Fixing Roads in a Hurry
Summary

Real GDP grew at 6.7 percent in FY11, continuing the upward trend in growth after declining during FY06-09.

This strong performance can be repeated in FY12 if exports continue to grow and if garment exports benefit from the agreement reached during the recent India-Bangladesh Summit, remittances continue to recover, and if investment is boosted by improved infrastructure services – particularly power.

Looking ahead, growing downside risks reduce the chances that Bangladesh would be able to sustain its strong growth performance in FY12.

Risks in the global economy can affect Bangladesh in several ways. The S&P downgrade of US debt as well as the debt problems in the Euro Zone are affecting the international markets and renewing fears of another global slowdown. This time around, limited fiscal and monetary space in developed countries increases the chances of a protracted slowdown. If this slowdown occurs, it can affect Bangladesh’s balance of payments through its impact on exports and remittances, put pressure on the exchange rate, increase economic uncertainty, and, in turn, weaken investment and growth.

Domestic policies will also affect Bangladesh’s economic prospects. A slow pace of reforms in the investment climate can affect domestic and foreign investment, as can inadequacies in energy supply and the poor quality of roads. The reversal of trade reforms as well as weakening of the financial sector can also affect export growth and investment. Expansionary macroeconomic policies could increase risks on the current account and make inflation management more difficult.

Unlike in 2008, Bangladesh has insufficient policy space to cushion the impact of a second global slowdown through fiscal stimulus packages and monetary easing. Rapid growth in subsidies, sustained high rate of growth of credit to the private sector as well as recourse to monetary financing of the fiscal deficit have led to the erosion of the fiscal and monetary policy space. Much improved fiscal and monetary discipline combined with stronger efforts to address the energy and infrastructure deficits will be critical for sustaining growth performance. Maintaining the long-established tradition of sound macroeconomic management will also be important.
Recent Economic Developments

GDP growth was strong in FY11

1. **In FY11, GDP growth rebounded from the decline seen earlier in FY09.** Preliminary estimates for FY11 released by the Bangladesh Bureau of Statistics show that real GDP grew by 6.7 percent, reaching the Government’s targeted rate (Figure 1). Declining since FY06, growth had bottomed at 5.7 percent in FY09. This trend was reversed in the past couple of years, with good performance in manufacturing and construction, two successive years of bumper harvests in the crop sector, as well as sustained high contribution from the services sector contributing to the growth. More specifically:

- The large and medium scale manufacturing sector saw a turnaround, with growth reaching 10.4 percent in FY11, up from 6 percent in FY10. The sector benefited from 30.5 percent real growth in exports, compared with 0.7 percent real export growth in FY10. Except for chemical products, pharmaceuticals and tea, exports rose across the board: garments, raw jute and jute products, leather, frozen food, engineering products and agricultural products.

- Cereal crop harvests grew by 4.7 percent in FY11 following 3.3 percent growth in FY10, because of timely rainfall, replacement of old seeds with new ones and adequate availability of other agricultural inputs. Acreage and input use decisions may also have been favorably influenced by high food prices.

2. **Meanwhile, a slowdown in remittances in FY11 caused GNI growth to decline from 6.3 percent in FY10 to 5.7 percent.** This arises from the decline in the contribution of net factor income from 0.7 percent to -0.4 percent, reflecting a slowdown in the growth of remittances. Remittances are important in the Bangladesh economy, constituting 10.2 percent of GDP in the past five years. The outflow of migrants stagnated at an annual average of 432 thousand in FY10 and FY11, compared with annual average export of around 550 thousand people during the five years preceding FY10. This is possibly the most important reason for the decline in remittance growth.

3. **Private investment has stagnated at around 19.5 percent of GDP.** However, the contribution of private investment to growth increased from 1.2 percentage points in FY10 to 1.8 percentage points in FY11. The impact of export growth on aggregate demand growth was more than offset by 32.6 percent real growth in imports. Consequently, the contribution of net exports turned from a positive 0.05 percentage points in FY10 to a negative 0.26 percentage points in FY11. As before, private consumption remained the dominant source of demand growth, although its contribution declined slightly from 3.6 percentage points in FY10 to 3.5 percentage points in FY11. Public consumption contributed 0.4 percentage points and public investment contributed 0.8 percentage points to growth in FY11.

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1 This brief was prepared by Zahid Hussain, Lalita Moorty, Md. Abul Basher, Sanjana Zaman, and Nadeem Rizwan (SASEP), under the guidance of Sanjay Kathuria (Lead Economist, SASEP). The team acknowledges comments from Vinaya Swaroop (Sector Manager, SASEP) and Deepak Bhattasali (Lead Economist, SASEP). The following also contributed to the brief: A.K.M Abdullah, Kiatchai Sophastienphong, Shah Nur Quayyum (SASFP), Sebastian James (IFC), and Tenzin Norbhu (TWICT). The cover photo is from The Daily Prothom Alo.
High inflation remains a concern

4. **Inflation is high and volatile.** Inflation continued to rise, with the year-on-year rate reaching almost 11.3 percent in August. This is the highest recorded in last three and a half years (Figure 2). Increases in the overall CPI were driven by food prices, but non-food prices have also started rising in recent months. Increases in food prices (y-o-y) peaked at 14.4 percent in April before declining to 12.7 percent in August. Non-food prices declined during the first half of FY11 reaching as low as 3.3 percent in December, but rose to 8.8 percent in August – the highest since March, 2010. The rise in non-food inflation has been driven by rise in prices of clothing and footwear, transport, furniture and household equipments, and miscellaneous goods and services.

5. **Both supply and demand side factors explain inflation in Bangladesh, with expectations playing a role as well.** Rising international commodity prices were the main source of food price increases. Rising oil prices also result in rise in prices of almost all other commodities in the consumer basket. Meanwhile, a loose monetary policy has stoked domestic demand, creating upward pressure on prices. Real growth in public consumption remained above 8 percent on average during FY10 and FY11, compared with less than 6 percent annual growth the previous two years, depicting signs of demand side pressures on price level. The growing gap between domestic demand and domestic production resulted in a nominal import growth of over 40 percent in FY11 (including the impact of a significant increase in import prices). It also appears to have contributed to the rise in non-food inflation that was concentrated in non-energy items. The current high inflation, whatever its source, can influence inflationary expectations. This can then become self-fulfilling through mechanisms such as wage contract renegotiations based on these expectations.

**Monetary tightening may be needed to contain inflation**

6. **Monetary targets are exceeded in practice.** During the last two years, although Bangladesh Bank’s (BB) monetary targets were in line with nominal GDP growth, they were exceeded in practice primarily because of growth in credit to the private sector (Table 1).\(^2\) In FY11, monetary growth was high partly because of the monetization of the fiscal deficit through government borrowing from BB. The stock of government borrowing from BB at end-June, 2011 was 43.6 percent higher relative to the stock at end-June, 2010.

7. **Monetary growth needs to be restrained to contain inflationary pressures.**\(^3\) The FY12 Monetary Policy Statement aims to restrain domestic credit growth by selectively containing the “growth of credit for wasteful, unproductive and speculative uses, while also ensuring adequate credit flows for all productive pursuits in manufacturing, agriculture, trade, and other services.” However, achieving this balance is difficult. As can be seen in Table 1, BB plans to reduce the growth of private sector

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\(^2\) BB explains the overshooting of both monetary growth and inflation beyond targeted levels in successive periods in terms of policy interventions required to relieve the stresses arising from the significant global growth slowdown of FY09.

\(^3\) Many observers attribute at least a significant part of the spurt in share prices (see next section in this Update) and the rise in real estate price to rapid expansion of private credit growth in the second half of FY11.
credit in FY12 to 18 percent from almost 26 percent in FY11, in order to achieve its 18.5 percent monetary growth target for FY12. To this end, BB increased the repo and reverse repo rates in early September by 50 basis points, from 6.75 and 4.75 percent to 7.25 and 5.25 percent respectively.

8. **Even the targeted growth rates in reserve and broad money for FY12 may be insufficient to reduce inflation to 7.5 percent.** BB appears to be counting on the new worldwide trend of fiscal and monetary restraint in most countries, including major mature advanced economies and fast growing India and China, to reduce global demand and hence commodity prices to moderate domestic food price inflation in Bangladesh. Needed adjustments in electricity, gas, and petroleum prices to relieve mounting subsidies in the budget will create pressure on non-food inflation, making the curtailing of excess demand even more important.

### Table 1: Monetary Policy and Outcomes

<table>
<thead>
<tr>
<th></th>
<th>FY09</th>
<th>Target</th>
<th>FY10</th>
<th>Actual</th>
<th>Target</th>
<th>FY11</th>
<th>Actual</th>
<th>FY12</th>
<th>Target</th>
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</thead>
<tbody>
<tr>
<td>Net Foreign Assets</td>
<td>26.6</td>
<td>27.9</td>
<td>41.3</td>
<td>-1.5</td>
<td>5.2</td>
<td>-1.6</td>
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<tr>
<td>Net Domestic Assets</td>
<td>17.8</td>
<td>13.1</td>
<td>18.8</td>
<td>20.0</td>
<td>25.0</td>
<td>22.1</td>
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<tr>
<td>Domestic Credit</td>
<td>16.0</td>
<td>15.6</td>
<td>17.6</td>
<td>18.8</td>
<td>27.4</td>
<td>20.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>public sector</td>
<td>20.5</td>
<td>11.9</td>
<td>-5.2</td>
<td>29.2</td>
<td>33.6</td>
<td>28.1</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>private sector</td>
<td>14.6</td>
<td>16.7</td>
<td>24.2</td>
<td>16.5</td>
<td>25.8</td>
<td>18.0</td>
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<td></td>
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<tr>
<td>Broad money</td>
<td>19.2</td>
<td>15.5</td>
<td>22.4</td>
<td>16.0</td>
<td>21.3</td>
<td>18.5</td>
<td></td>
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<tr>
<td>Reserve money</td>
<td>31.4</td>
<td>7.0</td>
<td>18.1</td>
<td>15.0</td>
<td>21.1</td>
<td>16.0</td>
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### Macroeconomic Outcomes

<table>
<thead>
<tr>
<th></th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12</th>
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<tbody>
<tr>
<td>Inflation (CPI)</td>
<td>6.7</td>
<td>6.5</td>
<td>7.3</td>
<td>6.3</td>
</tr>
<tr>
<td>Growth</td>
<td>5.7</td>
<td>5.5</td>
<td>6.1</td>
<td>6.7</td>
</tr>
<tr>
<td>Nominal GDP growth</td>
<td>12.6</td>
<td>12.0</td>
<td>12.9</td>
<td>13.0</td>
</tr>
<tr>
<td>Excess of money growth over nominal GDP growth</td>
<td>6.6</td>
<td>3.5</td>
<td>9.5</td>
<td>3.0</td>
</tr>
<tr>
<td></td>
<td>6.6</td>
<td>3.5</td>
<td>9.5</td>
<td>3.0</td>
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*Source: Based on BBS and BB data*

9. **The Indian and Chinese experience may be a useful guide for Bangladesh.** Amidst stubborn inflation, the Reserve Bank of India has raised policy rates by 325 basis points on twelve occasions over the last eighteen months. To tame inflation, China’s central bank in 2011 has raised the reserve requirement ratio six times and a key benchmark interest rates three times. While BB has also raised its rates, a more aggressive stance may help to dampen inflation and inflationary expectations in a more timely fashion.

**Financial sector weaknesses could dampen growth**

10. **Macroeconomic pressures are being reflected in the banking system.** First, the Government’s increasing reliance on domestic financing is raising concerns on crowding out. Domestic financing of the deficit, most of which came from banks, was 3.3 percent of GDP in FY11, and is projected at 3 percent of GDP in FY12 (Figure 7). This has intensified the liquidity pressures that some of the banks are facing. Second, the significant increase in export and import trade has increased the demand for trade financing including letter of credit facility, adding to liquidity

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4 Year-on-year inflation in India declined from 10.4 percent in March to 9.22 percent in July whereas in Bangladesh it only declined from 10.5 percent in March to 10.2 percent in June. Inflation in China is around 6 percent.
pressures. Third, the increase in interest rates (and the pressure to continue to raise rates) and the problems in the textile sector arising from liberalized rules of origin could add to the non-performing loan portfolio of banks and provisioning thereof, causing banks to tighten their underwriting standards, thus reducing loanable funds. Fourth, the exposure of some banks to the stock market (see below), as well as the creation of a fund with support from public financial institutions to shore up the market also reduces loanable funds for the private sector. The creation of the fund also increases contingent liabilities for the Government.

11. **These pressures could hurt the efficient allocation of capital and dampen economic growth.** All the above factors can hinder the banking system in its role of allocating resources to private activities with the best possible returns. Since these pressures are not likely to ease in FY12, the concerns will continue and could even intensify over the course of the year.

12. **The banking system has its own structural problems.** One, there has been a steady rise in the volume of non-performing loans (although not in the ratio of non-performing loans to total loans) due to deflation in asset prices, lending squeeze caused by liquidity pressures, and weak underwriting practices. Two, the capital levels of banks and other financial institutions may be over-stated due to unrecognized loan losses from evergreening of loans, weak loan classification and provisioning requirements, and intangible assets in state-owned banks. Three, weak corporate governance in parts of the banking sector, especially state-owned banks, leads to sub-optimal loan decisions. Finally, there are vulnerabilities posed by ad-hoc policy decisions such as changes in interest rate caps, contribution to a stock stabilization fund, and financing of large loss-making SOEs.

13. **Equity markets have remained volatile.** In face of policy uncertainty and delays in recasting of SEC, the capital market remained volatile in the entire second quarter of 2011 (Figure 3). Following a Government declaration allowing investment of black money in stocks the capital market went on a bullish streak that continued for most of July. The benchmark index rose by 18 percent and trade volume increased by around 470 percent in just a month. The market started on a downward trend again from the last week of July and lost around 10 percent of the gains made in the previous month. Attempts to cushion the decline in stock values through a relaxation of margin lending requirements and market support from public financial institutions have heightened fiscal risks and moral hazard problems. The banking sector's capital market exposure amounts to 3.6 percent of its total liabilities as against 10 percent allowable as per the Bank Companies Act A6(2). A few banks have higher exposure than this statutory limit. Also, some commercial banks have lent more than 15 percent of their total capital to their respective subsidiaries. According to BB rules, banks are not allowed to lend more than 15 percent of their capital to a single borrower, including their subsidiaries.

14. **The central bank has taken steps to reduce the exposure of banks to the stock market,** including tightening of the credit/deposit ratio of the commercial banks, and reining in consumer loans and loans to the real estate sector and SME sector. Moreover, BB plans to tighten the exposure limit further. The exposure limits of commercial banks will be reduced to 25 percent of their capital funds instead of 10 percent of their liabilities, according to the draft amendment to the Bank Companies Act.
Act which has been put on BB’s website for stakeholder consultation. However, for these measures to succeed they need to be fully enforced and the supervisory capacity of BB needs to be enhanced.

*External imbalances are growing*

15. **The current account surplus has narrowed due to rapid import growth and modest remittance growth.** Both exports and imports rose in FY11 while remittance growth slowed down considerably. Exports recovered strongly in FY11 from the depressed base of FY10. In dollar terms, exports rose by 41.7 percent in FY11, compared to just 4.1 percent in the year before, based on an impressive performance by the dominant garments sector. Imports rose by 41.8 percent in FY11, well above the 5.5 percent growth recorded in FY10. Imports of intermediate goods (accounting for about 50 percent of total imports) increased by 54 percent. Capital imports rose by 31.0 percent in FY11 compared to 6 percent in FY10. In real terms, imports grew by over 32 percent in FY11- import of intermediate goods, capital machinery and petroleum products increased on account of new rental power plants coming on stream; public food imports increased as the government tried to keep food prices under control. Rising food and oil imports, combined with higher international prices of oil and food, have intensified the pressures on the external account. In addition, remittances grew at a sluggish 6 percent in FY11, with inflows of $11.7 billion.

16. **Foreign exchange reserves came under pressure, with the import cover declining from 5.1 months in FY10 to 3.7 months in FY11.** The pressure came from a decline in the current account surplus from 3.7 percent of GDP (3.7 billion US$) in last fiscal year to 0.9 percent (1.0 billion US$) in FY11 while the financial account balance ended in a deficit of US$1.5 billion in FY11, compared with US$ 0.7 billion deficit in FY10 (Figure 4). The overall balance of payments deficit of US$635 million in FY11 has contributed to reserve losses and weakening of the taka against the US dollar. The taka depreciated by 6.6 percent in FY11 versus the US dollar despite BB’s US$925 million sales (Figure 5). The exchange rate premium in the curb market increased in FY11 to 3.3 percent on average, compared with 1.8 percent in FY10. This may be discouraging the use of formal channels to send remittances home.
The fiscal deficit increased, despite strong tax collections

17. The overall fiscal deficit for FY11 is estimated at 4.2 percent, below the planned 5 percent, but higher than last year’s 3.7 percent (Figure 6). The increase in the overall deficit in FY11 came entirely from the primary deficit, which increased from 1.6 percent of GDP in FY10 to 2.5 percent in FY11.

18. Strong revenue performance helped contain the deficit. Despite poor performance in non-NBR and non-tax revenues relative to the FY11 target, overall revenues grew by 24.5 percent. The gains in tax revenue reflected nominal GDP growth and better implementation of administrative reforms in the areas of automation, registration, and enforcement. Indirect tax collections from both domestic activities and imports exceeded expectations with growth of over 28.7 and 22.4 percent respectively, because of rising commodity prices and strong economic growth. Income tax collections grew by over 33 percent. As a result NBR revenues increased from 8.6 to 9.7 percent of GDP from FY10 to FY11, and total tax revenues rose from 9 to 10.1 percent. Achieving a tax collection in excess of 10 percent of GDP is a significant accomplishment for Bangladesh.

19. Total public expenditure in FY11 remained below the revised budget target because of the underutilization of Annual Development Program (ADP) expenditures. Rise in subsidies to agriculture, power, fuel, food and exports contributed to accelerating non-ADP expenditures. Including grants and pensions, total subsidies and current transfers amounted to 3.7 percent of GDP in FY11 which was partially offset by below-target development expenditures. The biggest component of development expenditures, the ADP, turned out at 4.2 percent of GDP in FY11. While an improvement over ADP expenditures of 3.7 percent of GDP in FY10, it is still much lower than the originally planned expenditure.

20. Domestic financing of the deficit rose in FY11. Foreign financing in FY11 is estimated at 0.9 percent of GDP, compared with the budget target of 2 percent. Domestic financing of the deficit is estimated to have increased from 2.4 percent of GDP in FY10 to 3.3 percent in FY11. With non-bank financing declining from 2.7 percent of GDP in FY10 to 0.7 percent in FY11 due to weak demand for NSD certificates, the share of bank financing in total domestic financing of deficit increased from -0.3 percent of GDP in FY10 to 2.6 percent in FY11.

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5 This has been a result of intensification of tax collection from the existing base rather than bringing into the net new tax payers.
21. **The FY12 budget is expansionary.** It builds on an already major increase in expenditure in FY11. The primary deficit is projected to rise from 2.5 percent of GDP in FY11 to 3 percent in the FY12 budget. At the current nominal effective interest rate of about 4.4 percent and GDP growth of 6.7 percent, this is sustainable in the sense that the debt-GDP ratio will remain stable at around 40 percent. But larger deficits in the current macroeconomic situation can lead to further demand-side pressures. The budget faces a major subsidy burden and has over-programmed the ADP. Its revenue target is ambitious in the wake of very strong revenue growth in FY11.

**Box 1: The FY12 Budget Highlights**

The FY12 revenue target is ambitious and revenue mobilization appears to rely heavily on buoyancy and strengthening of administration. The revenue target has been set at Tk. 1183.9 billion, which is 25.3 percent higher than FY11 total revenue. The revenue-GDP ratio is projected to rise by 1.2 percentage points of GDP – from 12.0 percent in FY11 to 13.2 percent in FY12. Revenue growth of 20 percent plus has never been achieved in two consecutive years in the last two decades. The target of 20.4 percent NBR revenue growth would involve high revenue performance on an already high base. NBR revenue growth in July 2011 was 14 percent.

**Total expenditure in FY12 is projected to increase by 27.8 percent** over FY11 expenditure to Tk. 1635.9 billion and the expenditure-GDP ratio is projected to rise from 16.2 percent in FY11 to 18.2 percent in FY12. Current expenditures, which declined from 9.7 percent of GDP in FY10 to 9.2 percent in FY11, are projected at 9.8 percent of GDP in FY12. However, subsidies are likely to increase well beyond the amount provided in the budget (Tk. 93 billion) in the absence of further administered price adjustments. Table-2 projects the subsidies after accounting for the most recent (September 2011) adjustments in administered prices. Non-discretionary expenditures are projected to rise as well.

**ADP has been over-programmed** again with Tk. 460 billion allocation, which is 40.1 percent higher than the FY11 actual ADP. This compares with an 8.1 average annual growth of actually implemented ADP over the last decade.

<table>
<thead>
<tr>
<th></th>
<th>FY11 actual</th>
<th>FY12 projected</th>
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<tbody>
<tr>
<td>BPDB</td>
<td>47.2</td>
<td>132.0</td>
</tr>
<tr>
<td>BPC</td>
<td>72.1</td>
<td>153.8</td>
</tr>
<tr>
<td>BCIC</td>
<td>3.8</td>
<td>19.8</td>
</tr>
<tr>
<td>Total</td>
<td>123.0</td>
<td>303.2</td>
</tr>
<tr>
<td>% of FY11 GDP</td>
<td>1.6</td>
<td>4.8</td>
</tr>
</tbody>
</table>

**Source:** Bangladesh Economic Review 2011 and WB Staff Estimates

22. **The projected composition of deficit financing in FY12 is a concern (Figure 7).** This expansionary budget also demands ambitious levels of foreign financing, which if not achieved, will exacerbate crowding-out concerns. The overall fiscal deficit is projected at 5 percent of GDP, of which 3 percent of GDP will be financed through domestic borrowing and the rest from external borrowing. Most of the domestic financing (70 percent) is projected to come from the banking system. The projected net external financing of over $2.5 billion will also set a historic high if achieved. Achieving this level of financing will require accelerated implementation of aided projects, particularly in energy and transport sectors, and pursuit of structural reforms. Otherwise the already high domestic financing target might be exceeded and the recourse to monetary financing is likely to increase. In this context, the government has already borrowed Tk. 69.3 billion from domestic sources from July 1 to September 8, 2011; nearly 54 percent of this constituted monetary financing. This unusual monetary financing in the first quarter of the fiscal year adds to concerns relating to inflation.

**Meanwhile, there is mixed performance on structural reforms**

23. Structural reform in major areas is important for sustaining and accelerating growth. Progress on this front has been mixed, with positive signals relating to telecommunications policy, attempts to reduce losses in state-owned power and fuel utilities, improvements in tax-related policies, and a potentially important increase in access to the Indian garments market. On the other hand, negative signals relate to tariff protection and the move to issue new bank licenses.
24. **Telecommunications.** In January 2011 the Ministry of Post and Telecommunications (MOPT), issued draft guidelines for renewal of 2G licenses for existing cell phone operators, and invited stakeholders to provide feedback. After wide consultations, the draft guidelines relating to pricing have been strengthened in several areas. Information on non-price aspects of the renewal is not yet available.

25. According to available information on the guidelines, the revised price terms for renewal represent improvements over the January 2011 version. Improvements include: (i) significant reduction in the previously very high prices for spectrum allocation; (ii) equalization of prices across spectrum bands (GSM 900 and 1800 MHz, and CDMA 800 MHz), making them technology neutral; (iii) reduction in the social obligation fund levy; and (iv) staggered payment options compared to major upfront payments proposed earlier, which will allow operators to mobilize resources for investment. However, the imposition of the asymmetric Market Competition Factor (earlier called Utilization Factor) penalizes operators that make more efficient use of spectrum and creates market distortions. It could also impact the future ability of the regulator to ensure a level playing field in the sector.

26. **Tax Laws and Administration.** Even while the government postponed the introduction of new laws on VAT and Income Tax, the 2011 Finance Act introduced many reforms through amendments of the existing laws. One significant reform was the introduction of an Alternative Dispute Resolution (ADR) mechanism for the major taxes, i.e., Income Tax, VAT and Customs. In addition, on Income Tax, a major amendment is the requirement for tax withholders to file withholding tax returns, which should improve withholding tax compliance. Amendments were also introduced to make Income Tax more automation friendly, through enabling provisions for re-engineering business processes and allowing outsourcing of routine business processes. On VAT, taxpayers below the tax threshold who currently pay turnover tax would now be provided Business Identification Numbers (BINs), which would improve compliance under the VAT system. The turnover tax for businesses under the threshold was also reduced to 3 percent from 4 percent, reducing the tax burden on small business. Also, the compulsory treating of branches of a business as separate business entities for purposes of VAT would now be optional. This would move the existing system closer to best practice, viz., treating a business entity as one tax unit with one Business Identification Number. Another amendment that moves the VAT closer to a true VAT is the one that extends the VAT law to service providers.

27. **Banking.** BB is planning to invite applications to establish new banks and insurance companies. Currently there are 47 banks and 62 insurance companies in Bangladesh, even though the country is facing the problem of “overbanking.” To this end, the Bangladesh Bank put out draft guidelines for establishing a bank on its website and invited feedback, following good international practice. BB’s Board approved the new guidelines on September 14. Permission for the entry of a new bank or financial institution was last granted in 2001. Allowing new institutions to enter the market may not necessarily increase competition or increase access to finance. New banks would also imply the need for closer regulation and supervision. The government has already opened a “Probashi Kallyan Bank” (expatriate welfare bank) to provide banking services to nonresident Bangladeshis working overseas.

28. **Trade.** The FY12 budget had several measures aimed at protecting local industries (motor cycle, power sector, pharmaceutical, furniture, printing, toilet paper etc) by raising customs, supplementary and regulatory duties. Nominal protection increased significantly (from 23.7 percent in FY11 to 26.5 percent in FY12) due to increase in supplementary duty on imports. Average protection on capital goods increased to 10.6 percent in FY12 from 8.6 percent in FY11, while protection on final consumer goods increased by 6 percentage points to 47.3 percent in FY12. Nominal protection on basic raw materials and intermediate goods shows minor change. Overall nominal protection rate is now at its 2006 level, because of increases in the duty structure after FY09. Such tariff changes that raise overall protection (and also increase its dispersion across products) are a setback to the agenda for trade diversification.
29. **Power and fuel tariffs.** Both power and fuel prices were raised in successive months, which reduces the burden on a strained budget and improves the health of the public institutions involved, including the Power Development Board, Bangladesh Petroleum Corporation and Petrobangla. The average bulk power tariff was increased from Tk.2.63 KWh to Tk.2.80 per KWh representing a 6.66 percent rise effective from August 1, 2011. This is the second stage increase ordered by the Bangladesh Energy Regulatory Commission. At the first stage, the average bulk tariff was increased by 11 percent from Tk 2.37 per KWh to Tk 2.63 per KWh effective from February 1, 2011. Earlier, an interim order was issued to raise tariffs for retail customers by 5.0 per cent, with effect from February 1, 2011. On the fuel front, the government announced significant increases effective from September 19/20, 2011. Prices of diesel, kerosene, petrol, octane, and CNG were increased by Tk. 5 to 8 per liter/cubic meter, or about 6 to 20 percent. The total fiscal impact of the petroleum and CNG is estimated at around Tk 49 billion (equivalent to 0.6 percent of GDP).

30. **Securities and Exchange Commission (SEC).** The SEC has initiated reforms in some key areas covering rules on the book-building method used for IPO pricing, lock-in period for institutional investors including mutual funds, rules on private placement etc. More broadly, the SEC has also begun work to provide a more predictable policy environment for long term investors. To begin with, it has decided to not impose frequent changes in policies relating to rules on margin loans given by merchant banks and brokerage houses.

31. **Access to Indian markets.** The Joint Statement issued on the occasion of the visit of the Indian Prime Minister’s September 2011 to Bangladesh sets forth several areas of mutual cooperation to advance trade, investment and economic cooperation. Key among the measures announced is the removal of “…all 46 textile lines which are of interest to Bangladesh from India’s Negative List for LDCs under the provisions of South Asian Free Trade Area (SAFTA), thereby reducing the applicable duty rate to zero with immediate effect.” This should help boost garment exports from Bangladesh to India’s vast and growing market.

**Economic Outlook**

32. **The near-term economic prospects for Bangladesh depend on global economic conditions as well as domestic policies and management.** According to IMF’s World Economic Outlook in September 2011, world output is projected to grow at 4.0 percent in 2011 and 4.5 percent in 2012. Advanced countries were projected to grow at 1.6 percent in 2011 and 1.9 percent in 2012. Of these, the US was projected to grow at 1.5 percent in 2011 and 1.8 percent in 2012, while the Euro area was projected to see much weaker growth rates at 1.6 and 1.1 respectively. Meanwhile, the emerging and developing countries were projected to see much higher growth rates of 6.4 percent in 2011 and 6.1 percent in 2012.

33. **Fears of a double-dip recession are now growing following turmoil in the stock markets and Standard & Poor’s downgrade of the US economy.** Consumer spending in the US fell in June for the first time in nearly two years, and incomes barely rose. Manufacturing data show renewed weakness around the world. Despite major credit ratings agencies re-affirming the United States' AAA credit rating, the sell-off in stock markets after the S&P downgrade of US government debt reflects growing anxiety about slowing growth in US and Europe and their implications for the rest of the world. The slowdown could be more protracted this time compared to 2008, given the limited room for fiscal easing in developed countries because of growing deficits and debts. Rising core inflation in the US and the Euro areas also limits options for monetary easing.

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6 Moody's and Fitch both maintained the top rating for the US government. Moody's has assigned a negative outlook to its AAA rating, suggesting a downgrade is possible in the next year to 18 months.
34. **However, a reduction in world demand could also lower food and fuel prices.** Although still volatile, food prices in April-July averaged roughly 5 percent below the World Bank Food Price Index in February. Prospects for the overall supply of food have also improved.\(^7\) Crude oil prices have declined during July-August.

35. **Potential shocks to the global economy could affect Bangladesh through several channels: commodity prices, trade, remittances and aid inflows.** Trade, remittances and aid are the three most important channels through which growth and external balances in Bangladesh can be affected if global growth weakens. The financial market channel for Bangladesh is rather muted because FDI inflows are small to begin with and the capital account is not open; hence, there is little risk of reversal in capital flows. The channels of impact are further discussed below.

- Garment exports may be less at risk initially due to the Wal-Mart effect and continuing loss of Chinese competitiveness in the low end markets. Also, garment exports could benefit from the recent increase in market access to India. However, a prolonged slowdown in markets could affect demand for all categories of Bangladeshi garments. Non-garment exports could be much more vulnerable, if the experience from the 2008 slowdown is any guide.

- As in 2008, lower commodity prices will work in Bangladesh’s favor.

- Lower commodity prices will help dampen growth in import payments, as in 2008, because Bangladesh imports oil, food, intermediate goods and capital goods. It will offset, in part, the widening of trade deficit if exports fall. However, payments for oil imports may still rise significantly because of the commissioning of new oil based power plants. Bangladesh is expected to import 7 million tons of oil compared to 4.8 million tons in the previous fiscal year.\(^8\) Lower world commodity prices will also help contain inflation.

- Remittances may be affected both directly, if Bangladeshi workers in US and Europe lose incomes and jobs, and indirectly, if recession in US and Europe weakens labor demand in the Middle-East by depressing oil prices. This could disrupt the recent pickup in the growth of overseas employment in FY12.

- Aid inflows, particularly bilateral aid from US, Europe and Japan may be adversely affected if governments in these countries look for sources of fiscal savings that will least affect their domestic economic activities.

36. **Domestic policies will also affect Bangladesh’s economic prospects.** A slow pace of reforms in the investment climate can affect the appetite for domestic and foreign investment, as can continued inadequacies in energy supply and the quality of roads. Upside growth potential can be realized if power production increases significantly and the pace and quality of public investment as a whole improves.

37. **Overall, given the growing external and domestic risks, the growth performance in FY12 remains uncertain.** Real GDP grew at 6.7 percent in FY11. This strong performance can be repeated in FY12 if exports continue to grow and if garment exports receive a boost from the agreement reached during the recent India-Bangladesh Summit, remittances continue to recover, and if investment is boosted by an expansion in the production of power. However, looking ahead, growing downside risks decrease the chances that Bangladesh would be able to sustain its strong growth performance in FY12.

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\(^7\) The World Bank, Food Price Watch, August 2011.

\(^8\) Import spike causes concern for smooth fuel transport, storage, The Financial Express, August 14, 2011
38. Several downside risks in the international environment can affect Bangladesh. The S&P downgrade of US debt and the debt problems in the Euro Zone are affecting the international markets and renewing fears of another global slowdown. This time around, limited fiscal and monetary space increases the chances of a protracted slowdown in developed countries. If this slowdown occurs, it can affect Bangladesh’s balance of payments through its impact on exports and remittances, put pressure on the exchange rate, increase economic uncertainty, and, in turn, weaken investment and growth.

39. On the domestic front, the appetite for domestic and foreign investment can be affected by the weak investment climate, shortages in energy supply and the poor quality of road transport. The reversal of trade reforms as well as weakening of the financial sector can also affect export growth and investment. Also, expansionary macroeconomic policies could increase risks on the current account and make inflation management more difficult.

40. Unlike 2008, Bangladesh has insufficient policy space to cushion the impact of a second global slowdown through fiscal stimulus packages and monetary easing. Growth in subsidies, sustained high rate of growth of credit to the private sector as well as recourse to monetary financing of the fiscal deficit have led to the erosion of the fiscal and monetary policy space. Much improved fiscal and monetary discipline combined with stronger efforts to address the energy and infrastructure deficits will be critical for sustaining growth performance. Maintaining the long established tradition of sound macroeconomic management will also be important.