The large cracks in Bangladesh that IMF missed

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In January 2023, Bangladesh entered into a $4.7-billion IMF programme, spanning over 42 months, to fight the pressures on the macroeconomy and arrest the associated economic downslide. These pressures, triggered by a series of external shocks emerging from Covid-19, global inflation and the Ukraine War, had accumulated over a number of years owing to weak economic management. The policy corrections, therefore, involve macroeconomic adjustments, structural reforms and institutional strengthening.

The core IMF programme was broken down into six reviews, and the associated policy reforms were designed to become progressively more challenging. The government should take some comfort in successfully negotiating the release of the second review on June 24.

While the government succeeded in ticking many of the conditionalities for the first and second review and convinced the IMF to be more flexible on some others, in substance, the two most important policy reforms implemented so far are the flexibility of the exchange rate and interest rate. However, fiscal correction has not happened, and the structural reforms in taxation, subsidies, state-owned enterprises, trade policy, and the banking sector have not made adequate progress.

Against this backdrop, the IMF has identified nine specific risks and uncertainties that could jeopardise progress with implementation of the IMF programme and constrain the ability of Bangladesh to successfully stabilise the macroeconomy and resume the growth process on a sustainable path. Five of these risks are global in nature and four are domestic.

The global risks include intensification of regional conflicts, commodity price volatility, abrupt global slowdown, systemic financial instability, and deepening geoeconomic fragmentation. The domestic ones relate to failure to maintain a market-based flexible exchange system, failure to address banking sector reforms, insufficient international support in resolving the Rohingya crisis, and higher frequency and severity of natural disasters related to climate change.

The global risks are well identified. It is hard to quarrel with them. Regional conflicts and deepening geoeconomic fragmentation are of particular concern. Yet, it is fair to say many of these risks have prevailed over the decades. The main policy implication of these risks is to make an all-out effort to stabilise the macroeconomy and resume the momentum of sustainable growth as quickly as possible. Growing economic resilience is the best way to absorb external shocks and take corrective actions in the future.

The list of domestic risks is way too conservative and misses out some big-ticket items. Regarding the Rohingya crisis, this is more in the nature of an external risk. Bangladesh is doing its best to drum up international support. Progress with fiscal reforms will help create more space to fund Rohingya needs.

Concerning climate-related natural disasters, this is more a long-term challenge, although admittedly, Bangladesh’s response in instituting policies and programmes to build greater climate resilience so far has been weak. It is not clear whether the IMF programme’s $1.4-

billion climate resilience component has been very effective in strengthening this policy response, especially in regards to mainstreaming climate change policies in planning, budgeting, incentives and institutional capabilities. I would like to throw the ball back at the IMF's court and ask it to reassess this component to see if the programme design was adequate to secure substantial climate reforms with potential long-term benefit.

The two remaining domestic risks are both very relevant and fall in the high risk category. It has now been 18 months since the IMF programme was approved, and little progress has been achieved in the banking sector. If anything, downside risks have increased. The volume of non-performing loans and distressed assets continues to increase, and there is little sign that a reversal is coming anytime soon. Without meaningful progress on banking reforms, the overall quality of the IMF programme will suffer.

On the exchange rate, an encouraging beginning has been made with the reform on May 8. The unification of the exchange rate and adoption of the interim crawling peg regime is a sound reform. Steps must be taken to quickly move to a fully flexible market-based exchange system. The risk of slippage is high, but the IMF must remain vigilant in monitoring this risk and engage with the government to stay on track.

Several substantial domestic risks have not been identified in the IMF risk matrix. These risks are not only high but present more immediate adverse consequences for the macroeconomy and resumption of growth momentum than the seven other risks noted by the IMF (the five global, the Rohingya, and the natural disaster ones).

First and foremost is the weakness of fiscal policy. This is the Achilles heel of Bangladesh's development strategy, and progress has been faltering for a long time. The 18 months of the IMF programme has brought in some marginal progress, but most of the institutional and structural aspects of the tax reform programme have not been addressed.

Of immediate concern is the consistency of the FY2025 budget with monetary policy for inflation control. At 4.6 percent of GDP, the budget deficit is way too high to allow the credit tightening that is needed to control inflation. There is a high risk that the budget will either crowd out private credit or cause a loosening of monetary policy thereby jeopardising inflation control.

A big missing item in the budget is the absence of reform of the state-owned enterprises (SOEs). The financial return on investments in SOEs is very low and net budgetary transfers to sustain these poorly performing SOEs are way too high. Reform of SOEs is an easy win and surprisingly not emphasised in the IMF programme.

On the spending side, the budget subsidy target is too high while the allocations for health, education, training, agriculture, water, and social protection are too low. At a time when job creation is constrained, the economy is slowing down, and inflation is high, the low level of spending on social protection (0.8 percent of GDP excluding civil service pensions) is very disturbing and must be corrected.

Another major structural reform where very little progress has been made concerns trade protection. This again is a long-standing challenge. The tax revenue's excessive dependence on customs duties, including supplementary and regulatory duties, has prevented any meaningful progress with trade reforms even after 18 months of the IMF programme. Consequently, the anti-export bias of trade policy prevails, which constrains export diversification and growth of non-RMG exports. Indeed, the slowdown in export growth to a mere 2 percent in FY2024 is a hugely worrisome development for both the sustainable management of the balance of payments and recovery of the growth momentum.

The final missing risk area is governance and institutions. The high incidence of corruption, some of which have erupted openly in the public domain, especially at a time when inflation is high and the economy has slowed, is a huge threat to social and economic stability. The government has adopted a policy of zero tolerance for corruption. This is comforting to know but it must now act decisively to implement its policy of zero tolerance. It must dig down to the root causes of corrupt practices and implement the required institutional and regulatory reforms that eliminate/minimise the scope for rent seeking.

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