of payments. The deficit in services trade has been widening since 1998 from \$0.37 billion to \$4.6 billion in FY15. This trend follows from an increased spending in international transport services especially freight which has accounted for over 60% of total service payments in the last couple of years. Bangladesh lacks comparative advantage over others in shipping business and suffers due to inefficiencies of the national airline, Biman. Other sources of expenditure include travel, telecommunications, health and education related services. On the other hand, the major source of receipts comes from earnings of the peacekeeping forces and state owned organizations serving abroad. The telecommunication, computer and information services sector is another rising contributor to the services trade receipts.

The LDC Services Waiver Decision that emerged from the 8th WTO Ministerial in 2011 in Geneva and subsequently confirmed for operationalization at the 13th WTO Ministerial in Bali in 2013 has provided Bangladesh the potential to expand its services export to other sectors of interest such as tourism, Information Technology (IT)-Business Process Outsourcing (BPO), nursing and labour services. Nevertheless, there are opportunities and challenges in each of these sectors which have to be overcome in order for Bangladesh to correct its history of service sector deficits.

Inflow of Remittance: The only saving grace of the Current Account was Remittance, which has grown by 7.6% in FY15 as opposed to a negative growth of -2% in FY14 (Fig.12). This pick

up in remittance growth in 2015 has reflected the buoyancy in Remittances to South Asia as a whole. The number of manpower intake by Saudi Arabia and UAE increased by 7% and 3% respectively in FY15 compared to those of Qatar (20%), Oman (30%), Bahrain (21%) and Malaysia (30%). Government policies have been supportive of the outward migration of workers through banking support for mobilizing remittances, fiscal incentives (tax free remittance inflows) and a stable exchange rate (Fig.13). Prospects for remittances in the near term look good as there is likely to be a high demand for workers in the coming years as Saudi Arabia has lifted its ban for Bangladesh jobseekers signing a Memorandum of Understanding (MoU) to receive manpower under 12 categories, and as Qatar prepares to host the football World Cup in 2022.



Foreign Exchange Reserves: Despite the deficit in the current account, the foreign exchange reserves continue to grow on account of an overall surplus in the balance of payments, standing at an all-time high figure of \$26.38 billion as of September 2015 (Fig.14). High levels of foreign exchange reserves act as a buffer during times of balance of payment crises. The country's credit rating gets a boost and that will enable foreign borrowings at competitive rates, to help increase investment. Reserve buildup is not without its share of demerits. Higher reserves mean idle and unproductive foreign currency that could have been invested in valuable assets and securities. A rapid reserve buildup also complicates monetary management for the central bank, as in case of Bangladesh. Bangladesh Bank had to actively engage in buying foreign exchange from the market in order to prevent any appreciation of the Taka, but that required a balancing act of simultaneous sterilization of the increase in money supply denting BB's own bottom line. That stoked further reserve build up to some \$27 billion by end October 2015. The reserves as of September 2015, will provide coverage for about 6.9 months of imports, which is quite comfortable since around five months of import coverage is generally deemed safe and comfortable for an emerging country like Bangladesh.

Exchange rate management and trends: Sustained stability of the exchange rate has been a cornerstone of exchange rate management for the last two years. There was virtually no change in the nominal exchange rate of Taka relative to the US Dollar in the latter half of FY15, which remained stable at 77.8. As in the years leading up to 2015, the accumulation of

foreign reserves continues to put appreciation pressures on the taka. However, Bangladesh Bank has sustained its prudent interventions in the foreign exchange market by buying dollars in order to counter the nominal appreciation of the taka, reinforcing its objective to maintain exchange rate stability.



Foreign reserves have undergone rapid growth in the past few years, growing from some USD 15 billion in FY13 to over USD 25 billion in FY15 and projected to grow by an additional billion in FY16. Although the central bank's intervention (i.e. purchase of foreign currency) is crucial in maintaining exchange rate stability, it leads to an increase in the money supply beyond the target level, thus undermining the inflation target. The improved performance of imports relative to exports does offer a ray of hope. If the trend of imports outpacing exports continues, a slowdown in the accumulation of foreign reserves will calm appreciation pressures, putting Bangladesh Bank in a position that enables depreciation with better ease.

Notwithstanding a slowdown in the accumulation of foreign reserves, the Taka still needs to fight off appreciation pressures. Bangladesh's Real Effective Exchange Rate (REER), which adjusts the nominal exchange rate for differences in domestic inflation and those of its main trading partners, has been trending upward since FY11 (Fig. 15). REER did fall somewhat in FY15, but continues to remain high compared to FY11.



The sharp appreciation of the REER is mainly due to higher inflation in Bangladesh relative to its trading partners. The major trading partners of Bangladesh include the US, European Union, China, India and Japan. A comparison of inflation in these countries with that of Bangladesh reveals a substantial difference (Fig. 16). The inflation rate differential with trading partners currently stands at 4 percentage points. Despite the low inflation target set by Bangladesh Bank, the differential is expected to remain wide over the next few years. The appreciating REER thus continues to undermine export competitiveness. The unsatisfactory performance of exports is a compelling factor in the argument espousing further depreciation of the exchange rate.



Bangladesh Bank's latest MPS (July-December 2015) reiterates the stance to preserve external sector stability, with an orderly transition of domestic currency exchange rate to new market equilibriums. It is expected that the recent sustained pick up in investment and consumption imports will ease appreciation pressures on the taka in the near term, thereby enhancing export competitiveness.



Trade Policy Developments: As the global landscape of trade undergoes transformation beyond the World Trade Organization's agenda of multilateralism in the direction of plurilateral and regional agreements, Bangladesh will have to steer its trade policy towards embracing a tariff structure and trade policy with a strong focus on market access, competitiveness, and alleviation of anti-export bias of the protection regime. Only then will the agenda of export-led growth based on a dynamic manufacturing sector see the light of day. In that respect, the Budget for FY16 revealed no fundamental change in the approach to trade protection (Table 9). The average Nominal Protection Rate (NPR) was reduced from 26.7% in FY15 to 25.6% in FY16 – a modest reduction that was largely due to the reduction of 1% in Regulatory Duty (RD).

Supplementary Duty (SD) has been the main anchor of para-tariffs (trade taxes other than custom duties that are akin to tariffs, e.g. SD and RD) in Bangladesh's trade policy. SD was introduced in 1991 under The VAT Act as a trade neutral tax, i.e. imposed at an equal rate on imports as well as domestic production. Over time, trade neutrality of SD was compromised by imposing differential SD on domestic production and imports. Since SD is imposed only on products that are already subject to the highest CD rate of 25%; and 82% of products subject to SD are final consumer goods (FCG), mostly with competing domestic production (Table 10), it has taken the shape of a protection instrument rather than a revenue source.



In FY16 budget, some 200 tariff lines with protective SD of 60% faced a reduction to 45%; at the same time 369 tariff lines with 15% SD saw an increase in protective duty to 20%. The net result provides no significant movement in the overall protective effect of SD. The budget

reduced the CD on import of capital machinery and parts from 2% to 1%, a measure that tends to encourage over-invoicing and illicit capital transfer. However, supplemented by para tariffs, the top NPR rate remains at 108%, especially on final consumer goods (FCG). Such high tariffs constitute de facto import bans. A huge challenge therefore remains in eliminating SD as a protective tax by either making them trade neutral (equivalent to SD on import and domestic production) or just removing SD from some tariff lines. This is expected to come into effect when the VAT and SD Act 2012 comes into force in July 2016.



Bangladesh presents a textbook case of how high protection can discourage exports. PRI's 2012 study on Effective Rates of Protection (ERP for selected sectors has revealed that trends in nominal tariffs indicate a growing wedge between output and input tariffs that is designed to offer progressively higher protection to domestic industries that are primarily engaged in the production of consumer goods. At the same time, there is minimal protection for intermediate and capital goods which arguably discourages domestic production of these goods (Fig.17: Average Tariff on Import Categories). The ERP computations across products and firms reveal that effective protection rate far exceed NPRs by wide margins because average input tariffs are well below output NPRs (e.g. 200% for biscuits as one of the startlingly high rates). More importantly, these high NPR and ERP levels favoring production for domestic sales (of import substituting industries) create anti-export bias by raising tariff-induced profitability of such domestic production against exports. Because of the free-trade channel (full duty-free export and import) provided to our 100% export-oriented RMG sector, RMG production is practically immune to the anti-export bias phenomenon; but other firms that produce both for exports and domestic sales are not so positioned. While supply side constraints raise trade transaction costs and undermine competitiveness of all exports, anti-export bias in non-RMG export production hurts the growth of non-RMG exports thereby serving as a policy barrier to export diversification. This phenomenon deserves urgent policy attention for corrective action.

Another phenomenon perhaps unique to Bangladesh is the relatively high rate of tariff escalation. Tariff escalation refers to the cascading tariff structure where every higher stage of processing is subject to higher tariffs, implying that value addition at higher stages of processing is protected by higher tariffs. This arrangement is validated by the 5 tariff slabs:

1-2% on capital goods, 5% on basic raw materials, 10% on intermediate goods, and 25%(+RD+SD) on final consumer goods (output or finished product). It is the high escalation rate in the last stage of processing that is perhaps unique to Bangladesh. In a cross country analysis of tariff escalation ratio (ratio of average output and input tariffs) as depicted in Table 11, one finds Bangladesh to have the highest ratio of 3.95 (2014), followed by Vietnam at 3.11, Thailand at 2.9 South Korea at 1 and India at 1.5, all in 2013. . The ASEAN group scores at 2.3 slightly above the data average of 2.1. More research is required to determine the costs and benefits of high tariff escalation in Bangladesh. Suffice it to say that when 'high performing' economies in Asia have chosen to keep tariff escalation relatively low, there must be good economic reason for such a policy.

Market access and rise of Plurilateralism: The emergence of the Trans Pacific Partnership (TPP), by far the largest trading bloc outside the WTO, with 12 Pacific Rim countries covering 40% of global GDP, has caused quite a stir in the global economic scene. Signed in October 2015, it took barely six years of negotiation to reach Agreement on several second generation trade and investment rules. The conspicuous exclusion of China, the largest Pacific Rim country, makes it a US-centered and geopolitically-motivated post-WTO trade agreement that could pose a challenge to the global influence of WTO. Another such bloc is in the offing on the Atlantic Rim between US-Canada and the EU members: Trans Atlantic Trade and Investment Partnership (TTIP). These plurilateral agreements are a reaction to the stalemate in multilateral negotiations at the World Trade Organization (WTO), especially since launching of the Doha Round (DR). Though in principle these trading blocs are largely compliant with WTO rules - in a WTO plus functioning mode - once fully operational, they will no doubt pose a serious challenge to the status and global clout of WTO. Critiques argue that the TPP and TTIP, both sponsored by Washington, are overtly discriminatory against low income countries violating a fundamental principle of multilateralism - non-discrimination.

Much has been said about what has become of the WTO decision making process, one that is based on the principle of decision by consensus of 161 members, and another that is based on the "single undertaking" i.e. all or nothing principle. Combination of these two principles often drive negotiations to the ground, as we have seen with the protracted Doha Round which is still inconclusive after 15 years of negotiations. So disillusionment with the WTO process is real. The speed at which the WTO and its rounds of trade negotiations are moving is acceptable to no one, given the fast pace of globalization and changing business

environments. The result? While accepting the WTO as the bedrock of the global trading system, countries around the world are considering issue-based plurilateral agreements proactively in parallel with pursuing FTAs.

What do these emerging trading blocs mean for Bangladesh which is geographically ineligible for primary membership? Not much, according to some analysts, as these blocs represent mostly developed nations that have already granted Bangladesh DFQF access, with the exception of USA. Indeed, Vietnam, a competitor of Bangladesh, is likely to become the major beneficiary of the TPP trade deal as it will soon get low or zero-tariff access to Japan and US markets.

Nevertheless, it would be useful to have a broader perspective. First, apart from SAFTA (South Asian Free Trade Area), and APTA (Asia-Pacific Free Trade Agreement), Bangladesh is currently not part of any other trade-related FTA, RTA or PTAs. The record of SAFTA shows that it has been largely ineffective in garnering trade and investment expansion in any significant magnitude, with intra-regional trade stagnant at about 5% and investment barely 1%. APTA, sponsored by ESCAP in 1975, has led to periodic tariff reductions among its members but still falls far short of a free trade arrangement with countries maintaining high protective tariffs on far too many products. What is perhaps disconcerting is that Bangladesh has not been able to initiate serious trade talks with any country or regional groups with regard to liberalization and rulemaking in trade. For instance, for lack of any known overtures to the ASEAN secretariat, Bangladesh has been completely left out of the most dynamic trade group in its neighborhood, whereas India, China, Japan, South Korea, Australia, and New Zealand, struck FTAs with ASEAN. Consequently, Bangladesh has no part of the lucrative job-creating regional value chain integration that has been a boon to East Asian economies for the past two decades. This contrasts with the proactive approach taken by our close neighbor, India, who has been actively pursuing FTA engagement with the ASEAN, Australia, China, the EU, Latin America and the USA.



Being an LDC, Bangladesh does not need FTAs with EU or most developed economies for the time being, but not for long as it is poised to graduate out of LDC status in 2018 if not by 2021. What is our level of preparedness to face a more competitive trading environment? For

the time being, the lack of active participation in large RTAs has not affected Bangladesh's exports adversely since the country currently enjoys duty free access to major markets like the EU, and substantially duty free access to many other countries under the rubric of GSP (Generalized System of Preferences). This allows Bangladeshi exporters to gain competitive advantage over many of its larger competitors like China, India, Indonesia, etc. Once Bangladesh graduates from its Least Developed Country (LDC) status, lack of FTAs or not being part of any trading blocs could hinder its export expansion as it is likely to lose the preferential access it has been enjoying as a LDC. Bangladesh has not linked up with major global supply chains that may open gateways for dynamic economic development with significant tariff concessions. Consequently, Bangladesh may miss out on advantages as a result of being excluded from the TPP and TTIP: harnessing comparative advantage, greater production efficiencies, access to a wider range of products, entry to foreign markets, recipient of FDI, employment generation for the export sector and therefore securing a considerable boost to economic growth.

FTAs and RTAs not only provide greater market access for products within the member countries, these arrangements also promote investment from the more developed to less/least developed members of the RTAs. Myanmar is getting much more FDI than Bangladesh because of its ASEAN membership; Vietnam's FTA with the US was a stimulus to its export dynamism which will soon get a further boost from its inclusion in the TPP.

Nevertheless, it is important to keep in mind that Bangladesh is a significant beneficiary of the multilateral trading regime right from the beginning. The fundamental principle of WTO was the equal treatment clause epitomized by MFN (most favored nation). Acknowledging that among WTO members there were developed and under-developed trading nations, and realizing that open trade could inflict adverse outcomes on the less prepared trading partners, rules were framed to accommodate special and differential treatment (SDT) for the less developed members, to which Bangladesh belongs. It is fair to say that Bangladesh has been a major beneficiary of the SDT and, to its credit, has taken full advantage of the facilities accorded in terms of non-reciprocal grant of market access under various preferential arrangements, including duty free quota free (DFQF) access in several countries (e.g. Canada, Japan, Australia) and country groups (EU). Though occasionally rules of origin (ROO) requirements undermine the concessionality of preferences, they are still better than nothing. The departure from MFN obligations come under the rubric of WTO's Generalized

System of Preferences (GSP) which allowed member countries to establish systems of trade preferences for other countries. EU's Everything But Arms (EBA) is a major concession to Least Developed Countries (LDCs) including Bangladesh allowing DFQF access, under the GSP umbrella. So are DFQF access offered to Bangladesh by Japan, Canada, Australia, and other countries. Exporters know of the gains in competitive advantage resulting from DFQF access when competitors face higher tariffs. Of the \$245 billion that Bangladesh exported in the past 15 years, rough and ready estimates suggest that some \$50 billion of these exports would have been the incremental contribution of preferential access.

The gains from WTO multilateralism notwithstanding, Bangladesh should gear up its economic diplomacy in order not to be left out of some of the emerging mega trade and investment partnerships. Because, just as China will lose out when TTIP 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 a potential free trade agreement for developed and developing countries such as the Free Trade Agreement of Asia-Pacific (FTAAP) sometime in the future would remain an option for Bangladesh to pursue. Since free trade in goods lists as the first item in the agenda of any of these mega trading blocs, Bangladesh's tariff regime could become a source of ineligibility unless rationalized on a fast track basis.

Looking beyond the current horizon: In 1941, Fortune Magazine founder Henry Luce described the 20th Century as an American century, predicting that by 2041 the 21st Century will be Asia's. That prediction is on way to becoming reality as Asian companies from China, S. Korea, Taiwan, Japan, and India, are fast overtaking age old giant companies of the West. Bangladesh can rightfully aspire to be a developed country by 2041, but it will have to be completely transformed in order to take advantage of the digital explosion that characterizes the Third Industrial Revolution currently under way – a revolution that throws up “exponential” companies by the dozens: Apple, Facebook, Amazon, Samsung, Huawei, etc. A Fortune Global Forum in San Francisco this month concluded that all companies in the digital age have to be technology companies because by 2025 there will be 500 billion connected devices that will know no borders between developed and developing economies. Innovation may come from small firms in remote parts of the globe, even from Bangladesh. Progress in this age is characterized by a new form of Schumpeterian creative destruction –

innovate, disrupt the old, and grow exponentially with the new. The environment in which global business and industry operate is changing so fast that antiquated efforts at export-led growth or export diversification may not bear fruit unless they keep step with the technology revolution as well. Firms that innovate will move ahead and gain market share while those who do not innovate will fall by the wayside in the wake of a new paradigm of comparative advantage. In that scenario, Bangladesh's labor cost advantage which is now the basis of its comparative advantage could become victim of the new trade in skill-intensive goods and services. The economy will therefore need to adopt technology at a much faster pace in order not to be left behind. That calls for a massive skill development program which should be given the highest priority with adequate resources earmarked for investment in high quality tertiary education. A strategy of courting FDI (regional and global) for harnessing the development of 21st century skills will be of paramount importance.

Before drawing the curtain on this report we would be remiss if we did not draw attention to the scarcity of domestic resources relative to the colossal investment challenge that Bangladesh faces in bringing its energy and transport infrastructure to the level that will be demanded in the 21st century. According to an estimate by the Asian Infrastructure Investment Bank (AIIB), the new multilateral agency of which Bangladesh has become a founding member, Asian countries will need \$730 billion annually over the next decade to meet their demand for infrastructure investment. Bangladesh's requirement, according to the 7th Plan, is \$9-10 billion annually. While AIIB offers a welcome new window, Bangladesh will have to scour the globe for both Official Development Assistance (ODA) resources and private FDI to meet the demand for infrastructure investment. Accelerated private sector investment-both domestic and foreign-will be the key to mobilizing resources under such format as Public Private Partnership (PPP) with the government's role being critical in creating the investment friendly environment with facilitating regulatory protocols. Notable progress has been made in the provision of power and land, the two factors identified as binding constraints to investment expansion. While power generation capacity was doubled during the 6th Plan to 11,500 MW, the fast tracking of 50 identified public and private Special Economic Zones, some with country specific assignments to Japan, China, India, and others could signal a breakthrough in resolving the land constraint in the drive towards augmenting FDI receipts to comparable levels with peers.

Thus in 2015, after an initial pause, Bangladesh continued on its march to attaining greater

heights of prosperity, with commendations coming from leading global experts. The economy's potentials have been recognized as vast emanating from its hard working and resilient population. Greater readiness for exploiting emerging opportunities and coping with the challenges remains the need of the hour.