

## The other side of the coin

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The global financial crisis is no longer limited to the financial sector. The onslaught has already spilled over into the sphere of production, consumption and jobs in the real economy. The irony of it all is that the big casualty of this phenomenon is not on Wall Street or the American Main Street. It is the world's poor. With \$3.5 trillion pumped in by western governments to shore up wayward financial institutions, it should hardly be a surprise to see resources for poverty reduction in short supply soon. That will also hurt poverty programmes in Bangladesh. More and more economists are in agreement that economies of Europe and USA are already in a recession mode. US third quarter gross domestic product (GDP) declined 0.3 per cent, while fourth quarter GDP is poised for a fall, according to analyst projections, thus validating the formal start of a US recession – one that by all indications is likely to be deep and protracted. To add fuel to the fire, September consumer spending in the USA took the greatest dip in 20 years. What does all this mean for the Bangladesh economy in the near term? The Chief Adviser, Dr. Fakhruddin Ahmed, made a clarion call for global concerted efforts in addressing this crisis. Upon his return from the World Bank-IMF meetings, Finance Adviser, Dr. Mirza Azizul Islam, assured us that economy was in good shape, donors continue to make generous commitment of aid

to Bangladesh, and the fallout from the financial tsunami on Bangladesh will be muted, at best. Bangladesh Bank (BB) Governor, Dr. Salehuddin Ahmed, made several public appearances last week where he also reassured money and equity markets that the financial sector would be under close watch, its exposure to western-style financial derivatives was nil, and there was no prospect of a credit or liquidity crunch of the sort that all but froze lending in developed country markets. Meanwhile, BB has made sure that all its holdings of foreign exchange reserves are in cash, US Treasury securities, accounts with central banks, and in sovereign bonds. Events of the past few weeks have confirmed that financial markets around the globe are deeply integrated, just as much as the market for goods and services. Now, it is the turn of the real economy to feel the pinch. Stark predictions about the future state of the world economy has come out of the International Monetary Fund (IMF) whose annual report, World Economic Outlook (WEO), is closely watched by governments, business and industry. October 2008 WEO has revised global growth projections downward to 3.9% for 2008 and only 3.0% for 2009, as compared with 5.0% actual for 2006 and 2007. For the developed countries, WEO projects 1.5% growth for 2008 and a mere 0.5% for 2009, compared with 2.8% in 2006 and 2007. These numbers have important implications for Bangladesh's economy as our superior export performance depends largely on the prosperity in the developed economies of North America and countries in the European Union (EU). Unfortunately, our export sector suffers from two vulnerabilities that we have been unable to overcome: first, export concentration, arising from the fact that 76% of our export basket is made up of one commodity group, readymade garments; second, over 90% of our exports are destined for

the markets of USA and EU. Efforts to diversify our export basket or export destinations have not yet borne fruit. With the economic crisis gripping these developed economies, can Bangladesh be immune? Highly unlikely. But most prognosis of the linkage suggests that the financial tsunami will only leave minor imprints, at least in the near term. By now it is clear that the ripple effects will be transmitted through trade flows rather than the financial markets. But the effects might be more muted than, say, the impacts that will be felt in our neighboring country, India. The latter economy is today much more integrated with the global economy through trade as well as capital flows. To be sure, the Bangladesh economy is much more open today than it was in 1990. But most of the opening up has taken place in current account transactions of the balance of payments, with current account convertibility having been invoked back in 1994 under IMF's Article VIII. The capital account remains non-convertible with very few private transactions, except foreign direct investment and portfolio investment, being permitted. Evidence regarding the impact of capital flows shows that FDI has the most stable and lasting impact on growth, whereas portfolio investment tends to be footloose. Private debt transactions are limited and strictly monitored by the central bank. Consequently, current account transactions, made up of exports and imports of goods and services, income and current transfers, including remittances, made up 65% of GDP in FY 2008 as compared to barely 35% in FY1990. On the other hand, capital account transactions, made up of capital inflows and outflows, have remained around 2.0% of GDP during the same time except for a brief period in the late 1990s when a surge of foreign direct investment was experienced in the energy sector. In contrast,

India's current account and capital account transactions are 53% and 64% of GDP, respectively. Fallout from the financial crisis has already prompted swift corrective actions on the part of the Reserve Bank of India. While Bangladesh might face some demand slowdown in its major exports, the financial sector appears quite immune to the current global crisis as our financial institutions are not exposed to the complex financial derivatives or synthetic securitization instruments that have proved to be the bane of western banks and financial institutions. Because of this there is no sign of any contagion emanating from western banks. There is clearly no crisis of confidence or any liquidity problem that could lead to a credit squeeze. Prudential regulations and strong monitoring by the Bangladesh Bank has kept the lending-deposit ratio of private banks within acceptable limits. The major impact might come through a fall in consumer expenditures which make up two-thirds of US and European GDP and are the prime drivers of these economies. To Bangladesh's advantage in this crisis, our RMG exports happen to be serving the low end of the market where demand tends to be less volatile. With incomes falling, some diversion of demand from high-end garment segment to low-end is not unlikely. Leading entrepreneurs of RMG have expressed optimism regarding riding out this storm without a major dent in their market position. What should be an appropriate response in the face of a possible slowdown in export demand, should that happen? With export growth averaging 15% for the past several years, it is only realistic to expect temporary declines even when there is no global crisis. The reality is that we can do nothing about demand changes in the

importing countries. This is not the time for subsidy. It seems the demand for holding off increases in power and gas tariffs for the time being is legitimate and should be honoured. This would be the time to enhance the efficiency of customs, ports, and infrastructure, as producers might face cost-cutting pressures to stay competitive. This is also the time to shore up safety net programmes for garment workers through public-private partnerships, an initiative long delayed.

Not much can be done about remittance flows if there is a slowdown. Remittance, sourced from USA and Europe, could face modest setback temporarily, though nothing catastrophic, as these account for roughly onethird of remittance inflows. Its phenomenal growth that we have been witnessing in recent years is likely to be moderated. In the Middle East, from where two-thirds of our remittance originate, reports suggest migrant jobs are likely to hold steady though fresh recruitment might suffer. Reports indicate that governments in the Gulf countries and Saudi Arabia have taken preemptive action to shore up banks at the slightest sign of trouble.

These countries have accumulated enormous foreign exchange reserves by running current account surpluses for years together and show no sign of weaknesses. In fact, London's Barclays Bank has looked to the Gulf region and obtained a \$12 billion bailout from private sources rather than turn to the British government. The fall in oil prices might wipe out somewhat the windfall gains to these oil exporting countries which continue to be flush with dollar and Euro reserves. The massive programmes of modernization and infrastructure buildup in this region might be tempered but not halted. As such, migrant workers from Bangladesh would continue to be in demand.

Assuming the developed world suffers from a long and deep recession, oil prices continue to

remain at their current lows, and commodity prices remain depressed, that would surely ease Bangladesh's battle with inflation. Lower import prices will help improve the terms of trade with favourable implications for the current account of the balance of payments. Typically, Bangladesh economy does not go through cyclical phases like the developed economies. The last time we had a fall in GDP (recession) was in 1989 in the wake of severe floods and political turmoil. Since then, growth has always been positive, averaging six per cent in the past five years. GDP growth of 6.5 per cent projected for FY2009 is likely to be achieved, despite the global economic crisis, unless the economy is overtaken by some other catastrophic event. Finally, it has to be acknowledged that Bangladesh economy continues to have strong macroeconomic fundamentals that make it capable to withstand adverse shocks emanating from short-term declines in export demand. To Bangladesh's advantage, the current account has been running surpluses, the exchange rate is flexible, foreign exchange reserves appear comfortable, inflation is moderating lately, and budget deficits are within tolerable limits. Thus the macroeconomic scenario looks good for Bangladesh to cushion an adverse external shock should it happen. (Dr. Sattar, a former civil servant and World Bank economist, is Vice Chancellor, The Millennium University)