ISAS Insights

No. 165 – 23 May 2012

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

State of Bangladesh Economy: A Prognosis for the Future

Ishraq Ahmed[1]

Abstract

Against the backdrop of the global economic slowdown, the Bangladesh economy has performed strongly over the past few years. Despite the fallout from the Euro debt crisis still contributing to an uncertain economic environment, the Bangladesh economy has pursued accommodative monetary and fiscal policies. However, if the global economic slowdown is much more prolonged than the current forecasts indicate, the impact on Bangladesh is expected to be adverse. The economy has persevered so far in the face of global recession, but the domestic challenges are manifold with respect to soaring inflation, import-export imbalances, devaluation of the currency, a slow growth of remittances, increasing budget deficit and government borrowing. This paper provides an overview of the Bangladesh economy with respect to its fiscal, monetary and trade performance. The aim is twofold – to assess the current state of the economy, followed by an appraisal of Bangladesh's economic outlook and opportunities ahead.

The Current State of the Economy

The table below presents a brief snapshot to show how the Bangladesh economy has performed in comparison to the world economy and other economies in the Asian region.

[1] Ishraq Ahmed is a Research Associate at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He can be reached at isasishr@nus.edu.sg. The views expressed in this paper are those of the author and do not necessarily reflect those of the institute.

One of the ways to evaluate how the economy has fared can be seen by comparing the growth of GDP since 2009.

<u>Table 1</u> – GDP Growth rates at a glance

	Actual			Projections	
	2009	**2010**	**2011**	**2012**	**2013**
World Output	-0.6	5.3	3.9	3.5	4.1
Emerging and Developing Economies	2.8	7.5	6.2	5.7	6
Developing Asia	7.1	9.7	7.8	7.3	7.9
China	9.2	10.4	9.2	8.2	8.8
India	6.6	10.6	7.2	6.9	7.3
Pakistan	1.7	3.8	2.4	3.4	3.5
Bangladesh	5.9	6.4	6.1	5.9	6.4

<u>Source:</u> IMF World Economic Outlook

Compared to the global average, Bangladesh has witnessed higher GDP growth rates. Despite a fall in world output during the immediate aftermath of the financial crisis in 2009, Bangladesh has consistently exceeded growth rates of five percent since 2009. However, when compared to the developing and emerging countries which rebounded strongly from 2010, Bangladesh has achieved average growth rates – its economic growth has not quite stood out among other countries and is projected to remain close to the developing countries' averages in 2012 and 2013. Further disaggregating the countries in the developing Asia region, it can be seen that output growth of Bangladesh has been below average since 2009. While regional powers like India and China have witnessed growth rates of around nine to 10 per cent, Bangladesh has been hovering around the six per cent mark. The GDP growth is also projected to be lower till 2013 – China and India are estimated to have rates of 8.8% and 7.3% respectively, while Bangladesh is estimated to be at the six per cent mark. Compared to Pakistan, the Bangladesh economy has fared much better over the last three years – the economy has grown more than three times faster on average.

The performance of the economy can be evaluated through the three channels: fiscal, monetary and trade.

Fiscal Channel

Until recently Bangladesh's financial sector did not experience any substantial turbulence from the aftermath of the global financial meltdown. This can be attributed to its limited connectivity with the international financial system and as such, Bangladesh was relatively well insulated on the financial side of the economy. The banking sector is a major player in the financial sector and it has functioned reasonably well since 2009. The profitability of the banks has improved quite substantially over the period 2007 to 2010, as illustrated by the return on assets and return on equity:

Table 2- Performance of the Banking System

	Profitability Ratios	
Year	**Return on Assets (%)**	**Return on Equity (%)**
2007	0.9	13.8
2008	1.2	15.6
2009	1.4	21.7
2010	1.8	21

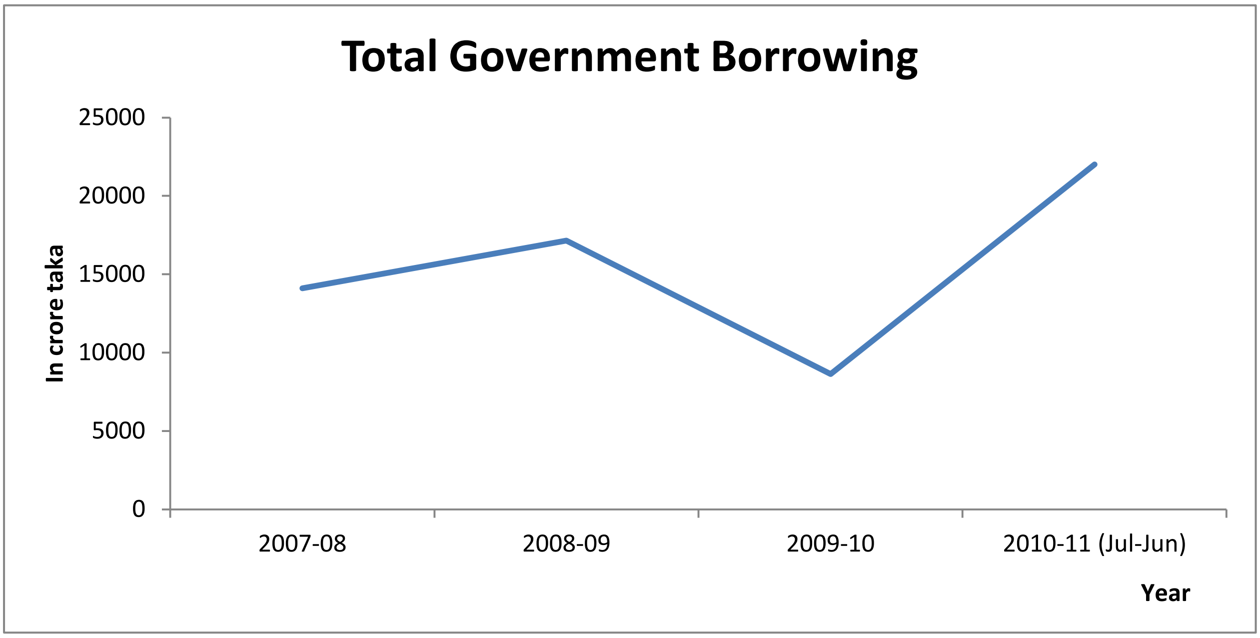
Source: Bangladesh Bank

The return on assets in the banking system has increased from 0.9% in 2007 to 1.8% in 2010, while the return on equity has increased significantly from 13.8% in 2007 to 21% in 2010. The basic banking sector indicators appear to have improved over the period and as such the sector is quite vibrant.

On the fiscal side of the government, cracks have begun to emerge due to increasing subsidy costs borne to maintain fuel consumption at a reasonable price. This strain has emerged despite tax revenues exceeding around 10 per cent of GDP in FY 2011 (Fiscal Year)[2] – a record first for Bangladesh. [3] Despite an improved tax revenue mobilisation, the government fiscal management has been mediocre in this regard. Along with spending pressures from fuel subsidies, other sources include spending on agricultural input subsidies and higher cost of crude oil. The government borrowing from the banking sector has also increased quite significantly. According to the latest banking statistics, loans to the government from the commercial banks has reached around Tk 163 billion (US $1.96 billion) in addition to those from the central bank, during the first nine months from July 2011 to April of the current fiscal year. From the commercial banks alone, the government has borrowed around $1.3 billion. However, the government loan was less than a billion US dollars ($0.92 billion) during the first nine months of FY 2011[4] – borrowing has more than doubled over the last one year leading to concerns of higher inflation in the economy. The borrowing has in fact exceeded the entire fiscal year target in nine months due to a large spending on subsidy in the power and energy sectors and on social safety net coverage. Since FY 2008, government borrowings have increased substantially, with only a dip in FY 2010 (Figure 1).

2 Fiscal year/ Budget year runs from July 1st to June 30th of the next year.
3 Annual Report 2010-2011, Bangladesh Bank (2011).
4 *Ibid.*

Figure 1- Government borrowing



Source: Bangladesh Bank

The government borrowing has increased significantly even by historical standards – this could manifest itself in various problems for the economy. First, the increased borrowing may force up interest rates and crowd out private sector investment in Bangladesh. Second, if this borrowing trend continues, the government may need to increase the tax burden in the long-run. In addition to a dampening of demand and economic growth, this decision will be deeply unpopular. Finally, the increase in national debt would mean that the annual interest payments will rise – money that could have been spent in priority areas of the economy.

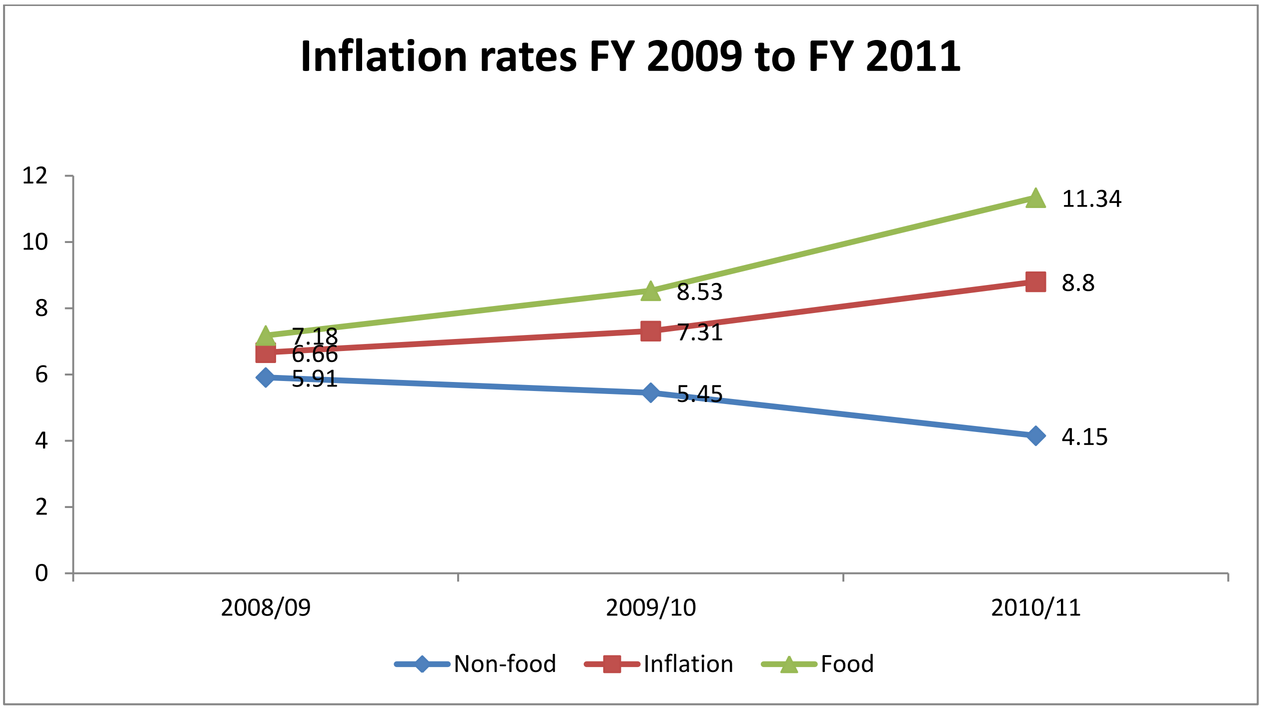
Monetary Channel

On the monetary side, the rate of inflation has reached very high levels during FY 2011. This is probably the single most important indicator that affects all spheres of the Bangladesh population. According to Figure 2, general inflation has been increasing since FY 2009. The initial target for the general inflation was around 6.5% in FY 2011, but it ended up being around 9%. Food inflation has been a major driver of inflation, increasing steadily over the last three years while non-food inflation has been falling somewhat. Food inflation hurts the poor even more than non-food inflation – the general basket of goods of the poor typically consists of a higher proportion of food items. As of March 2012 inflation has reached double digits around 10.92%.[5] Food inflation has eased somewhat to 11.91% (12-month average basis) in the same month largely as a result of a good harvest, but non-food inflation has exhibited a reversal in its trend exceeding 9%.[6] If the first few months of 2012 are any

5 Bangladesh Bank Economic Data. Accessed 2 May 2012.
6 Major Economic Indicators: Monthly Update, April 2012, Bangladesh Bank (2012).

indications to what lies ahead, Bangladesh is in danger of exceeding its end of the year target yet again. Higher inflation has been attributed to rising commodity prices in the world market and is also a consequence of higher than budgeted government spending. In addition, the high rate can be attributed to continuing supply and infrastructural bottlenecks – the road and railway networks are still very dilapidated nationwide which leads to poor market linkages within the districts. The inflationary pressures have persisted despite a bumper rice production along with potato, fruits and vegetables production in the economy. The growth rate of money supply has also been identified as an important determinant of this rising inflation by the Bangladesh Bank (the central bank of the country) and as a result, a restrained monetary policy is currently being adopted.

Figure 2- Inflation



Source: Bangladesh Bureau of Statistics (BBS)

An accommodative monetary policy has been identified as one of the causes of a precarious macroeconomic situation. The increase in broad money which includes demand deposits, time deposits and saving deposits has increased by 18 per cent at the end of January 2012. Domestic credit growth has further exhibited an increase of 23.59% at the end of January 2012, with credit to the private sector increasing by 18.94%.[7] These figures illustrate the years of liquidity expansion at rates beyond what is considered sustainable for maintaining economic activity and growth. Such expansion has led to the asset price inflation prevailing in Bangladesh at the moment, along with the recent stock market bubble and the subsequent burst – the excess liquidity overhang could cause the economy to unravel.

[7] Major Economic Indicators: Monthly Update, March 2012, Bangladesh Bank (2012).

Trade and Current Account Channel

The balance of payments went into a deficit in FY 2011, the first time in a decade. Balance of payments pressures have stemmed from rising oil and capital goods imports, volatile commodity prices and weak aid inflows. Large oil and capital imports have been associated with the newly-installed fuel-intensive power stations. However, exports achieved a growth spurt in FY 2011 due to the ready-made garments (RMG) sector. Bangladesh's relative performance has been very strong and as such, it has been one of the better performing textile exporting countries in the US and EU markets. The slowdown in remittance inflows along with increased import payments for goods and services have however offset the large gain in export growth. Imports had increased by around 40 per cent in FY 2011 resulting from a strong domestic demand and high global commodity and petroleum prices, thus causing the trade balance to deteriorate.

Figure 3 – Trade Balance

(In million US$)

	2009-2010 July-June	**2010-2011 July-June**
Trade Balance	-5155	-7328

Source: Bangladesh Bureau of Statistics (BBS)

The data further shows that trade balance has taken a turn for the worse – trade deficit has increased by 42 per cent over one year. The current account balance has deteriorated by around three percentage points of GDP as well.[8]

The foreign currency reserves of Bangladesh have increased to $10.19 billion in April 2012 after the first installment of the IMF loan was disbursed under the Extended Credit Facility (ECF) arrangement.[9] According to the Bangladesh Bank, the foreign reserves had been hovering below the $10 billion mark since last August. This led to concerns that the policy buffers were inadequate in the event of adverse real shocks. Furthermore the IMF had stated that $9 billion is not a sufficient reserve for three months' imports. Higher import payments might have exerted pressure on the foreign exchange combined with a relatively lower growth in export and remittances. A significant portion of the foreign reserve buffer built during 2009-2010 has been used up in 2011. The IMF loan could therefore bolster the volatile reserves somewhat and create some breathing space for the macroeconomy to function.

The fall in foreign currency reserves had caused a very steady depreciation of the taka against the US dollar last year and also during the first few months of this year. The weakening balance of payment situation and instability in the money market has also contributed to a

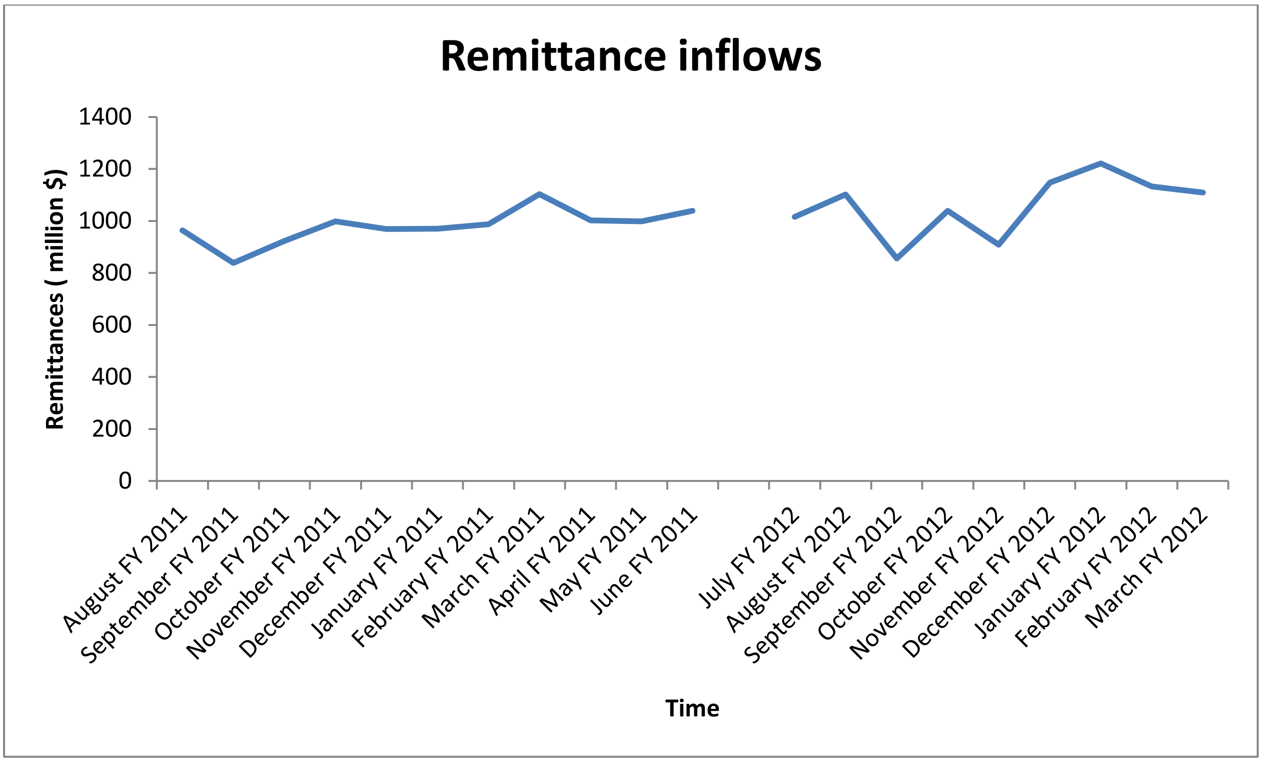
[8] Bangladesh Bank Economic Data. Accessed 4 May 2012.

[9] "Bangladesh's April foreign currency reserves rise on IMF loan disbursement", *Xinhua News,* May 2 2012, http://news.xinhuanet.com/english/business/2012-05/02/c_131564383.htm. Accessed 4 May 2012.

significant depreciation of the nominal exchange rate of the taka against the dollar and other major currencies. Official data as of March 2012 on the taka-dollar exchange rate (end period) has revealed that one US Dollar equalled to about 81.829 taka compared to about 72.7648 taka one year ago. The taka has depreciated by over 12 per cent over the last one year (March 2011 to March 2012), thus further increasing the dollar amount of import, debt servicing and interest payments.

The inflow of remittances, which make up a crucial component of the economy, have picked up to some extent during the current fiscal year with some fluctuations. Inflows have been more volatile during the current fiscal year, with a low of around $855 million in September 2011 and $900 million in November 2011. January 2012 witnessed a record high in remittance inflows, crossing $1.2 billion.

Figure 4 – Remittance



Source: Bangladesh Bank

The Outlook

Despite the sluggish global economic situation, the Bangladesh growth performance has been consistent, with GDP growth rates consistently exceeding 5% or so. While the medium-term prospects are favourable, the long-term economic outlook of Bangladesh will be determined by the extent to which it can correct its macroeconomic fundamentals.

Fiscal Scenario

The immediate government forecasts show that the fiscal deficit (excluding grants) is expected to widen to US$5.4 billion in FY 2012, equivalent to five per cent of GDP.[10] Fiscal policy therefore risks being somewhat unstable if there are no concrete plans of fiscal prudence. Fiscal consolidation needs to be undertaken to reduce inefficient and wasteful spending and create more space for critical, growth-oriented spending – budget management has to be a priority.[11] The Asian Development Bank (ADB) also forecasts a significant budget deficit, in part due to the high subsidies provided to the energy sector along with recent hikes of fuel, diesel and octane prices. The government will have to either cut its spending and/or raise taxes, or finance the increasing deficit through some other means. The former option presents political difficulties, while the latter option poses significant macroeconomic risks through inflation and crowding out private investment, the scenarios of which are currently present.

The subsidy bill, which had constituted less than one per cent of GDP historically, has been estimated to increase to 2.43% in FY 2012. However, the amount of subsidies demanded by the relevant ministries had originally pushed the figure to around 5.4% of the GDP and even after the estimates were revised downwards, the subsidy bill has now been estimated to be more than four per cent of the GDP in the current fiscal year. The government's insistence to keep on subsidising food and energy prices will place a lot of strain on the public finances in the near future. However the rationale is that a provision of subsidies will support poverty-alleviation efforts and is also intended to be a populist measure – the risk of social unrest is expected to be reduced greatly.[12] In order to fund the high subsidy bill, the government sanctioned an increase in electricity tariffs in March, thus compounding inflationary pressures further – Bangladesh continues to have one of the highest inflation rates in Asia.

Monetary Scenario

On the inflation side, IMF projects the rate to decline and stabilise around single digit at the end of this year through a combination of restrained fiscal and monetary policies along with an easing of supply constraints over time. It is hoped that with a stable and flexible exchange rate and interest rate, inflation can be stabilised. A tighter monetary policy is however expected to be politically unsavory, as it would involve hiking up interest rates to curb the excess liquidity in the market. The private sector and consumers will deem the hikes to be restrictive and investment might be hampered as a result. In addition, should there be further credit squeeze in the global financial market, interest rates will rise even more. Lenders will

---

10 Annual Report 2010-2011, Bangladesh Bank (2011).

11 "IMF Executive Board Approves Three-Year ECF Arrangement for Bangladesh", International Monetary Fund, 11 April 2012, http://www.imf.org/external/np/sec/pr/2012/pr12129.htm. Accessed 3 May 2012.

12 Economist Intelligence Unit (April 2012).

seek relatively less risky borrowers and credit spreads will widen as a result – Bangladeshi businesses will find it even harder to borrow money thus adversely affecting investment.

Trade and Current Account Scenario

The IMF predicts that the current account will most likely reach a deficit in FY 2012 of about 0.75% of the GDP and will remain at or near this level over the next few years. However remittances and exports are expected to be at a favourable level over the near future, although the encouraging outlook will be offset by increased fuel imports and infrastructure-related investment, which is long overdue. The government contrary to its election mandate has so far failed to address the inadequacies in infrastructure; and the stalemate in securing the World Bank funding to construct the Padma Bridge has been perceived as a microcosm of the government failure.

Foreign reserves are predicted to cover only 2.3 months of import cover at the end of this year, compared to three months cover at the end of last year. This is indeed a precarious situation that Bangladesh finds itself in – the import cover is expected to decline further over the medium term if stronger policy adjustments and structural reforms are not carried out. If the import cover does run out, Bangladesh will have to resort to domestic and external sources of financing, which will further pile up its levels of debt. In fact, Bangladesh has recently signed up for the ECF on a three year arrangement in the sum of US $987 million. The ECF arrangement is expected to support the restoration of some macroeconomic stability and strengthen the external position. [13]

However on the brighter side, which will take quite a long time coming, the overall balance of payments is projected to return to a surplus in FY 2013 through more conducive global conditions, a combination of tightening measures and exchange rate flexibility. The foreign reserves are expected to exhibit an upward trend, reaching close to about three months import cover by FY 2015.[14] It will be extremely critical that remittance earnings continue to rise even more rapidly, since remittances have bolstered household income and boosted consumption in recent years. If remittance growth falls, it will have an impact not only on consumption levels but also on the financial sector whose business depends heavily on these inflows. Furthermore, the flow of remittances will remain a crucial component of the current account as they make up the bulk of inward transfers. With respect to the exchange rate, a high inflow of remittances is also expected to cause the taka to gain against the US dollar. Further appreciation of the taka against the dollar can be achieved by limiting the supply of taka – as such, Bangladesh will be able to maintain the stability of its currency and protect its value against the major currencies.

[13] IMF (2012).
[14] "IMF Article IV Consultation with Bangladesh", International Monetary Fund, 1 November 2011.

Conclusion

Bangladesh economy is at a critical juncture, where the policymakers will have to tackle the ongoing and emerging macroeconomic pressures head-on. Although the economy is still quite robust, the macroeconomic indicators do point to warning signs that need to be heeded. Inflation is still rampant across Bangladesh and it risks becoming a drag on the growth rate. Bangladesh Bank has finally adopted a contractionary policy to counter the excess liquidity which has been further exacerbating the inflation. However there is a risk that private investment might be deterred with the spike in interest rates and a slowdown in private sector credit growth. Furthermore the government needs to cut back its borrowing in case it spirals out of control. To that end, revenue mobilisation has to be stepped up further to lessen the need for excessive borrowing. It is also high time that Bangladesh diversify its export basket – a continuing reliance on RMG exports will result in Bangladesh being a perennial producer of garments. Dependence on just one commodity might prove to be unwise if the global economic downturn takes a turn for the worse – the trade balance will become even more unfavorable.

There is little room to maneuver at the moment. Should the worst case scenario come to pass – an extended global slowdown causing demand for Bangladeshi exports to fall combined with continuing inflation in Bangladesh – the country could face a period of stagflation with high inflation and low economic growth. The growth forecasts by the IMF, ADB and the World Bank have repeatedly been revised downwards, even though the policymakers in Bangladesh maintain an optimistic view. A view through rose-tinted glasses with little or no acknowledgement of the emerging economic strains might prove to be costly.

.....