

April 2018

Bangladesh Development Update

Building on resilience



BANGLADESH DEVELOPMENT UPDATE

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Preface

The objective of this report is to share perspectives with the Government of Bangladesh, think tanks and researchers, the public as well as the Bank's senior management on the state of the economy, outlook, risks, progress on structural policy reforms and key challenges the economy is currently facing. The coverage includes developments in the real sector focusing on poverty, growth, and inflation; external sector developments focusing on the balance of payments, foreign exchange reserves and the exchange rate; fiscal developments focusing on revenue mobilization, public expenditures, and deficit financing; financial sector developments focusing on credit and interest rates; and monetary developments. This update also assesses the progress in Bangladesh's poverty reduction since 2010, based on the Household Income and Expenditure Survey 2016/17, and concludes with an exposition of the policy challenges that need to be addressed to sustain and accelerate the momentum of poverty reduction.

Acknowledgements

This report was prepared by a team comprising of Zahid Hussain (Lead Economist), Ruth Hill (Senior Economist), Maria Eugenia Genoni (Senior Economist) and Shegufta Shahriar (Team Associate). Mona Prasad (Lead Economist) and Christian Eigen-Zucchi (Program Leader) provided extremely useful comments. Manuela Francisco (Practice Manager) provided overall guidance in the preparation of this report.

Abbreviations and Acronyms

ADP	Annual Development Plan
ADR	Alternative Dispute Resolution
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BDT	Bangladeshi Taka
BFIU	Bangladesh Financial Intelligence Unit
BSEC	Bangladesh Securities and Exchange Commission
CPI	Consumer Price Index
DSE	Dhaka Stock Exchange
DSEX	Dhaka Stock Exchange Board Index
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FY	Fiscal Year
FYP	Five Year Plan
GCC	Gulf Cooperation Council
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GNI	Gross National Income
HIES	Household Income and Expenditure Survey
iBAS	Integrated Budget and Accounting System
IFF	Illicit Financial Flows
IMED	Implementation Monitoring and Evaluation Division
IMF	International Monetary Fund
IPO	Initial Public Offering
KSA	Kingdom of Saudi Arabia
LC	Letter of Credit
LTU	Large Taxpayers Unit
MLT	Medium and Long-Term
MoF	Ministry of Finance
MT	Metric Ton
NBR	National Board of Revenue
NEER	Nominal Effective Exchange Rate
NPL	Non-Performing Loan
NSD	National Saving Directorate
PE	Price Earning
QIIP	Quantum Index of Industrial Production
REER	Real Effective Exchange Rate
RMG	Ready-Made Garments
SCBs	State-owned Commercial Banks
SD	Supplementary Duty
SLR	Statutory Liquidity Requirement
TDTL	Total Demand and Time Liabilities
UAE	United Arab Emirates
UK	United Kingdom
VAT	Value Added Tax
WEF	World Economic Forum
Y-O-Y	Year-on-Year

Executive Summary

Industrial production and services growth remained resilient. Inflation has accelerated, primarily due to supply shocks. Monetary policy has been accommodative. Financial sector vulnerability is rising. With a tightening of prudential controls, lending rates are back to double digits. Despite significant recovery in both exports and remittances, the current account deficit widened sharply, driven by a surge in imports. The overall balance of payments swung into deficit for the first time since FY11. Consequently, the exchange rate has depreciated. Interventions to smoothen exchange rate adjustments have eroded foreign exchange reserves. The fiscal deficit has been contained as weak revenue growth was counterbalanced by even weaker growth in expenditures. GDP growth is projected in the 6.5-7 percent range in the medium-term, while macro stability will require heightened vigilance. Poverty reduction has continued but slowed. The amount of poverty reduction achieved by each percent of growth fell by a third. Extreme poverty is projected to fall modestly to 11-12 percent in the medium-term. Downside risks center on the solvency of banks and the run-up to elections elevating instability and policy uncertainty. Going forward, investment and innovation enabling reforms will be key to accelerating development progress.

Strong growth continued, despite challenges. GDP growth in FY18 is benefitting from recovery in exports and robust domestic demand. Garment exports have resurged. Remittances from Gulf Cooperation Council (GCC) countries, the United States and others have recovered significantly. Capital machinery imports have been buoyant. Although agriculture had a bad start in FY18 due to above normal floods, sustained momentum in industrial and services growth continues to impress. Private investment remains constrained by cumbersome business regulations and inadequate coverage, as well as the poor quality of infrastructure. The competitiveness ranking has improved, but Bangladesh remains well behind competitor countries in South and East Asia.

Macroeconomic vulnerability has increased. Inflation has accelerated to 5.8 percent in the first half of FY18, driven by increase in rice prices resulting from supply shocks and delayed policy response. Monetary policy remained accommodative. Risky banking practices caused private credit to far outpace growth in deposits, leading to a tightening of bank liquidity and a consequent increase in interest rates, as Bangladesh Bank signaled stricter application of macro-prudential regulations. The exchange rate depreciated 6.5 percent between January 2017 to March 2018 with the emergence of excess demand in the foreign exchange market as the overall balance of payments was in deficit for the first time since FY11, driven by a large rise in the current account deficit. Attempts to smoothen exchange rate volatility by selling dollars contributed to over \$1.6 billion fall of external reserves (to 3.7 percent of imports) and consequent 1.8 percent of total demand and time liabilities drying of bank liquidity. Notwithstanding an expansionary budget, the fiscal deficit in the first half was narrower than the target, as weak revenue growth was offset by even weaker growth in expenditures. An adverse shift in the composition of public domestic debt from bank to non-bank (national savings certificates) sources continued.

Bangladesh is expected to maintain economic resilience. Notwithstanding emerging stresses, growth is projected to be in the 6.5 to 7 percent range during FY18-20. Exports and private

investments are likely to be the key growth drivers. Export growth is projected to remain robust with a broad-based cyclical upturn in the global economy, aided by a rebound in investment and trade. The rebound in officially recorded remittances may continue, as GCC economies benefit from higher oil prices and incentives for remitting through formal channels are enhanced. Investment is likely to maintain recent 8-9 percent growth, helped by growing confidence on infrastructure development prospects, strong domestic demand and stronger global markets.

The macroeconomic outlook is challenging. Inflation is projected to accelerate as global commodity prices pick up, combined with expansionary fiscal policy and possible supply shocks in the run up to elections. With actual output exceeding potential, the output gap is already positive. Together with the increase in incomes from growing exports and remittances, this will exacerbate pressure from the already depreciating exchange rates and uptrend in global commodity prices. Nonetheless, a monetary accommodation is likely to be maintained. A further pick up in payments due to increased food and industrial raw materials imports, as well as a rise in oil prices, are expected to keep the current account in deficit over the medium-term. Over the short-term, sizeable foreign exchange reserves, equivalent to 7.6 months of imports of goods and nonfactor services, will allow the Bangladesh Bank (BB) to moderate the pace of currency weakening. A large shortfall in revenue due to the postponement of the implementation of the new VAT law, additional pressures on expenditures due to the Rohingya refugee crisis, rising subsidies, and the impact of elections could lead to overshooting the 5 percent of GDP budget deficit target. While the public debt to GDP ratio will increase, the risk of debt distress is low.

Near-term risks are elevated making investors cautious to commit. Concerns about political uncertainty, the weak business environment, strains in the financial sector, and shortcomings of infrastructure are among the reasons for investor's caution. On the external front, the global growth recovery is expected to be sustained over the next couple of years, although not without downside risks. The latter include tightening financing conditions, a pick-up of global inflation and associated impacts on expectations, increased protectionism, and rising geopolitical tensions.

Poverty has been falling, thanks to strong growth in all sectors of the economy, but the pace of poverty reduction has slowed. Average consumption growth did not keep up with GDP growth, and the pattern of growth became less favorable to the sectors where poor households are engaged. Agricultural growth has become less equal and poverty reducing. About half of the population are vulnerable to falling back into extreme poverty. The influx of over 688,000 Rohingyas since August 2017 has put a strain on host communities and service delivery in the affected areas in Cox's Bazar.

Going forward, reforms will be the key to boost development progress. With around two million young people entering the job market every year, Bangladesh must achieve export-led growth by breaking into new markets with new products to create more and better employment opportunities. This in turn requires enhancing private investment in capabilities and innovation to put growth and employment generation on a healthy and sustainable path.

- Policy initiatives to accelerate physical and human capital growth, remove barriers to female labor force participation, and improve institutions could help raise potential growth and reduce inequality. A key near-term challenge is to implement investment enabling reforms, such as the recently passed One-Stop-Shop Act, while stemming policy slippages (such as in changes to the Banking Companies Act, and the delay in VAT Law implementation).
- As the election gets closer, a promising policy strategy is to take advantage of the prevailing (though fading) tailwinds of low international commodity prices and comfortable foreign exchange reserves to build greater economic resilience. This means pushing ahead with reforms to strengthen the regulatory framework, improve infrastructure project management, and enhance skills development to raise the economy's job creation potential.
- Efforts to strengthen macroprudential frameworks and enhance exchange rate flexibility would improve resource allocation, reduce vulnerabilities, and boost resilience.
- Additional measures will be needed to ensure revenue buoyancy, such as seeking efficiency gains from the ongoing automation of tax administration, improving administrative processes to facilitate compliance, introducing carbon taxes, streamlining tobacco taxes, and rationalizing tax incentives and exemptions.
- Expenditure prioritization to find additional savings is needed in the context of expanding subsidies on exports and food, the repeated recapitalization of state-owned banks, and spending pressures related to the Rohingya refugee crisis response. There is room in the budget to apply fiscal austerity measures on non-development capital expenditures and loans and advances, as well as government financed ADP projects.
- Increased caution on the monetary policy stance is warranted given the concerns on the rising headline inflation, surging global crude oil prices and fiscal slippage.

Recent Developments

Bangladesh has maintained growth resilience. Following a poor performance in FY17, exports and remittances have recovered impressively in FY18. Agriculture had a better start than last year. Machinery and industrial raw materials import have been buoyant. Official growth estimates have been tracking the 7th Plan growth targets very closely. While consistency with high frequency indicators remains an issue, the continuation of Bangladesh's growth resilience is beyond dispute.

Healthy output growth maintained

Overall, the economy is moving forward, growing at a decent pace by Bangladesh's own historical as well as international standards. Growth on the supply side in FY17 was driven by services and industry which accounted for 3.4 percentage point out of the officially estimated 7.3 percent GDP growth (Table-1). Domestic demand growth appears to have been the driving force with private consumption contributing 4.7 percentage points and investment contributing 3.25 percentage points. Weak exports and strong imports dragged growth in FY17. Private investment stagnated as a percentage of GDP.

Table 1: Contribution to Growth

	FY12	FY13	FY14	FY15	FY16	FY17
GDP Growth	6.5	6.0	6.1	6.6	7.1	7.3
<i>Contribution of Production Sectors (%)</i>						
Industry	2.47	2.59	2.27	2.74	3.24	3.10
o/w Manufacturing	1.70	1.80	1.60	1.93	2.26	2.21
Services	3.40	2.90	2.90	3.00	3.21	3.41
Agriculture	0.50	0.40	0.70	0.53	0.43	0.44
Import Duty	0.10	0.13	0.16	0.28	0.24	0.34
<i>Contribution of Expenditure Components (%)</i>						
Consumption	3.02	3.77	3.09	4.29	2.41	5.09
Private consumption	2.90	3.48	2.70	3.84	1.97	4.68
Government consumption	0.20	0.29	0.40	0.45	0.44	0.41
Investment	3.10	1.63	2.98	2.23	2.81	3.25
Private Investment	2.30	0.42	2.19	1.46	2.47	2.00
Government Investment	0.80	1.21	0.79	0.77	0.34	1.25
Resource Balance	-0.05	0.20	0.36	-1.25	1.90	-0.92
Exports, goods & services	2.40	0.50	0.63	-0.54	0.38	-0.39
Imports, goods & services	-2.50	-0.30	-0.30	-0.70	-1.52	0.53
Statistical discrepancies	0.45	0.40	-0.37	1.28	0.00	-0.13

Source: Bangladesh Bureau of Statistics (BBS)

Sustained momentum in industrial growth continues to impress. The *industries* sector grew at double digit (10.2 percent) in FY17 with significant contribution from the 11 Percent growth in large and medium scale manufacturing industries. Quantum Index of Industrial Production (QIIP) data suggests that many large-scale industries posted significant growth in FY17 including leather and related products (53.4 percent), in spite of the production dislocation due to shifting of factories from the Hazaribagh area, textile (21.2 percent), pharmaceuticals and medicinal chemical manufacturer (32.1 percent) and manufacture of other non-metallic mineral products (32.3 percent). Combined weight of these four industries was about one-third of the total industrial production. The QIIP for medium and large-scale manufacturing grew even faster (20.6 percent) in the first quarter of FY18 led by textiles, pharmaceuticals and leather products. Electricity production index in the first quarter increased by 10.4 percent and trade cargo handled by the Chittagong port.¹

Agriculture had a bad year in 2017 due to fungus attack and recurring floods. The crops most affected were Aus, Aman, Aman seedbed, seedling, jute, and vegetables. The secondary flooding destroyed freshly planted Aman paddy and seedbeds, which dealt a fresh blow to farmers. The setback was partially overcome by replantation through supply of seedlings and other related services in the affected areas. Some farmers switched to early winter crops instead of the costly seedlings, going for rice varieties that are submergence-tolerant and can withstand 15 to 17 days of stagnant water. The transplanting of Aman was completed quite late in the season owing to an atypical monsoon.

Services had a better year with growth rising from 6.25 percent in FY16 to 6.7 percent in FY17. Services growth was driven by wholesale and retail trade, transport and hotel and restaurants. Export of services grew by 10.8 percent in nominal dollars in FY17, compared with a 2.6 percent decline in FY16. Service export growth increased to 14.1 percent in the first half of FY18, compared to the same period a year earlier.

Investments: Private investment growth in real terms slowed to 8.1 percent in FY17, compared with 10.3 percent growth in FY16. Consequently, private investment as a share of GDP almost stagnated at 23.1 percent, compared with 23 percent in FY16. On the other hand, public investment boomed, growing by 17.3 percent in FY17, compared with only 4.5 percent growth in FY16, leading to a significant 0.7 percentage points increase as a percentage of GDP to reach 7.4 percent. Import of capital goods increased 19.4 percent in the first half of FY18, compared with 23.7 percent increase during the corresponding period of the previous year. However, capital machinery import increased by 32.5 percent in the first half of FY18, compared with 23.6 percent increase in the first half of FY16. The key driving force appears to have been the capital imports needed by the mega public investment projects such as the Padma bridge, Dhaka Metro Rail Transport and the Special Economic Zones.

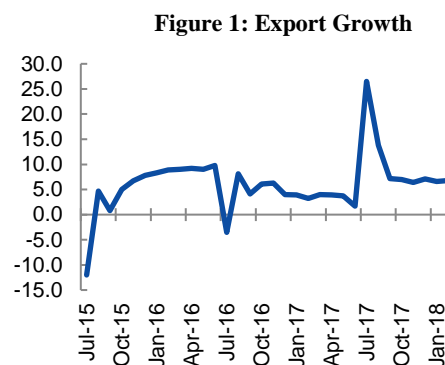
¹ Bangladesh Bank, Major Economic Indicators: Monthly Update, February 2018 and Bangladesh Bank Quarterly, July-September 2017.

Private investments remain constrained by cumbersome business regulation and inadequate coverage as well as quality of infrastructure. Bangladesh slipped one notch to 177 ranking in Doing Business 2018. This is the second lowest among South Asian economies, after Afghanistan (183). During the DB 2018 period, no reforms were recorded in Bangladesh. Bangladesh's overall ranking was significantly affected by a nine-place slippage in the Starting a Business indicator. Minor improvements were recorded in DB 2018 rankings only in the areas of Dealing with Construction Permits and Getting Electricity. The continued lackluster performance in DB indicators underlines significant shortcomings in Bangladesh's business environment.

Competitiveness ranking has improved, but Bangladesh remains well behind the competitor countries in South and East Asia. Bangladesh's ranking in the World Economic Forum (WEF) Global Competitiveness Index for 2017-18, improved by seven places to 99th among 137 countries. Despite the improvement, Bangladesh ranked well behind all but Pakistan in South Asia and all its competitors in East Asia. Only Nepal ranks poorer than Bangladesh on infrastructure in South Asia. Bangladesh's close competitors such as Vietnam, Cambodia and India are far ahead. Moving forward, Bangladesh will not only have to run, but also run a much faster to survive and prosper in the highly competitive and rapidly transforming global markets.

Modernization of land policy, improving the quality of infrastructure building and maintenance, expeditious completion of special economic zones that are in an advanced stage of development and reduction of cost and time to navigate through various business regulations would be required to create an enabling business environment and attract domestic as well as foreign investments. Improving ICT infrastructure and use remain among the biggest challenges for the country. In the past decade, technological readiness stagnated in Bangladesh.

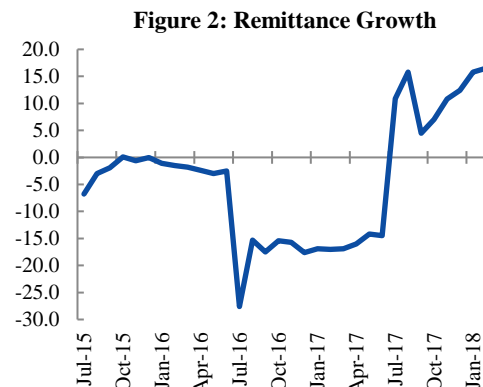
Exports: Exports have rebounded in FY18. Total export earnings increased by 7.4 percent in July-February, FY18, compared with 3.2 percent growth in the corresponding period of FY17 (Figure-1). However, the export growth is short of track to attain the FY18's 8.2 percent growth target. Exports will need to grow by 14.9 percent during March-June 2018 relative to the same period in FY17 to achieve the target. Export growth this fiscal year has so far been driven by Ready-made garments (RMG) recording a growth of 8.7 percent during July-February, FY18, thanks to the 11.6 percent growth in export of knit products. Growth appears to have been primarily volume driven. Growth from non-RMG export earnings was unable to keep pace.



Exports to the EU market gained some momentum with a growth of 11.7 percent in the first eight months, higher than the growth rate for the corresponding period in FY17. Phase-out of the initial shock emanating from the *Brexit* and improvements in the global economic outlook contributed. Exports to US market grew by a miniscule 1.5 percent, leading to a fall in US market share in Bangladesh's total export from 16.9 percent in July-February 2017 to 16 percent during the same

period this year. This is attributable to loss of price competitiveness and lack of product diversification. Bangladesh's export earnings from US declined by 6 percent in FY17, with its market share dropping from 18.2 percent in FY16 to 16.8 percent in FY17. Other prime competitors of Bangladesh experienced significant growth in the US market. Vietnam registered over 7 percent growth in the US apparel market, followed by Mexico at 5.33 percent, India at 1.19 percent and Pakistan at 1 percent in 2017. Vietnam is taking the advantage of China's displacement much better than her close competitors such as Bangladesh. China, the largest exporter of apparel products, also had a decline in export earnings as well as market share in the US. In general, however, RMG imports by the US has been on the decline in recent years.

Remittance: Remittance flow recovered impressively, growing 16.5 percent in the first eight months of FY18, following successive declines in two previous years (Figure-2). The recovery has been spread over several countries such as GCC, US, UK and others. Rise in crude oil price, increase in the number of Bangladeshis working abroad, change in policies in KSA (a rise in minimum wage, change in *akama* system), depreciation of taka, and effective action against illegal money transfers may have contributed to the recovery. Note however that the level of remittance was still 3.2 percent lower than the level achieved in July-February FY16. The



composition of remittance inflow has remained unchanged with about 56 percent of remittance earnings coming from the Gulf countries in the first eight months of FY18, reflecting resilience in the concentration of migrants in the Middle East.² Bangladesh Bank increased their vigilance on mobile banking transfer. In September 2017, Bangladesh Financial Intelligence Unit (BFIU), the anti-money laundering wing of Bangladesh Bank, ordered bKash to suspend activities of 2,887 agents for breaching the laws and sent the account details of the agents to law enforcers for further probe and legal actions. These interventions may have helped improve Bangladesh's remittance earnings and bring more transparency in the mobile banking transfers.

² In keeping with the trends over the last two fiscal years, during the first seven months (July-January) of FY18, out-migration to GCC countries grew by 26.8 percent, accounting for 49 percent of total outflow in FY18 through January.

Box 1: Assessment of FY17 growth estimates

Official growth figures, based almost exclusively on production statistics, are questionable in an economy with dilapidated infrastructure worsened by hostile weather, sagging exports, remittances and ailing banks. The most puzzling disconnect continues to be with the high frequency indicators. ADP implementation rate, growth in LC settlement of construction materials, export growth, remittance growth, private sector credit growth and growth in the quantum index of large scale manufacturing in FY17 were all lower than in FY16 (Table-2), yet GDP growth was higher.

Table 2: High Frequency Indicators (%)

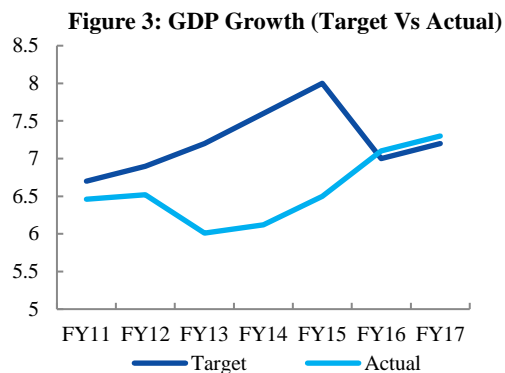
	FY17	Same period FY16
NBR Tax Revenue growth, July-June	19.0	14.6
ADP implementation, July-June (% of original)	88.8	91.8
Industrial raw materials import growth, July-June		
LC Opening	5.3	4.2
LC Settlement	3.5	3.2
Growth in import of construction materials, July-June		
LC Opening	10.1	-3.3
LC Settlement	-0.5	5.7
Growth in import of capital machinery, July-June		
LC Opening	10.5	10.3
LC Settlement	37.4	14.1
Growth in quantum index, Manufacturing July-February	8.8	11.3
Remittances growth, July-June	-14.5	-2.5
Credit flow to private sector, July-June	15.7	16.8
Exports, July-June	1.7	9.8

Sources: Bangladesh Bank, IMED, NBR, and EPB

The table above illustrates inconsistencies in national accounts data. The inconsistency between manufacturing growth and growth in the Quantum Index of Industrial Production (QIIP) is worth pondering. True, the QIIP covers large industries and leaves out most small industries, but the latter have not been growing faster. Nor does the 11.2 percent growth sit well with slow bank lending to corporations, or feeble exports growth (every other Asian miracle economy had double-digit export growth). Therefore, an independent audit of Bangladesh statistical systems is critical.

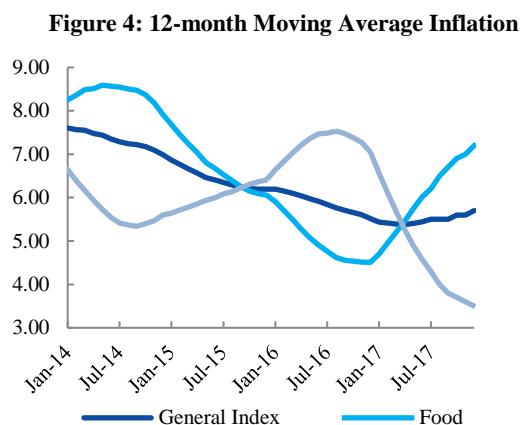
There has also been a dramatic convergence between the GDP growth targets in the 7th Five Year Plan and the actual GDP growth estimates (Figure-3). Compared to the gap between the target growth and actual growth during the 6th Plan period, the difference has shrunk massively, both in magnitude and direction, during the 7th Plan period so far. GDP growth target during the 6th FYP exceeded actuals by about 0.95 percentage point annually whereas the actual GDP growth during the first two years of the 7th Plan has exceeded the target by 0.1 percentage point.

Bangladesh needs a revamped national accounts system. However, even if a revamped system lowers GDP growth from 7.3 percent to say 6.8 percent or even 6 percent in the last two years, Bangladesh will still be among the fastest-growing countries in the world. Despite many flaws, it is performing decently in a lackluster world economy. Incomes are certainly increasing, though not as rapidly as one would infer from official growth statistics.



Supply shock has increased inflation

Inflation has increased since March 2017. At 5.4 percent in FY17, inflation was at its lowest level in five years and well within the target of 5.8 percent envisaged in the Monetary Policy Statement of Bangladesh Bank (BB). Inflation declined steadily from January until the end of FY17. Non-food inflation dropped from 7.5 percent in September and stayed at 4.6 percent through June 2017. On the other hand, food inflation moved up from 4.5 percent in December 2016, reaching 6 percent in June 2017. Food inflation increased further subsequently, reaching 7.1 percent (y-o-y) in December 2017 while non-food inflation dropped to 3.8 percent. Consequently, headline inflation in December rose to 5.8 percent, exceeding the 5.5 percent target for FY18 (Figure-4).



Supply shocks and delayed policy response explain the surge in food prices. Production of both rice and wheat declined by 2.6 percent in FY17 after stagnating at the same level in the preceding two years. Production of rice declined by 9.4 lac MT and wheat production by 0.4 lac MT. The production shortfall of rice was mainly attributable to the loss of boro rice during the early flash flood in haor areas. According to the BBS, about 9.8 lac MT boro rice was damaged during that flood. Similarly, summer vegetable crop was damaged by the early flash flood. Among the three main rice crops, only aman rice production posted a 1.3 percent growth. In addition to production losses, weak management of public food stock exacerbated the food situation in FY17. Government managed to procure only 20 percent of targeted amount of rice from millers and paddy from the farmers during the boro harvest season. At the same time, public food stock replenishment through import of rice was inadequate to stabilize the market price. The decision on duty reduction on rice import came rather late and unsuccessful attempts to import rice

through public channels eventually transmitted wrong signals to the market. Consequently, the price of rice and hence, food inflation, surged significantly.

Monetary management deflated price pressures. Monetary outcomes so far have largely been below target. The 10.9 percent monetary growth in FY17 fell short of the estimated 12.9 percent nominal GDP growth (Table-3). Broad money growth remained subdued at 10.14 percent through January 2018 despite a reserve money growth of 11.5 percent. Slowdown in the growth of net foreign assets and decline in public sector borrowing from the banking system accounts for the slower growth in reserve and broad money. Domestic credit growth was stunted by the 11.7 percent decline in public sector borrowing through January 2018. Growth in net foreign assets dropped from 17.8 percent in January 2017 to 5.9 percent in January 2018. Bangladesh Bank (BB) has taken a passive approach to domestic liquidity management. It has been reinjecting only part of the liquidity losses from the market due to its foreign exchange market intervention on the supply side.

Table 3: Monetary Program Performance											
	FY 14		FY 15		FY 16		FY 17		FY 18		
	Target	Actual	Target	Actual	Target	Actual	Target	Actual	Target	Actual	*
Net Foreign Assets	10.0	41.2	3.6	18.2	11.1	23.2	10.1	14.4	0.1	5.92	
Net Domestic Assets	18.6	10.3	20.2	10.7	16.2	14.2	17.3	9.7	17.9	11.63	
Domestic credit	17.8	11.6	17.4	10.0	15.5	14.2	16.4	11.2	15.8	14.29	
Public Sector credit	22.9	8.9	25.3	-2.6	18.7	2.6	16.1	-12.0	8.3	-11.70	
Private Sector credit	16.5	12.3	15.5	13.2	14.8	16.8	16.5	15.7	16.8	18.36	
Broad Money	17.0	16.1	16.5	12.4	15.0	16.3	15.5	10.9	13.3	10.14	
Reserve Money	16.2	15.5	15.9	14.3	14.3	30.1	14.0	16.3	12.0	11.54	
Inflation (end of period average)	7.0	7.3	6.5	6.4	6.1	5.9	5.3-5.6	5.4	5.7-6	5.8**	
Growth	5.8-6.1	6.1	6.5-6.8	6.6	6.8-6.9	7.1	7.2	7.2	7.4		

Source: Bangladesh Bank and Bangladesh Bureau of Statistics

*January 2018; **December 2018

Single digit lending rates disappearing

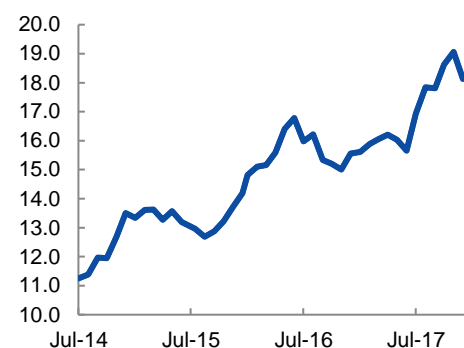
Excess liquidity in the banking system has begun to recede. Credit growth exceeded deposit growth, thus moderating excess liquidity as measured by the ratio of excess of Statutory Liquidity

Requirement (SLR) assets to Total Demand and Time Liabilities (TDTL). At around 11.2 percent end-June 2017, the relative size of excess of SLR assets declined to 9.4 percent by end-December 2017, below their 2012 levels. Total demand and time deposits grew by 10.2 percent, while domestic credit grew by 14.5 percent in the 12 months ending December 2017. Call money rates have tended to rise recently to over 4 percent. The apprehension that sustained low deposit rate environment might encourage banks to take excessive risks and loosen lending standards appears to have materialized.

Private sector credit growth boomed. An aggressive loan disbursement strategy in 2017 produced 18.4 percent growth (y-o-y) in loan portfolios through January 2018 (Figure-5). This was not matched on the deposit side (y-o-y growth of 5.6 percent through January 2018), resulting in a rapid increase in the advance to deposit ratio. The loan portfolio expansion also surpassed BB's 16.3 percent target rate of private sector credit growth, with steep quarterly increases. This increase in credit coincided with a surge in stock market trading volume and market capitalization, raising concerns that credit was partially utilized for speculative investments in equities.

The BB undertook corrective action in January 2018. The target for private sector credit has been reset at 16.8 percent or 1.3 percent lower than the actual growth at end 2017.³ As BB aims to decrease its regulatory limit for ADR (from 85 percent to 80 - 83.5 percent by December 2018), this accentuated pressure on market competition for deposit collection and the interest rate on advances. Combined with the competitive rates of the national saving schemes and pressures from the import payment obligation, there has been a steep reaction in interest rates. The media reports an increase in corporate loan rates of 2-3 percent in two months. With no signs of change in National Savings Certificate (NSC) borrowing, private sector banks may continue to be crowded out of the deposit base and rates are likely to converge closer to the NSC rates. Spreads have decreased by 400 basis points since July through December 2017. The saturation of Bank profitability in the corporate segment has induced banks to be more adventurous towards SME and retail.⁴ Additionally, home loans show similar saturation like the corporate segment.

Figure 5: Private Sector Credit Growth (%)



Source: Bangladesh Bank

³ BB, Monetary Policy Statement, January – June 2018.

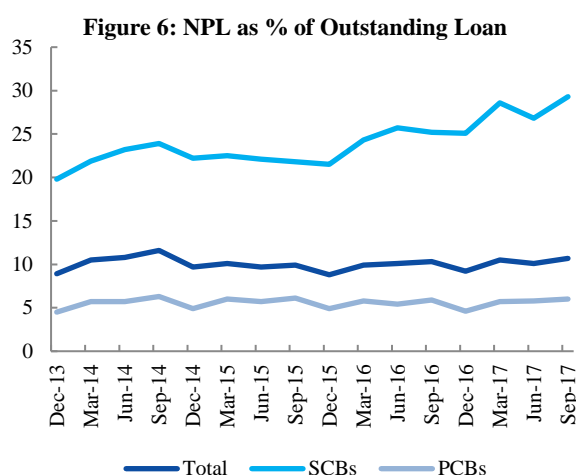
⁴ A related impact of this interest in SME and retail has been some hyperactivity in poaching and salary pressures due to shortage of skilled personnel in the industry.

Banking woes continue. The banking sector, the most important player in the money market, has continued to move in the wrong direction. Despite some push from the BB, asset quality and governance has not improved. State owned Commercial Banks (SCBs) performed with a poor record of large non-performing loans, bad governance, and continued recapitalization (Table 4). The setback from several major financial scams has taken a heavy toll on both the health and reputation of SCBs. The 9 fourth-generation private banks are beset with large amounts of non-performing loans (NPLs) and are making losses. BB's Financial Stability Report 2016,⁵ revealed that when exposed to various credit shocks, 23 out of 49 banks would become undercapitalized mainly due to default by large borrowers. This was a clear recognition of the gravity of the banking sector woes in Bangladesh.

Table 4: Capital Shortfall (September 2017)			
	Risk Weighted Assets (% of sector)	Capital Shortfall (crore)	CRAR (%)
State-owned commercial banks			
BASIC	1.4	2523.0	(11.1)
Janata	5.0	1273.0	7.0
Rupali	2.3	690.0	6.5
Sonali	5.5	3140.0	3.3
Specialised banks			
BKB	1.7	7540.0	(41.8)
RAKUB	0.5	743.0	(6.6)
Private commercial banks			
BCBL	0.3	231.0	6.0
FBL	0.6	75.0	8.5
ICB	0.1	1485.0	(110.5)

Source: Based on Bangladesh Bank Data

NPLs have been rising at a fast pace over the past years (Figure-6). Non-performing loans (NPLs) surged to over Tk 800 billion (4 percent of GDP) for the first time at the end of September 2017 from Tk 657.31 billion (3.8 percent) a year back. The total NPLs accounted for 10.67 percent of the total outstanding loans from the banking sector at the end of September 2017. These figures do not include loan write-offs which amounted to Tk 4.52 billion in the last quarter of FY17 alone, higher by over 18 times relative to the third quarter. Thus, once restructured, rescheduled loans and write offs are factored in, the NPL size would increase very significantly. Poor management of state owned commercial banks, underpinned by malpractices and corruption, has contributed to the high levels of NPL. State owned commercial banks have been awarding loans with even routine assessment of the potential risks associated with the borrower. The government's tendency to fund loss making state owned enterprises, through state owned commercial banks, has aggravated the problem even further.



The maintained prudential standards are rather low. Capital adequacy in the banking system is still below BASEL III requirements for some banks (Table-4), and the prospects of full BASEL III implementation by 2019 seem bleak. Two amendments of dubious nature to the Banking

⁵ Released on July 31, 2017.

Company Act passed recently is likely to undermine good governance.⁶ Major changes were made to Islami Bank management, which had already been suffering from poor governance, on allegations of terror financing and political violence.

Questionable use of public money persists. Bailouts of banks using taxpayers' money continued this year even though bailouts have time and again proven to be ineffective.⁷ The government has taken recourse to this measure on a regular basis, spending Taka 157.05 billion⁸ in recapitalizing the banks during the period FY09-17. This amount is roughly half the cost of the construction of the Padma Bridge. Most of these funds were allocated to the failing SCBs. The authority's lack of readiness to seriously recognize and address root causes behind the banking sector is not helping. Defaulters are hardly ever penalized while, on the contrary, loans are restructured to permit further lending to the same borrowers. Such regulatory forbearance has given the wrong signals leading to moral hazard. Issuing license to more new banks without proper banking due diligence is likely to add to the fragility of the banking industry.

⁶ The tenure of board of directors is proposed to increase from 6 years to 9 years, and up to four family members would be allowed to be on the Board, instead of the earlier two per family. These changes are apprehended to reinforce crony capitalism in a sector of the economy already impaired by poor governance.

⁷ The government is providing Tk 20 billion to 7 state owned financial institutions from the FY18 budget to meet their capital shortfall. This constitutes 10 percent of their total capital shortfall.

⁸ Monthly Fiscal Frameworks, Budget Briefs, Finance Division.

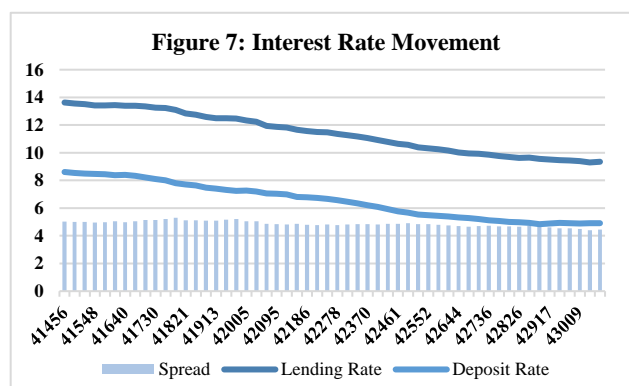
Box 2: Liquidity Crunch

The liquidity crunch was in the making for the last several years with a declining growth in banks deposits, primarily due to the diversion of household financial savings to National Savings Directorate instruments. Large excess liquidity in the banking system made the impact of this diversion of deposits away from the banking system escape notice. Since the growth in bank deposits continued to plunge and growth in private sector lending accelerated, the excess liquidity evaporated rapidly. To sustain profit growth, many banks started to violate macro-prudential conditions such as the advance-deposit ratio. The violations pushed the ratio of many banks to the 90-92 percent range, well above the prudential norm of less than 85 percent. The liquidity problem was also accentuated by the increasing burden of non-performing loans. Due to this excess lending, banks on the verge of becoming illiquid, started scrambling for deposits, thereby pushing up the deposit rates.

BB had to minimize the damage by focusing on the macro-prudential condition with respect to loan-deposit ratio. It instructed all commercial banks to reduce their ratios to 80-83.5 percent and to 89 percent for Islamic banks. It has given the banks until December 2018 to ensure compliance with the revised ADRs. Predictably, this has already led to rising deposit and lending rates. Banks facing withdrawal pressures are offering over 10 percent on time deposits. The result of this process is the loss of “single-digit lending rate” that Bangladeshi entrepreneurs and other

borrowers had been enjoying in recent times. Note that the interest rates offered for savings instruments have been serving as the anchor for the deposit rates in the banking system. As long as they stay well above the bank deposit rates, the deposit growth will remain subdued, thus sustaining pressure on the deposit rates to rise with the tightening of liquidity. Historical data indicate that when bank deposit rates are within 1 to 1.5 percentage points of the savings certificate rates of same maturities, the deposit rates stabilize, inducing deposits to start flowing back into the banking system.

The adjustments brought about by market forces will surely help rejuvenate deposit growth from its recent historic lows, and at the same time help decelerate credit growth due to the combined pressures of lower advance-deposit ratio and higher interest rates. This convergence of the lending and deposit growth rates will be instrumental for easing the liquidity crisis in the banking system. The government missed the opportunity to reform the method of setting the savings certificate interest rate structure when market interest rates were at their lowest points. The market rates had to rise towards the savings certificate rates to ensure market equilibrium since the administered savings certificate interest rates were not allowed to decline to the levels of market determined rates. Such an avoidable bad equilibrium resulted from policy inattention.

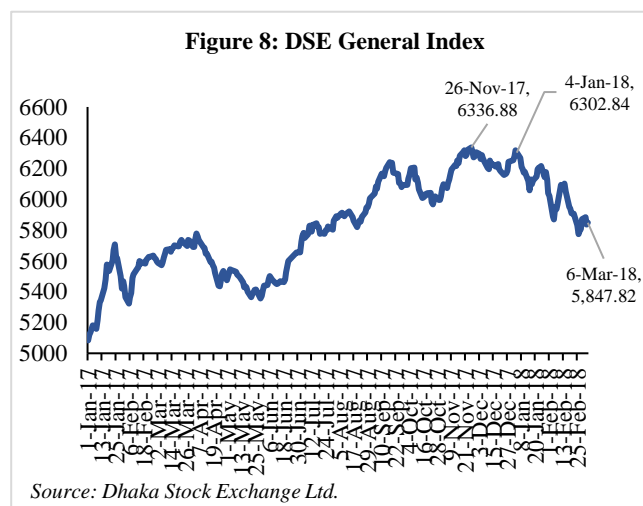


Capital market struggling to consolidate confidence

Stock prices increased by more than 10 percent in DSEX since June 2017, reaching a recent high, before starting to decline again (Figure-8). DSE turnover recorded the highest level in 2017 since the large stock market corrections in FY11. Participation by overseas investors and stable macroeconomic outlook contributed to the buoyance in stock trading activities. Foreign portfolio investment in the first half of FY18 amounted to \$209 million, compared with \$184 million in the first half of FY17. Bangladeshi diaspora abroad appeared to have increased their participation with their contribution in total foreign portfolio investment rising from 51.2 percent in the first half of FY17 to 67.3 percent in the first half of the current fiscal year. The stock market witnessed several positive developments in 2017:

- Premium on the IPOs was stopped. Any company which wants to come under premium, must use the book building method, which has gone through major reform as well. However, the number of IPOs approved in 2017 were the lowest in last 5 years. During this time, a total of Tk. 3.5 billion was raised from the market, of which Tk. 1.1 billion was raised by two mutual funds and the rest were taken by eight companies.
- Bangladesh Securities and Exchange Commission (BSEC) has been more active in regulating the exchange market while BB surveillance of the statutory limits of the capital market exposures contributed to restraining volatility.
- Non-financial corporates have been raising funds by issuing long maturity bonds, thus signaling a long-awaited shift from reliance on bank loans for long tenor financing.

The price earnings ratio, turnover, and issued capital of the DSE increased in the first quarter of FY18. The average price earnings ratio of the DSE edged up to 16.47 in September 2017 from 15.75 at the end of June 2017.⁹ Total turnover in the DSE increased by 60.3 percent in the first quarter of FY18 compared to the previous quarter. The value of issued equity and debt increased by 2 percent. One new company was listed in the capital market, increasing the number of listed securities to 343 at the end of FY18 first quarter. The sector-wise DSE data show that market capitalization expanded in the major sectors (Banks, Financial institutions, Engineering, Food and allied products Pharmaceuticals and chemical, Insurance and Telecommunication sector). These sectors



⁹ Bangladesh has moderate PE ratio among the South and East Asian countries while dividend yield of Bangladesh is the highest among these countries. See Bangladesh Bank Quarterly, July-September 2017.

contributed three fourth of total market capitalization. All other sectors (Cement industry, Fuel and power, Textile, Service and real estate, and Miscellaneous) declined during Q1FY18.

The market has been slipping of late. The investors have been following a “go slow” strategy amid growing liquidity shortage and ambiguity over the DSE’s share sales to a strategic partner.¹⁰ Since mid-November till early March, DSE index declined by 8 percent, from 6336.88 to 5835.34. The daily average turnover on the DSE declined to about Tk 4 billion in February, compared with Tk 5.6 billion in January. Retail investors appear to have preferred to book quick gain on their investment over the recent price surge. The banking sector saw the highest correction.

Overall balance of payment in deficit for the first time since FY11

External balances reversing. Current account deficit widened to over \$5.3 billion in the first seven months of FY18, compared with \$890 million deficit in the corresponding period of FY16. This was mainly driven by near doubling of the trade deficit from \$5.3 billion to \$10.1 billion. A 25.2 percent growth in merchandize imports, driven by petroleum, food and industrial raw materials, far outweighed the modest 7.3 percent rebound in exports. These, together with an expansion in the service account deficit and weak recovery in remittances, led to the large increase in the current account deficit.¹¹ The overall BoP was helped by more than doubling of medium and long-term (MLT) foreign loans from \$1.2 billion in the first half of FY17 to \$2.9 billion in the first seven months of FY18 and over \$1.2 billion net inflows from the banks’ holding of foreign currency denominated assets and liabilities, compared with just \$ 186 million in the corresponding period of FY17. Yet, the overall balance recorded a deficit of over \$1 billion, compared with \$2.2 billion surplus during the same period of the previous year (Table-5).

Table 5: Selected Balance of Payments Indicators					
US\$ million					
Items	FY15	FY16	FY17	FY17 (Jul-Jan)	FY18 (Jul-Jan)
Trade balance	-6965	-6460	-9472	-5282	-10123
Merchandise export f.o.b. (inc. EPZ)	30697	33441	34019	19618	21053
Growth	3	9	2	4.4	7.3
Merchandise import f.o.b. (inc. EPZ)	-37662	-39901	-43491	-24900	-31176
Growth	3	6	9	9.9	25.2
Services (net)	-3186	-2708	-3284	-1995	-2585
Income (net)	-2869	-1915	-2007	-1128	-1167

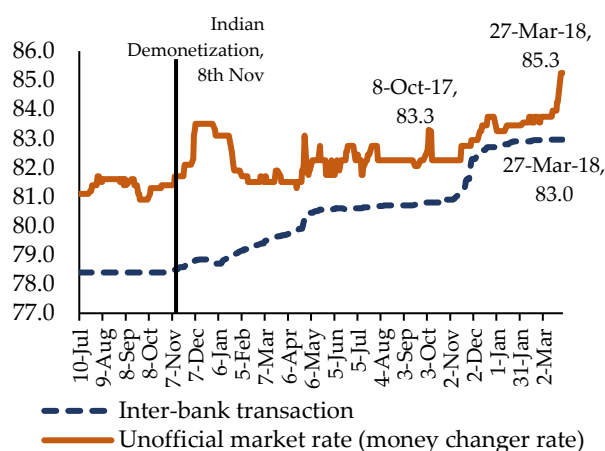
¹⁰ The DSE needed to sell 25 percent of their share to a strategic partner to abide by the demutualization rule. Out of the two bidders interested, one Chinese and the other Indian, the DSE Board approved the bid of the Chinese consortium Shenzhen Stock Exchange and Shanghai Stock Exchange. However, the stock market regulator Bangladesh Securities and Exchange Commission decided to consider the Chinese consortium’s conditions to see if it was eligible to get the approval.

¹¹ A negative current account is not alarming if it is the result of import-intensive investment which can be expected to yield employment and output growth. However, if deficit is due too slow down of exports, as seems to be at least partially the case in Bangladesh recently, then policy actions are warranted.

Workers' remittance	15170	14717	12591	7071	8128
Growth	-7	-3	-14	-16.9	15
Current Account Balance	2875	4262	-1480	-890	-5347
Capital account (net)	496	464	314	177	94
Financial account	1925	944	4179	2537	4744
o/w Foreign direct investment (net)	1830	1285	1706	1959	1990
MLT loans (excludes suppliers credit)	2472	3033	3174	1245	2893
Growth	9	23	5	-17.3	132.4
Other short-term loans (net)	-105	-435	992	783	762
Trade Credit (net)	-2508	-2101	-1185	-405	-1060
Errors and omissions	-923	-634	156	351	-595
Overall Balance	4373	5050	3169	2190	-1034

Source: Based on Bangladesh Bank data.

Figure 9: Nominal Exchange Rate



Source: Bangladesh Bank

The exchange rate has been allowed to adjust downwards (Figure-9). The BOP deficit has so far been handled through a mixture of adjustments in the exchange rate (Figure 10) and using up the foreign exchange reserves (Figure-11). The Real Effective Exchange Rate (REER) depreciated by 5.7 percent through end-December 2017 relative to its average in January 2017 (Figure-11).¹² The nominal taka-dollar rate depreciated by 6.5 percent between January 2017 to

Figure 10: Foreign Exchange Reserves

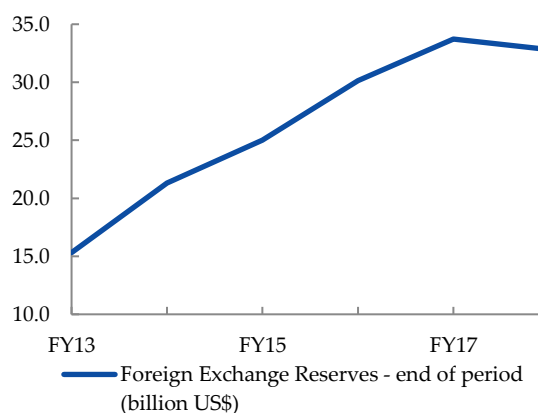
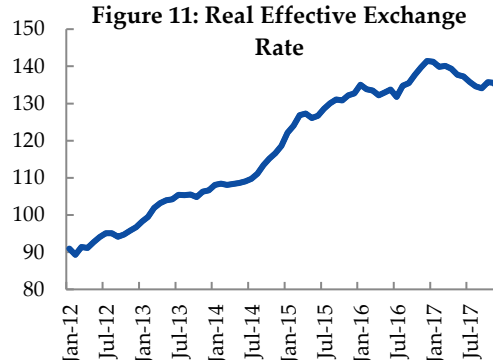


Figure 11: Real Effective Exchange Rate



Source: IMF

¹² The Nominal Effective Exchange Rate (NEER) and the Real effective Exchange Rate (REER) depreciated by 10 percent and 7 percent respectively in 2017. See Bangladesh Bank, Monetary Policy Statement January – June 2018.

mid-March 2018.¹³ The gap between the interbank average exchange rate and the informal market rate has narrowed to less than one taka, but recently jumped again to over 2 taka per dollar as news about burgeoning current account deficit caught on. BB has intervened on the supply side by selling over \$1.5 billion in the first eight months which helped smoothen adjustments in the interbank exchange rate. Yet, foreign exchange reserve has remained within a comfortable \$31-32 billion range in early March 2018, after peaking at \$33.5 billion as of 30 June 2017.

The volatility in the informal market exchange rate premium signals varying incentives for using informal channels for foreign exchange transactions. Capital flight has remained a concern in Bangladesh and this is heightened in an election year. The Global Financial Integrity report 2017 estimated \$53-75 billion illicit financial flows (IFF) over the period between 2005 and 2014, accounting for between about 12 to 17 percent of total trade. Trade misinvoicing is the primary measurable means for shifting funds in and out of Bangladesh illicitly. Over invoicing of imported machinery, raw materials and food items are main suspects.¹⁴ IFF is mainly an offshoot of rigid exchange controls. The slide in remittances and falling export growth last year could have been in part due to widening gap between formal and informal market exchange rates. This may have encouraged under invoicing of exports, over invoicing of imports and diversion of remittances through hundi channels. The archaic Foreign Exchange Regulation Act 1947 need to be reformed in a way befitting the realities of the twenty-first century and the government's policy of export-led growth.

BB has shied away from a clear stance on the exchange rate policy. It cannot continue to inject dollar liquidity to prevent the depreciation of taka. Such interventions would lead to further withdrawal of liquidity from the banking system. Besides, they cannot be effective in changing the market dynamics when large imbalances in the balance of payments and in the interbank foreign exchange market persist. Interbank exchange rate has depreciated to almost Tk 83 per dollar, despite the BB's use of "moral suasion" while at the same time pumping foreign exchange in the interbank market. There are limits to running down reserves. The pipeline for import is very strong. The outstanding stock of import LCs at the of December 2017 was \$36.6 billion, 79.6 percent higher than the outstanding stock at the end of December 2016. With the settlement of these LCs, the pressures on the foreign reserves will continue to mount. It is therefore important to contain the domestic demand pressure. Higher interest rates and a further depreciation of the currency to discourage imports and encourage exports will help address the imbalances.

Fiscal business as usual continues

*Fiscal balance contained in the first half of FY18.*¹⁵ The overall budget deficit (excluding grants) decreased in the first half to Tk 62.96 billion from Tk 65.75 billion during the same period in FY17.

¹³ Cross-currency rate with Bangladesh's major trade competitors have tended to move the taka towards its pre-appreciation level. For instance, INR-BDT exchange rates, now Tk 1.27/INR, has reached the rate in 2015.

¹⁴ Import data for certain items often are found incongruent with the global price movement, letter of credit settlement figures, domestic production and credit uptake and investment trends.

¹⁵ Based on Finance Division data.

This reflects undershooting of both the revenue and expenditure targets, with the size of the expenditure shortfall relative to the budget target exceeding the size of the revenue shortfall.

Table 6: Fiscal Outcomes (Taka in billion)				
	FY16	FY17	FY17 (Jul-Dec)	FY18 (Jul-Dec)
Total Revenue	1729.5	2007.9	889.67	882.03
o/w Tax Revenue	1518.9	1778.2	787.4	789.81
Total Expenditure	2384.3	2612.5	955.42	944.98
o/w Current Expenditure	1444.3	1611.3	691.66	687.58
ADP	793.5	772.4	224.27	214.15
Others	146.6	228.7	39.09	42.97
Deficit	-654.8	-604.6	-65.75	-62.95
Net External Financing	147.4	79	3.24	18.86
Net Domestic Financing	507.3	525.64	61.21	43.87
o/w Non-Bank Borrowing (Net)	401.2	613.8	146.46	89.78

Source: Ministry of Finance

A large revenue shortfall is in the offing. Total revenue collection declined by 0.9 percent in the first half, reflecting 9.8 percent decline in nontax revenues. Tax revenue collection grew marginally by 0.3 percent despite high import growth and exchange rate depreciation. NBR tax revenue decreased by 0.9 percent from the level of corresponding first half in FY17. Leading contributors to the decline were income tax (-5.8 percent) and VAT (-0.9 percent). Import taxes grew 4.3 percent and supplementary duties by 2.9 percent. In the backdrop of anticipated revenue shortfall, primarily emerging from the failure to implement the VAT and SD Act 2012, the government has been exploring alternative avenues of revenue mobilization, particularly in collecting unpaid VAT accruing to the Large Taxpayers Unit (LTU). Many large companies – including state owned Petrobangla (Tk 45 billion) – allegedly owe a large amount of VAT collected but not paid. Appropriate use of the Alternative Dispute Resolution (ADR) system could be a useful step in this direction. There is potential to mobilize Tk 83.65 billion in additional revenue from large taxpayers¹⁶ by resolving legal disputes and 4G licensing, according to the NBR.

NBR data show 15.37 percent tax revenue growth in the first seven months of FY18, with tax revenue collection falling about Tk 148 billion short of target already. All the three NBR wings – income tax, customs, and VAT – failed to meet their respective targets during the July-January

¹⁶ VAT LTU contributes 56 percent to total VAT collection

period despite buoyant domestic activity, high import growth in dollar terms and exchange rate depreciation.

Expenditures on track to usual undershooting. According to the Finance Division data, total expenditure in the first half of FY18 was about 1.1 percent lower relative to the corresponding period in FY17. Both nondevelopment and development expenditures declined by 0.6 percent and 4.6 percent respectively, the latter reflecting 4.5 percent shortfall in ADP expenditure relative to the first half in FY17. However, IMED data on ADP fund release portrays significant improvement during the first eight months of FY18. Actual ADP funds released in July-February, FY18 was 38.5 percent of the originally planned allocation, compared with 37.6 percent during the same period in FY17. Project aid utilization was almost 42 percent, the highest since FY10, while nearly 35 percent of allocated local resources was spent. Concerns about the quality of expenditures remain.¹⁷ Non-development expenditures have faced pressure from floods, food imports, and soaring interest payments.¹⁸

Management of deficit financing continues to lack prudence. The good news is that the net foreign financing increased from Tk 3.24 billion in the first half of FY17 to Tk 18.86 billion in the first half of FY18. The higher foreign financing reflected more than doubling foreign resource mobilization from Japan, the Asian Development Bank, and China. Net NSC sales in the first half amounted to Tk 215.35 billion, constituting 71.4 percent of the budget target for FY18. Higher interest rates compared to bank deposits continued to induce the savers to invest more in the NSD certificates. The government made a net repayment of Tk 45.9 billion to the banks, thus continuing the financially inexplicable practice of borrowing from expensive sources while paying off the cheaper sources of debt. Government deposits at end-December 2017 (Tk 161.5 billion) was 2.8 times the deposit at end-December 2016 (Tk 56.98 billion).

Data discrepancies contributing to fiscal confusion. Discrepancy in data from different government agencies (NBR, IMED, Bangladesh Bank, and the iBAS based MoF fiscal reports) in recent years has become very glaring, thus drawing attention to the divergence in the data collection and reporting practices and the need for an effort to reconcile.¹⁹ While MoF data are generally considered more reliable, it is important to have a precise sense of the source of the differences so that there is ultimately a convergence after all accounts are closed at the end of the fiscal year. Within year discrepancies are not unusual, but persistence of such large discrepancies,

¹⁷ The Center for Policy Dialogue (CPD) conducted an exercise covering all the projects which were declared completed in FY06 and in FY16 with a financial progress of 80 percent or more. CPD found that in FY16, out of 201 completed projects that had more than 80 percent financial progress, 93 projects faced cost overrun with a cumulative amount of Tk. 56.4 billion, equivalent to 13.1 percent of the costs of all the completed projects in FY16. Ministry/Division-wise breakdown suggests that out of 24 Ministries and Divisions that faced cost escalation in FY16, Local Government Division, Ministry of Communication, Energy and Mineral Resources Division, Ministry of Food and Disaster Management, and Ministry of Primary and Mass Education were the top five Ministries and Divisions which experienced increased cost escalation compared to FY06. On the positive side, Power Division could minimize the escalated cost of its completed projects in FY16 compared to FY2006.

¹⁸ Interest payments on the national savings certificates increased by 92 percent in the first five months of FY18.

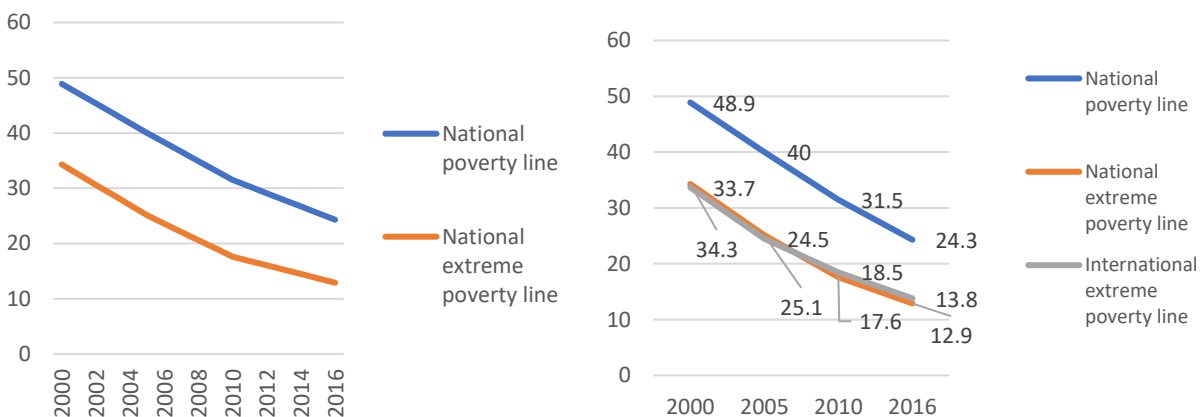
¹⁹ For an excellent compilation of these discrepancies see CPD, State of Bangladesh Economy in 2018, First Reading, January 13, 2018.

not just in magnitude but also in direction, when the year is well past seriously jeopardizes fiscal transparency.

Sustained, but slowing, poverty reduction

Bangladesh is continuing progress in reducing poverty, thanks to strong growth in all sectors of the economy. However, the pace of poverty reduction has slowed while inequality has increased. The results, from the HIES 2016/17 data, presented here identify trends in poverty reduction in locales and sectors, and describe differences in characteristics of the poor and non-poor. Further analysis is needed to help identify what caused changes in poverty reduction in the past 6 years and what are the constraints that are preventing households from achieving faster progress.

Figure 12: Bangladesh has continued to reduce poverty



Bangladesh has continued to make good progress in poverty reduction.

In October 2017 the latest official poverty numbers using the 2016/17 Household Income Expenditure Survey were released, and showed that Bangladesh has continued to make impressive strides in reducing poverty.^{20, 21} As recently as 2000, half of the country's population lived in poverty based on the national poverty line; by 2016, 24.3 percent of Bangladeshis live in poverty (Figure-12). Bangladesh's progress as measured against the international extreme poverty line is similarly impressive. However, with almost 1 in 4 people still living in poverty,

²⁰ The household consumption data used to estimate poverty in Bangladesh is collected for one year. The 2016/17 data was collected from April 2016 until March 2017. The same is true for data collected in previous surveys: 2000/1, 2005/6, 2010/11. For the rest of this report we refer to these poverty estimates as from 2000, 2005, 2010 and 2016 respectively.

²¹ For a full discussion of how poverty is measured in Bangladesh and comparability across rounds of HIES see "Description of the Official Methodology used for Poverty Estimation in Bangladesh for 2016/17". All poverty estimates are measured with error and the standard errors for these poverty estimates are included on the graphs to indicate the precision with which poverty is measured in Bangladesh.

further progress is needed. Half of them, 12.9 percent of the population, live on less than the national extreme poverty line.

Although poverty reduction has been sustained, it is slowing. The annual pace of poverty reduction fell from 1.7 percentage points annually from 2005 to 2010, to 1.2 percentage points annually from 2010 to 2016. This is despite GDP growth increasing from an average of 6.1 percent before 2010 to 6.5 percent after. The amount of poverty reduction each percentage point of growth delivers (the elasticity of poverty reduction to growth) thus fell from 0.35 to 0.23. Measures of the depth and severity of poverty tell the same story. Whilst both measures have fallen from 2010 to 2016, the rate of progress has been slower than in previous periods.

Some adverse developments in 2017 could have decelerated poverty reduction further after the HIES 2016/17 was completed. Remittances declined; garment exports were flat; rice prices increased; and early floods in the haor areas in April and severe monsoon flooding in July-August in the north and north-eastern regions affected the lives and livelihoods of over 8 million people in 32 districts. As if these were not enough, massive influx of Rohingya refugees has exacerbated the economic challenges. Since 25 August 2017, an estimated 688,000 Rohingya have crossed into Bangladesh, increasing the total Rohingya population to over 1 million. New arrivals are living in spontaneous settlements with increasing need of shelter, food, clean water, and sanitation (Box 3).

Figure 13: Spatial Progress was uneven

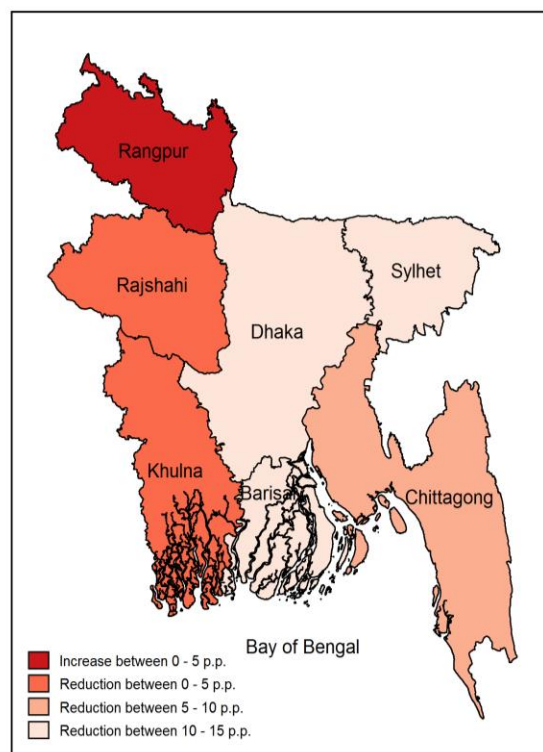
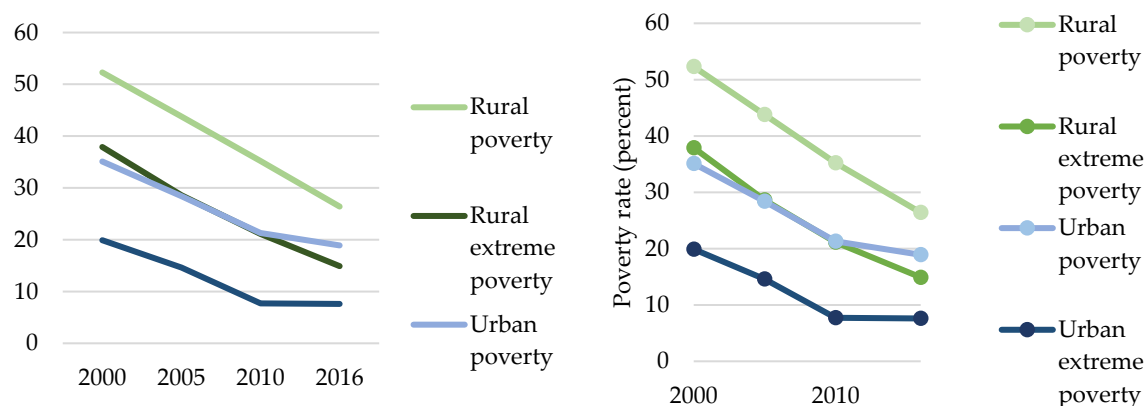


Figure 14: Poverty and Extreme Poverty



What follows in the rest of this section is a descriptive account of poverty trends, based on the recently released Household Income and Expenditure Survey 2016/17 data.

Strong national poverty reduction, masks differences in welfare trends between rural and urban Bangladesh. The national poverty rate fell in both rural and urban areas, but the speed of reduction was much slower in urban Bangladesh (Figure 14), largely because of slower rates of poverty reduction in Dhaka and increasing poverty in Chittagong. There was no progress in reducing extreme poverty in urban areas: the proportion of the urban population living in extreme poverty was 7.7 percent in 2010 and 7.6 percent in 2016. Given that Bangladesh continued to urbanize during this time, there are now more people living in extreme poverty in urban Bangladesh (3.3 million) than in 2010 (3 million).

Welfare differences between the historically poorer west and the rest of the country have re-emerged as poverty rose in the north-western division of Rangpur and stagnated in Rajshahi and Khulna in the West (Figure 14). This combined with the stronger progress of poverty reduction in the eastern regions countered the gains that had been recorded from 2005 to 2010 in reducing the welfare gap between eastern and western Bangladesh.²²

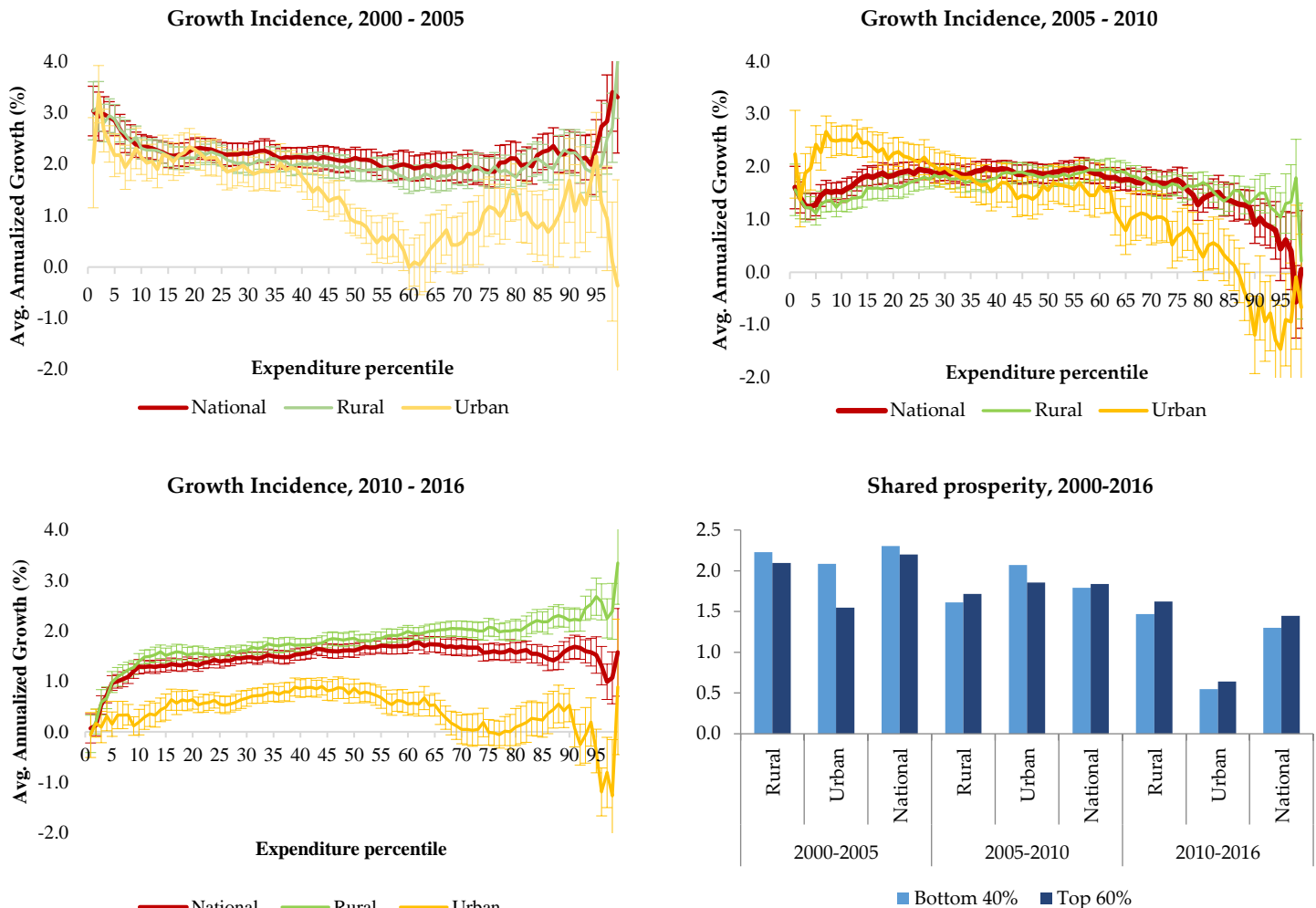
Why has growth become less poverty reducing?

Average consumption growth did not keep up with GDP growth. Although GDP growth was higher between 2010 to 2016 than before 2010, household survey data shows consumption growth has been slower in this period. Figure 15 presents the growth incidence curve which indicates the growth in consumption at each point of the consumption distribution (from the poorest on the left to the richest on the right) for 2000-2005, 2005-2010 and 2010-2016. The bottom right quadrant summarizes the average growth of the bottom 40 percent and the average growth of the top 60 percent. Average annual consumption growth fell from 1.8 in 2005 to 2010 to 1.4 from 2010 to 2016. This mirrors the declining importance of private consumption in total GDP. The share of

²² World Bank, Bangladesh Poverty Assessment 2013.

private consumption in total GDP declined from 74 to 69 percent between 2010 and 2016 and investment increased by 3.4 percentage points.

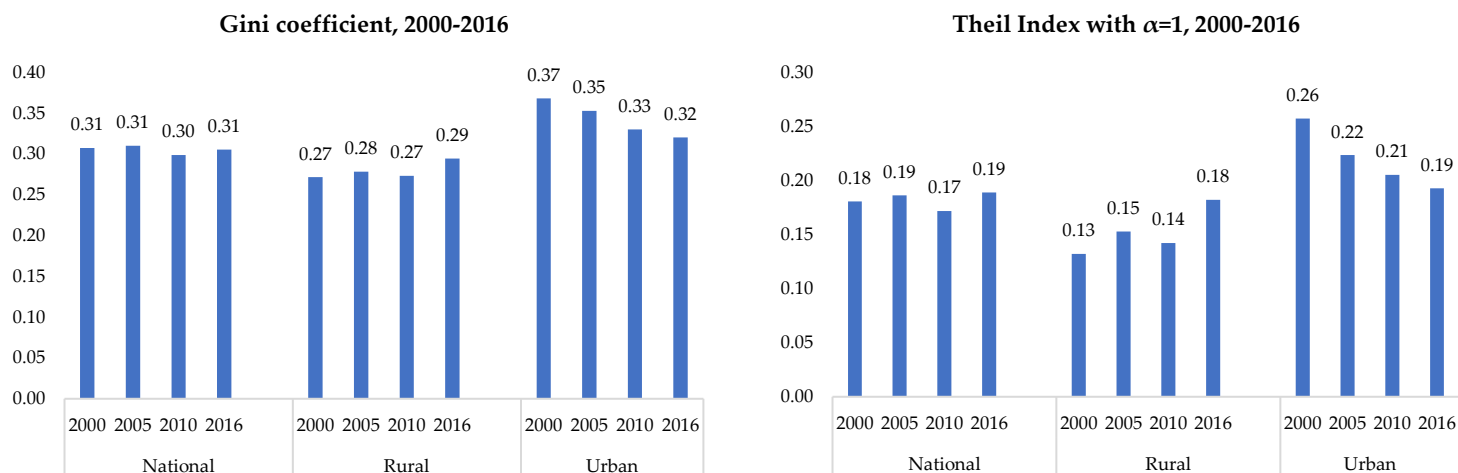
Figure 15: Consumption growth became slower and less equal



Source: Own calculations using HIES 2000, 2005, 2010 and 2016

Consumption growth became less equal, particularly in rural areas. Consumption growth was highest for the 40th to 75th percentile. It was lower for the poorest and lower for the richest, most likely because of lower consumption growth in urban areas (which tend to be richer than rural areas) and particularly among the top third of the urban distribution. Consumption growth was highest for the most well-off rural households. As a result, although Bangladesh recorded healthy consumption growth among the bottom 40 percent which allowed poverty to fall, most measures of inequality increased from 2000 to 2016. The Gini coefficient increased by one percentage point and Theil index (alpha equal to one which gives more weight to changes at the top and bottom of the income distribution) by two percentage points (Figure 16). It is in rural areas that inequality has particularly increased. Inequality in urban areas fell because of the low growth of consumption at the top end of the consumption distribution.

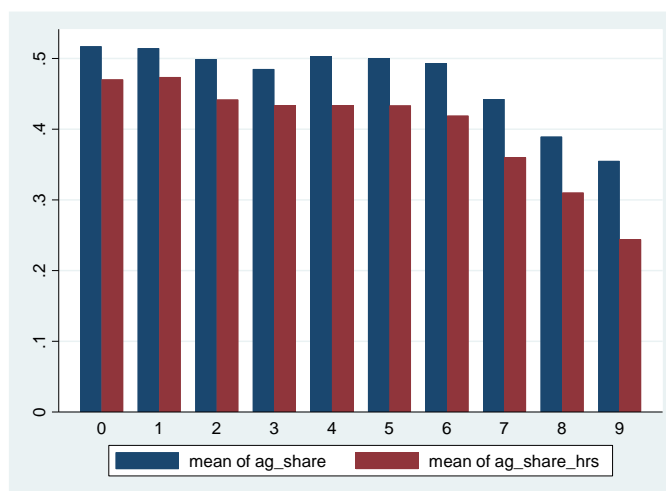
Figure 16: Inequality has increased because of rising inequality in rural areas, urban inequality fell



Source: Own calculations using HIES 2000, 2005, 2010 and 2016

The pattern of growth became less favorable to the sectors poor households are more engaged in, and not enough jobs were created to increased employment in more dynamic sectors. In 2010, poorer households spent more of their time and derived more of their income from agriculture (Figure 17). Agricultural growth, if evenly distributed, would have benefited them more. However, agricultural growth slowed post 2010 whilst industrial growth accelerated. Between 2011 and 2016, agriculture and industry output grew 3.4 and 9.5 percent annually respectively, in contrast to 4.5 and 7.4 percent from 2000 to 2010. The service sector grew at a uniform 6 percent across the period 2000-2016. However, accelerating growth in the industrial sector post 2010 was not matched by stronger job creation in this sector.²³ Job creation in industry slowed sharply between 2010 and 2015.

Figure 17: Agriculture is the main source of income for the poorest households



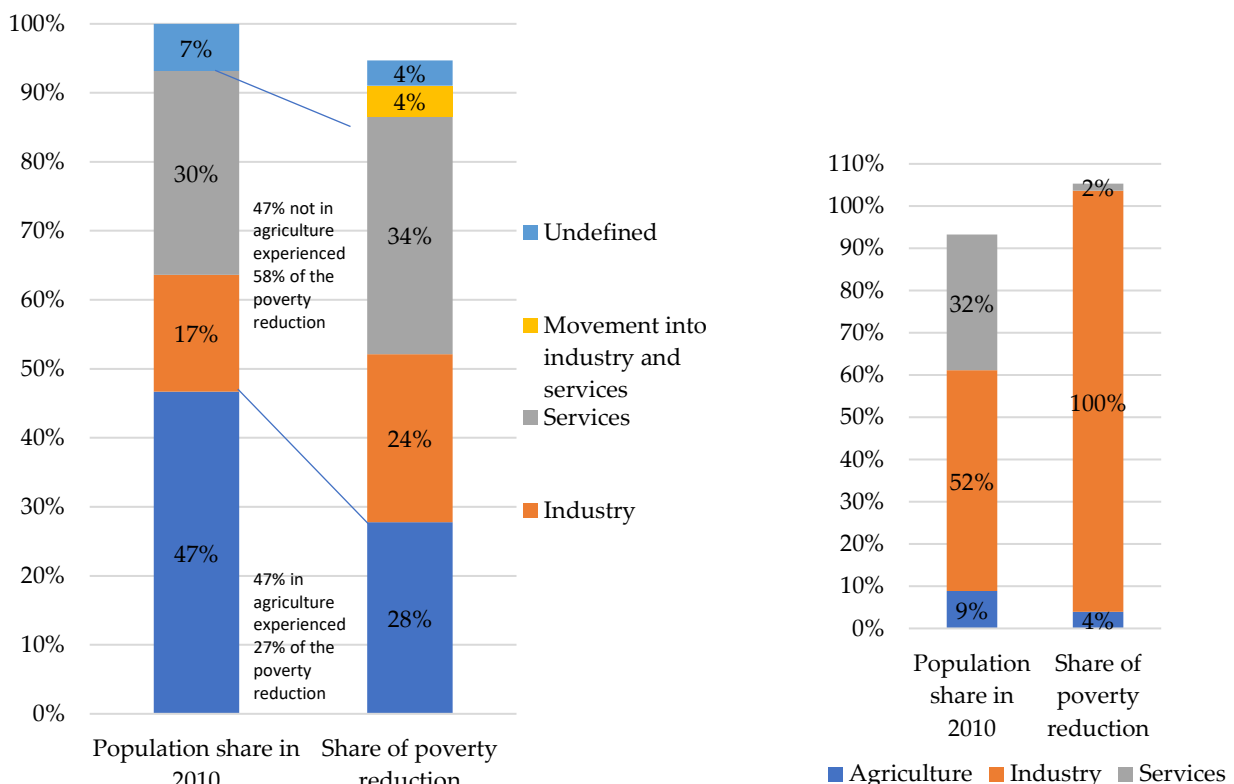
Decomposing poverty reduction by sector of employment shows that poverty did indeed fall faster among households in more dynamic sectors. Households do not tend to move in and out of sectors rapidly, so strong poverty reduction in one sector can often indicate that growth in incomes in that sector were of importance in bringing about poverty reduction. Changes in the share of the population

²³ World Bank, Bangladesh Jobs Diagnostic 2017.

engaged in any given sector can also be examined to assess whether there were any large structural changes in employment that may have contributed to changes in poverty.

A sectoral decomposition of poverty trends shows that although 90 percent of poverty reduction took place in rural Bangladesh, it was gains among non-agricultural households that drove this. Although 47 percent of rural households are primarily engaged in agriculture, they accounted for 27 percent of rural poverty reduction. Most rural poverty reduction, 58 percent, occurred among the 47 percent of households whose primary sector of employment is industry or services (split almost equally between these two sectors). Data that follows the same households over time during this period documents the same trend: households with higher shares of non-farm income saw faster progress.²⁴ Despite strong growth in non-agricultural sectors, the share of the population in households primarily engaged in non-agricultural activities increased by only 3 percentage points. This shift contributed just 4 percent to poverty reduction (Figure 18).

Figure 18: Decomposing poverty trends



In addition, agricultural growth has become less equal and less poverty reducing. Each percentage point of agricultural growth delivered less poverty reduction among agricultural households. From 2005 to 2010 one percentage point of growth was associated with a fall in poverty among agricultural households of 1.18 percent. From 2010 to 2016, the fall in poverty

²⁴ Ahmed 2017.

from each percent of agricultural growth was just 0.58 percent. Understanding why the nature of agricultural growth become less poverty reducing is important. Land ownership is highly skewed to richer households and daily wage labor in agriculture is much more important for poorer households.

In urban areas poverty reduction was entirely driven by welfare gains among households primarily engaged in industry, and more specifically in garments. The poverty rate among households engaged primarily in manufacturing fell from 37 percent in 2010 to 21 percent in 2016. As a result, manufacturing alone accounted for 85 percent of poverty reduction in urban areas (Figure 18). It was households in the garment industry that contributed to poverty reduction the most. Construction was also an important sector in poverty reduction. There was very little poverty reduction among urban households in the service sector. However, closer inspection reveals different trends for different service sectors. There was almost no structural shift in the main sector of employment, limiting the degree to which households could move into the more dynamic sectors and reduce poverty. The limited poverty reduction in the service sector and the lack of structural shift resulted in slower rates of poverty reduction in urban areas.

What of remittances and fiscal transfers?

*The last Bangladesh Poverty Assessment showed that poverty reduction from 2005 to 2010 was driven primarily by growth in labor income.*²⁵ Labor income increased mainly thanks to higher agricultural incomes driven by real wage growth in agriculture. Bangladesh conforms to the international norm of poverty reduction being driven mostly by changes in labor income with changes in transfers—be it safety net transfers or remittances—having an important, but smaller impact.²⁶

An initial look at the 2016 data, suggests that poverty reduction in Bangladesh has continued to be delivered by changes in labor income rather than transfers. The proportion of households receiving the main sources of transfers to households (social protection programs and international and domestic remittances) has not increased at the lower end of the consumption distribution. The proportion of households in the bottom 40 percent receiving international remittances fell from 4.5% to 2.75%. The proportion of households receiving social protection transfers fell from 34.4% to 31.2%.

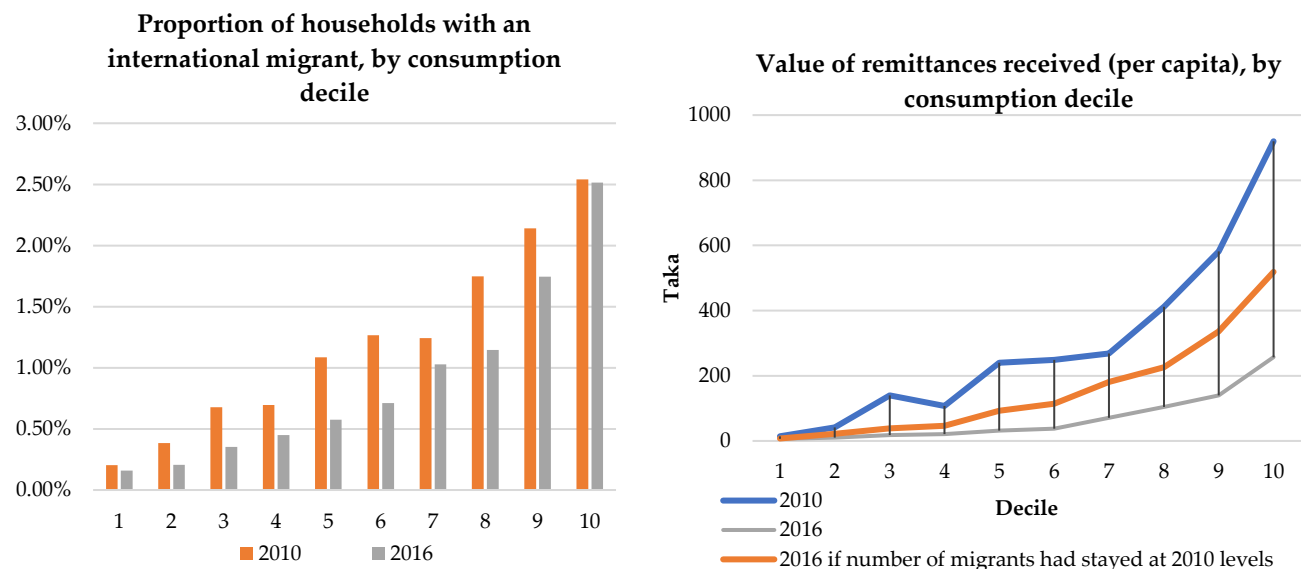
The amount of international remittances that households report receiving has fallen quite dramatically. This is a result of a combination of factors: fewer households report having a member that migrated, fewer households report receiving remittances, and when remittances are transferred the average value of remittances received per household is lower (Figure 19). It is not clear why the average value of remittances would have fallen so much, as the characteristics of those that migrate have not changed substantially since 2011. It could reflect households being less willing

²⁵ World Bank, Bangladesh Poverty Assessment 2013.

²⁶ Azevedo, J.P. G. Inchauste, S. Olivieri, J. Saavedra and H. Winkler "Is labor income responsible for poverty reduction? A decomposition approach". Background paper for the WDR 2013.

to report remittances that are being transmitted through informal channels. Although the drop in reported remittance income is striking, it is unlikely to have a large effect on poverty rates or explain the slowdown in poverty reduction as households at the bottom of the income distribution were less likely to receive remittances in the first place. In fact, even under the assumption that the share of households with international migrants and the size of remittances had remained at 2010 levels, the annual rate of poverty reduction would have still been slower between 2010 and 2016 than between 2005-2010 (1.4 versus 1.7 percentage points per year). The fall in remittances has particularly affected incomes of the top 60 percent who are more likely to benefit from international remittances. Assuming that migrant members would earn no income if they did not migrate, the poverty rate would only increase by 1.9 percentage points if all remittance income ceased.

Figure 19: Remittances have fallen, with larger impacts on better off households



Source: HIES 2011, 2016. Note: In the graph on the right-hand side, the distance between the blue and orange line is the reduction in the value of remittances arising because of the reduction in reported remittances per household that reported remittances. The distance between the orange and grey line is the reduction in the value of remittances arising because of the proportion of households reporting a migrant sending remittances falling.

Box 3: Rohingya refugees and poverty trends: a severe, but local crisis

Starting at the end of August 2017, the district of Cox's Bazar in Chittagong division experienced a dramatic increase in the number of refugees arriving from Myanmar. By end of January 2018, approximately 688,000 Rohingya refugees arrived to the two small upazillas of Teknaf and Ukhiya, more than doubling the population living in the area.

This latest influx of Rohingya refugees poses a considerable welfare challenge. The majority of newly arrived refugees, 7 out of 10, have settled in one area, the Kutupalong- Balukhali Expansion Site. The refugees have arrived with very little, if anything, and their immediate needs for food, water, sanitation, shelter and health care are substantial. It is estimated that 80 percent of the refugees are women and

children.²⁷ Aid is reaching many refugees, but they are highly vulnerable and it is estimated that 76 percent of refugees would not be able to meet their basic needs were aid removed.²⁸ A cyclone-prone hostile terrain combined with high population density (15 sq meters per person on average) pose increasing risks for refugees, particularly as the monsoon season approaches. About 3 in 4 refugees live in places only accessible by footpath. About a third of the population in collective sites and half of the population in dispersed host areas are more than 30 minutes away from a health facility.²⁹

The concentration of refugees in a small geographic area is putting pressure on local wages and prices of locally sourced-commodities. Prices of goods that can be cost-effectively transported from other parts of Bangladesh have not experienced much inflationary pressure. A recent market assessment indicates that markets serving local and Rohingya customers have good availability of key commodities and that prices of cereals such as rice and wheat have not increased by much and variation in prices across markets is small.³⁰ These can be sourced easily from other parts of Bangladesh and whilst the increase in demand is large in the local areas, it is not large in the context of Bangladesh. However, prices of goods that are costlier or challenging to transport, such as fresh fruits and vegetables and fresh fish have increased more substantially.³¹ Firewood was most commonly identified as having insufficient availability.³²

About 70 percent of local workers in Cox's Bazar derive income from wage employment and 50 percent from daily work, making changes in daily labor wages of concern for local residents' incomes. Casual/daily labor is particularly important for poor households, as 80 percent of local workers living in poverty obtain income from daily labor.³³ Prior to their displacement, refugees had similar livelihood activities to the Bangladeshi living on the other side of the border, which includes engaging in unskilled agricultural and non-agricultural labor, small businesses/petty trade, farming, and fishing. The newly arrived refugees are largely dependent on external support from both formal and informal sources, although they also engage in the local labor market particularly in unskilled non-agricultural labor.³⁴ The impact on local labor markets appears to have been quite severe, with reports of wages falling quite dramatically. Estimates suggest that a fall in the daily wage of 25 percent would have caused poverty in Cox's Bazar to rise by 50 percent while a fall in the daily wage of 50 percent would have doubled the current poverty rate for the host population in Cox's Bazar (from a base of 23 percent). Settling refugees in a broader geographic area could be a strategy to lessen changes on prices of goods and labor markets and reduce the vulnerability of refugees and host populations.

²⁷ UNICEF Humanitarian Action for Children. Bangladesh: Rohingya Influx, 2017-2018

²⁸ Rohingya Emergency Vulnerability Assessment (REVA), December 2017.

²⁹ Authors calculations from IOM Needs and Population Monitoring Round 7.

³⁰ Market Assessment in Cox's Bazar. Bangladesh Food Security Sector and the United Nations World Food Programme. November 2017.

³¹ Action Against Hunger Market Assessment in Cox's Bazar (September 2017).

³² Market Assessment in Cox's Bazar. Bangladesh Food Security Sector and the United Nations World Food Programme. November 2017.

³³ Authors' calculations from HIES 2016-2017.

³⁴ Rohingya Emergency Vulnerability Assessment (REVA), December 2017.

Near and Medium-Term Outlook

Bangladesh is projected to maintain growth resilience despite internal political headwinds and emerging macroeconomic pressures. Rebound in exports and private investments are likely to be the key growth drivers. The impetus for such a rebound is expected from the broad-based cyclical upturn in the global economy, aided by a bounce back in investment and trade. This is expected to be sustained over the next couple of years, although not without downside risks. The latter include the possibility of financial stress, increased protectionism, and rising geopolitical tensions. With actual output exceeding the potential, inflation in Bangladesh is projected to rise. Investment driven imports will cause current account deficit to persist while fiscal space is likely to shrink with stagnating revenue effort and elevated expenditure levels.

Global economy recovering

Stronger global growth expected. A broad-based cyclical global recovery is underway, aided by a rebound in investment and trade, against the backdrop of benign financing conditions, generally accommodative policies, improved confidence, and the dissipating impact of the earlier commodity price collapse. Global economic growth is projected to increase to 3.1 percent in 2018 as the recovery in investment, and manufacturing continues. Growth in advanced economies is expected to moderate slightly to 2.2 percent in 2018, as central banks gradually remove their post-crisis accommodative policies and quantitative easing and the investment growth upturn stabilizes. Growth in emerging market and developing economies is projected to strengthen to 4.5 percent in 2018, as activity in commodity exporters continues to recover amid firming prices.

Growth could even accelerate somewhat in emerging market and developing economies (EMDEs), thanks to a rebound in commodity exporters. These regions are generally expected to see faster growth during the forecast horizon, as commodity prices rise and the impact of the earlier terms of trade shock diminishes. Reforms across the region are expected to gain momentum and fiscal constraints are expected to ease as oil prices stay firm. The good news for Bangladeshis migrants is that GCC economies are anticipated to lead stronger growth in the region, supported by easing fiscal adjustment, infrastructure investment such as the UAE Expo 2020, and reforms to promote non-oil sector activity. Growth among the GCC countries as a group is forecast to pick up to 2 percent this year from 0.7 percent in the year just ended.

Trade growth may moderate somewhat. Global goods trade volumes have gathered significant momentum since mid-2016, benefitting from a cyclical rebound in investment. The momentum was sustained throughout 2017, with trade growth reaching a stronger than expected 4.3 percent. Services trade also recovered in 2017, albeit at a slower pace than goods trade. Recovery in import demand from both advanced economies and EMDEs contributed. Global trade growth is set to moderate somewhat in 2018-19, at an average of 4 percent, in line with the projected deceleration of capital spending in advanced economies and China. Besides the effects of maturing recoveries, global trade is expected to remain constrained by structural forces, including the slower pace of global value chain integration and trade liberalization.

Global growth is expected to be sustained over the next couple of years. Although near-term growth could surprise on the upside, the global outlook is still subject to substantial downside risks, including the possibility of financial stress, increased protectionism, and rising geopolitical tensions. With output gaps closing or already closed in many countries, supporting aggregate demand with the use of cyclical policies is becoming less of a priority. The focus now is on structural policies needed to boost potential growth and living standards. Continued geopolitical conflicts and oil price weakness could set back economic growth in EMDEs. Risks to the outlook have become more balanced in some regions, but continue to tilt down in all of them.

*Inflation expectations have increased in advanced economies.*³⁵ Global inflation has remained subdued, at 2.3 percent (year-on-year) in January, despite rising oil prices and strengthening global growth. Among major economies, inflation has recently picked up in the United States, the United Kingdom, and Japan, but remains stable at low levels in the Euro Area, and declined in China and key commodity-exporting Emerging Market Developing Economies (EMDEs). While hidden slack, rising productivity, or structural forces such as globalization and technological changes could allow for additional growth without accelerating inflation, a persistent period of low unemployment could strengthen workers' bargaining power and push wage growth back to levels observed in previous recoveries. The expected boost to activity from fiscal stimulus measures in the United States also risks generating additional inflation pressures. An escalation of trade restrictions, such as the recently announced tariffs on steel and aluminum in the United States, will put upward pressure on import prices and inflation in the affected countries.

An improving global growth outlook, weather events in the United States, the extension of the OPEC+ agreement to limit oil production, and geopolitical tensions in the Middle East have supported crude oil prices. These have risen to over \$60 per barrel by December 2017, with some further increase in early January 2018. Markets expect prices to gradually decline over the next 4–5 years—as of mid-December, medium-term price futures stood at about \$54 per barrel, modestly higher than in August.³⁶ Oil prices are anticipated to rise from average \$53/bbl in 2017 to \$56/bbl average in 2018 on strong oil demand and restraint in OPEC and non-OPEC production, despite projected increases in U.S. shale production.³⁷

Bangladesh's economic outlook is positive, with manageable macroeconomic pressures

Growth in Bangladesh is projected to remain resilient. While increased public spending on infrastructure, along with an improvement in exports and remittance inflows, will provide support to Bangladesh's economy, adverse weather conditions and a problematic banking sector are likely to limit the country's growth prospects. These, in addition to the country's poor business

³⁵ Based on World Bank, *Global Inflation: Recent Developments and Implications*, March 2018.

³⁶ *Energy* prices are forecast to climb 4 percent in 2018 after an estimated 24 percent leap in 2017. Nonenergy prices are projected to gain 1 percent in 2018, after falling 5 percent in 2017.

³⁷ World Bank, *Commodity Price Outlook*, October 2017.

environment, inform our forecast for Bangladesh to struggle towards achieving a 7 percent growth rate in FY18-20. With potential growth rate in the range of 6-5-6.6 percent, sustaining 7 percent growth by maintaining strong domestic demand growth brings with it the risk of accelerating inflation. So far in FY18, the economy has shown resilience, despite facing the lingering effects of repeated flooding in 2017 and the ongoing accommodation of nearly 700,000 Rohingya refugees. The natural production condition of the aman season has been benign while boro plantation has been completed without any disruption. Agricultural growth is projected to rise in FY18 because of expected bumper in boro production and the base effect. Apart from a favorable exchange rate, the rising shipment of higher value-added items, brighter image of Bangladesh's garment sector after remediation works, relative political calm and automation of production should help prop up garment exports in the near and medium-term. Besides, the economies of Bangladesh's major export destinations are gradually rebounding from the shocks of Brexit and general elections in many EU countries. A good number of new factories are expected to come into operation in the next couple of years with entrepreneurs investing to capture the shifted work orders from China. Output growth in FY18 is expected to be around 6.5 percent, driven by industry and services. Exports are projected to grow faster than last year with recovery in global trade, remittances turnaround to persist as GCC economies benefit from higher oil prices and incentives for remitting through informal channels weaken, and investments likely to maintain recent 8-9 percent growth induced by growing confidence on infrastructure development prospects, strong domestic demand and stronger global markets.

Table 7: Bangladesh Macro Outlook Indicators
(annual % change unless indicated otherwise)

	2015	2016	2017	2018 f	2019 f	2020 f
Real GDP growth, at constant market prices	6.6	7.1	7.3	6.5	6.7	7.0
Private Consumption	5.8	3.0	7.4	5.5	5.5	5.6
Government Consumption	8.8	8.4	7.8	8.0	8.4	8.8
Gross Fixed Capital Investment	7.1	8.9	10.1	11.9	10.5	10.2
Exports, Goods and Services	-2.8	2.2	-2.3	7.5	7.2	7.2
Imports, Goods and Services	3.2	-7.1	2.9	14.0	10.5	9.0
Real GDP growth, at constant factor prices	6.5	7.2	7.2	6.5	6.7	7.0
Agriculture	3.3	2.8	3.0	3.3	3.1	3.1
Industry	9.7	11.1	10.2	9.4	9.5	9.6
Services	5.8	6.2	6.7	5.7	5.9	6.3
Inflation (Consumer Price Index)	6.4	5.9	5.4	5.9	6.2	6.2
Current Account Balance (% of GDP)	1.5	1.9	-0.6	-2.8	-2.3	-0.9
Financial and Capital Account (% of GDP)	1.2	0.7	1.8	2.8	1.6	1.1
Net Foreign Direct Investment (% of GDP)	0.9	0.6	0.7	0.9	1.0	0.9
Fiscal Balance (% of GDP)	-3.9	-3.8	-5.0	-5.4	-5.1	-5.1
Debt (% of GDP)	31.5	31.2	32.1	35.1	37.1	39.0
Primary Balance (% of GDP)	-2.1	-1.9	-3.2	-3.5	-2.9	-2.6

Sources: World Bank.

Notes: e = estimate, f = forecast.

Macroeconomic stability is likely to be challenged. Inflation is projected to increase as pick up in global commodity prices combine with possible supply shocks in the run up to elections. Aggregate demand is likely to be stimulated by both an expansionary fiscal policy and rise in nonpublic spending in an election year. Together with the increase in incomes from growing exports and remittances, this will increase domestic demand and add to pressure from the already depreciating exchange rates and uptrend in global commodity prices. Monetary accommodation is likely to continue. BB's Monetary Policy Statement for the second half of FY18 accommodates the expected nominal growth in the economy with a broad money growth target of 13.3 percent and domestic credit growth of 15.8 percent. BB decided to only partially correct the 2 percentage points overshooting of the private sector credit growth target in the first half of FY18 through a mixture of direct quantitative tightening and adjusting upwards the target itself.

The concern about excessive growth in private credit derives from concerns about credit quality. The banking system is already fragile due to contraction in deposit growth, capital shortfalls and bad loans. Private credit expanded as imports picked up, lending rates declined and bankers turned to aggressive strategies. With increase in non-performing loans and provisioning shortfalls, banks' balance sheets have become more fragile. Election induced lending could exacerbate the pre-existing weaknesses in their balance sheets. Under these circumstances, overshooting of an already accommodative target is risky, particularly in an election year, both in terms of its impact on prices and exchange rates as well as on credit quality. Mispricing of risks cannot be ruled out in the banking industry, as both global and our own experience shows. BB has chosen not to adjust the policy rates while signaling closer surveillance on complying with prescribed Asset Liability Management and Foreign Exchange Risk Management guidelines and a directive requiring banks to rationalize their ADRs.

Continued strong growth in payments on account of food and industrial raw materials imports and rise in oil prices could be expected to keep the current account in deficit, albeit it is declining, over the medium-term as well. This is manageable with flexible exchange rate. Over the short-term, a sizeable foreign reserve will allow the BB to control the pace of currency weakening. Over the long-term, the taka is likely to weaken further due to higher inflation and an overvalued real effective exchange rate, but higher interest rates vis-a-vis the US should see the taka continue to outperform the US dollar in terms of total return. A large shortfall in revenue due to the jettisoning of the implementation of the new VAT law and additional pressures on expenditures due to the Rohingyas, rising subsidies³⁸ and the elections could lead to overshooting the 5 percent of GDP budget target.

Unlike in previous years the overall fiscal deficit in FY18 may not only exceed last year's outturn but also overshoot the original budget target, with underperformance in revenue outweighing

³⁸ The government has expanded the list of exports eligible for cash incentives to include some more nontraditional goods. The apparel sector gets 5 percent cash incentive for exporting goods to traditional destinations like the US, Canada and the EU. The rate is 8 percent for new markets. The government plans to give Tk 45 billion in cash incentives to export oriented sectors in FY18.

underperformance in spending. A modest increase in public debt is thus projected. Fiscal policy should continue to be oriented toward keeping the public debt ratio broadly stable. A budget deficit target of 5 percent of GDP is consistent with this principle, with moderate public debt and good medium-term growth prospects giving scope for some cautious deficit spending. As in previous years however, the budget is based on overly ambitious projections for revenue growth and correspondingly ambitious capital spending targets. This together with the large deviation in last year's outturn from that planned in the budget shows that the scope to improve the credibility of the budgeting process remains large. The public debt-to-GDP ratio is projected to increase but remain below 40 percent of GDP. This favorable debt outlook is sensitive to the assumption of continued robust growth and revenue gains from tax reforms.

Risks and challenges

Near-term risks are elevated making investors reluctant to commit. Political uncertainty in the run up to elections, weak business environment, financial weaknesses and infrastructure shortcomings are among the reasons for investor's caution. Foreign exchange reserves are at an adequate level covering over 7.6 months of goods and non-factor services imports. Asset quality and profitability are weak in the financial sector. Enhancing private investment will be pivotal to put growth on a healthy and sustainable path.

The economy likely to face several headwinds

Downside risks are primarily domestic but external risk is also brewing. The downside risks to the outlook include increased policy uncertainty in the run up to elections, a reversal in the recovery of exports and remittances due to internal and/or external factors, and failure to improve corporate governance in the banking system. Surge in private credit growth to a recent historic high of 18 percent in the 12-months ending January 2017 could deepen the banking sector's NPL problem. However, export demand and remittances could surprise on the upside if investment and productivity growth pick up faster than expected in North America, Europe and the GCC economies. The drying of external aid for Rohingya refugees can stress the government budget. The pressure on the budget will likely persist in the absence of a permanent solution.

Rising protectionism worldwide could hurt export prospects by shrinking global trade. Quantifying the potential impact is complicated, but history suggests that the global economy would take a significant hit. According to some studies, global trade war (one that included a rise in import barriers for all countries) would reduce real incomes around the world by 3.5 percent on average.³⁹ Note that average GDP growth for all countries in the world was around 3 percent in 2017. Thus, the average country would lose over a year of economic growth from a global trade war. Even isolated attempts to resort to beggar-thy-neighbor policy measures by large economies could be met with retaliatory responses that could translate into wide-ranging negative effects for participating countries and the rest of the world.

³⁹ Ralph Ossa, Trade Wars and Trade Talks with Data, Working Paper 17347, National Bureau of Economic Research, <http://www.nber.org/papers/w17347>, 1050 Massachusetts Avenue, Cambridge, MA 02138, August 2011

The economy's resilience may be tested again. The repeat of the type of instability experienced before elections in 2014 cannot completely be ruled out. This may further damage domestic and foreign investors' perception regarding the country's stability. Economic activity could be negatively affected in the short term by eroding consumer confidence, fueling credit bubble, and retarding revenue collection, while also worsening inflation. As have been the case in the run up to elections in the past, a big chunk of wealth may go off from the country ahead of the national election. Note, however, that the economy has proven relatively resilient to political protests and blockades in the past. GDP growth remained robust in FY14 even with the prolonged protests in the latter months of 2013, as factories moved work shifts to nights and weekends. The deeper structural risk to Bangladesh from the ongoing polarization is the potential impact this could have on long-term investment decision-making. Moving factories to other countries and changing big suppliers take time. The concentration of exports in RMG means that a structural slowdown in the sector or any broader trend to transfer production assets to other countries would threaten Bangladesh's long-term growth potential.

Challenges in sustaining development progress

Increasing potential growth. Policy initiatives to accelerate physical and human capital growth, remove barriers to female labor participation, and improve institutions could help raise potential growth and reduce inequality. Recent evidence on Bangladesh's largest export oriented garments manufacturing show that progress in using advanced machineries and technological change is very slow and that female workers lack skills in operating diverse set of machinery.⁴⁰ A key near-term challenge is to accelerate the reforms momentum while stemming reversals as seen recently (Banking Companies Act, VAT Law). As election gets closer, a promising policy strategy is to take advantage of the prevailing tailwinds (low international commodity prices, comfortable foreign exchange reserves), before they fade, to build greater economic resilience. This means rebalancing policy towards regulatory, infrastructure management and skills development reforms to raise the economy's jobs creation potential. Highest priority need to be given to making effective the recently passed One Stop Shop act and addressing congestion in Chittagong port, Dhaka-Chittagong Highway, Dhaka Airport and Benapole Land Port to shorten lead time. Adequate power and gas need to be ensured.

Exchange rate flexibility and monetary policy independence can mitigate external risks. The Bangladesh economy will continue to remain exposed to global uncertainties and external shocks. Efforts to strengthen macroprudential frameworks and greater exchange rate flexibility would improve resource allocation, reduce vulnerabilities, and boost resilience. It is therefore essential that the Bangladesh Bank (BB) maintains sufficient foreign exchange reserves. Even modestly weaker than projected remittances growth, export demand, or commodity price spikes could reduce coverage considerably. This calls for the BB to continue its flexible approach to exchange rate management, actively allowing the level of the nominal rate to adjust as needed to

⁴⁰ Presentation by Dr. Khondokar Golam Moazzem, Ongoing Upgradation of RMG Enterprises: Preliminary Results from a Survey, Center for Policy Dialogue (CPD), March 3, 2018.

preserve reserve buffers.

BB should maintain a tight policy stance given the concerns on the rising headline inflation, surging global crude oil prices and fiscal slippage. In its January 2018 bi-annual Monetary Policy Statement, BB maintained a status quo in the repo rate at 6.75 percent. The 5.8 percent CPI inflation in December 2017 was the highest in the last 17 months. BB's inflation expectation survey suggests upside inflation risks. Expectation of one year ahead average inflation is around 6-7 percent, with over 50 percent of the respondents having over 6 percent inflation expectation. Rise in crude oil prices can bring imported inflation via oil and other items. Fiscal deficit in FY18 is also likely to increase and the target for FY19, being the election year, may be fixed at higher than the usual 5 percent of GDP. BB has been pursuing an accommodative stance in recent years. The repo rate saw 50 basis points reduction from a high of 7.25 percent more than a year ago. Despite the deterioration on the inflation front and a more upbeat 7.1-7.4 percent assessment of economic growth prospect in FY18, the BB stayed on hold with a neutral stance on the policy rates. BB appears to be looking beyond the inflation overshoot in the near term and may act if inflation displays a trend not consistent with its 5.7 – 6 percent forecast in FY18.

Need to tap additional sources of revenue. Policy initiatives should continue to focus on mobilizing revenue by broadening the tax base, reducing poorly targeted subsidies, and channeling spending into areas that lift potential growth and improve the livelihoods of all. With the delay in implementation of the VAT law until FY2020⁴¹, additional measures will be needed to ensure revenue buoyancy. Greater revenue yield will most readily come from a combination of seeking efficiency gains from automation, making administrative improvements in business processes to facilitate compliance, introducing carbon and tobacco taxes, and rationalizing tax incentives and exemptions. Automation and process simplification will be instrumental in improving transparency, reducing administration costs, facilitating compliance, and improving the business climate.

- A microsimulation model developed by the World Bank for Bangladesh suggests that automation may bring additional revenues ranging from 0.3 to 0.7 percent of GDP in FY2018.
- Carbon taxes could raise additional resources up to 1 percent of GDP. In addition to boosting revenue, carbon taxes can nudge Bangladesh to a lower carbon and cleaner growth path, helping to make it more sustainable and improving environmental and health conditions for its citizens.
- Tobacco taxes could generate additional resources equivalent to about 1-2 percent of GDP. While estimates of revenue gains from tobacco taxes under the new tax framework have yet to be prepared, the rough estimates based on the former tax framework indicate potential revenue gains ranging from 1-2 percent of GDP.

⁴¹ Microsimulation model estimates suggest that the implementation of the VAT Law 2012 at the planned rate of 15 percent would have yielded additional revenue from VAT of 1 percent of GDP in FY2018, and 0.8 percent of GDP in FY2019.

Expenditure prioritization to preserve fiscal space. Expenditure saving will be needed to cope with revenue shortfall, accommodate the Rohingya pressure and the repeated recapitalization of the state-owned banks. There is room in the budget to apply fiscal austerity measures on non-development capital expenditures and loans and advances as well as government financed ADP projects. Non-development revenue expenditures comprise of acquisition of assets and works outside the development budget and investment in shares and equities (including recapitalization of the state-owned banks), loans and advances represent predominantly the financing of the losses of state-owned enterprises, and 63 percent of the total ADP is financed from the government's internal resources. With a 50 percent cut in loans and advances, 25 percent cut in non-development capital expenditures and 5 percent cut in government financed ADP projects, the deficit could range between 4.6 to 4.9 percent of GDP. Domestic financing could then be between 3.7 to 3.9 percent of GDP and bank borrowing between 1.6 to 1.9 percent of GDP.

Appendix

Table 8: Bangladesh Macroeconomic Indicators

Description	FY12	FY13	FY14	FY15	FY16	FY17
Growth Rates (%)						
GDP Growth	6.5	6.0	6.1	6.6	7.1	7.3
GDP Growth Per Capita	5.3	4.8	4.8	5.4	5.9	6.1
Per Capita GDP (current US\$)	859.2	954.8	1086.8	1212.2	1358.9	1514.6
Per Capita GNI (current US\$)	931.9	1031.6	1159.2	1290.9	1437.1	1579.6
Per Capita GNI Atlas Method (US\$)	950.0	1010.7	1076.5	1188.4	1327.7	1496.0
Inflation (%)						
Rate of Inflation (CPI, %) (year on year)	8.7	6.8	7.3	6.4	5.9	5.4
Inflation (GDP deflator)	8.2	7.2	5.7	5.9	6.7	5.3
Saving & Investment (% of GDP)						
Gross Domestic Saving	21.2	22.0	22.1	22.2	25.0	26.1
Gross National Saving	29.9	30.5	29.2	29.0	30.8	30.3
Private Investment	22.5	21.7	22.0	22.1	23.0	23.0
Of which: FDI	0.9	1.2	0.8	0.9	0.6	0.7
Public Investment	5.8	6.6	6.6	6.8	6.7	7.3
Central Govt. Budget (% of GDP)						
Total Revenue	10.9	10.7	10.4	9.6	10.0	11.2
Total Expenditure	14.4	14.6	14.0	13.5	13.8	16.2
Overall Budget Deficit	3.6	3.8	3.6	3.9	3.8	5.0
Total Public Debt	33.0	32.3	31.9	31.5	31.2	32.5
Balance of Payments (% of GDP)						
Trade	43.0	40.1	38.4	35.0	33.1	31.0
Exports	18.0	17.7	17.2	15.7	15.1	13.6
Imports	25.0	22.4	21.2	19.3	18.0	17.4
Services & Income (net)	-3.4	-3.7	-3.9	-3.1	-2.4	-1.9
Current Transfers	10.1	9.9	8.6	8.1	6.9	5.3
Current Account Balance (including transfers)	-0.3	1.6	0.8	1.5	1.9	-0.6
External Indicators						
Total Debt as % of GDP	33.0	32.3	31.9	31.5	31.2	32.1
External Debt (US\$ b.)	25.5	25.4	27.7	30.8	31.7	33.7
Ext. Debt as % of GDP	19.1	16.9	16.0	15.8	14.3	13.5

BB Gross Reserves (US\$ b.) (end of period)	10.3	15.3	21.3	25.0	30.1	33.7
BB Gross Reserves (in months of imports)	3.3	5.5	5.8	7.0	7.9	8.0
Money and Credit						
M2 Growth (% , year-on-year)	17.4	16.7	16.1	12.4	16.3	10.9
Net Domestic Asset Growth (% , year-on-year)	18.5	11.8	10.3	10.7	14.2	9.8
Ratio of Private Sector Credit to GDP (%)	38.7	37.7	37.8	37.9	38.7	39.7
Exchange Rate						
Nominal Period Average (TK/US\$)	79.1	79.9	77.7	77.7	78.3	79.1
Nominal End of Period (TK/US\$)	81.8	77.8	77.6	77.8	78.4	80.6
Real Effective Exchange Rate-REER Index, 2000-01=100 (8 Currency Basket)	93.7	98.5	106.9	119.6	131.8	137.8
Memorandum Items						
GDP at Current. Prices (Taka bill.)	10552.0	11989.2	13436.7	15158.0	17328.6	19758.2
GNI at Current. Prices (Taka bill)	11445.1	12953.5	14332.2	16142.0	18326.7	20607.2
GNI at Current. Prices Atlas Method (US\$ bill)	146.8	158.3	171.2	191.3	216.3	246.7
GNI at Current Prices (US\$ bill)	144.7	162.1	184.4	207.8	234.1	260.5
Population (mill.)	155.3	157.2	159.1	161.0	162.9	164.9
Human Development Index (Value)	0.55	0.56	0.57	0.58		

Source: Bangladesh Bureau of Statistics, Bangladesh Bank, Ministry of Finance, The World Bank and IMF

* Population data is from DECPG.

Table 9: Bangladesh Current Macro Economic Indicators

	FY15	FY16	FY17	FY18 (Projection)	FY18 (July-Jan)	FY17 (July-Jan)
GDP Growth (%)	6.6	7.1	7.3	6.5
Inflation	6.4	5.9	5.4	5.9	5.8*	5.0*
Export Growth (%)	-2.8	2.2	-2.3	7.5	6.6	3.9
Import Growth (%)	3.2	-7.1	2.9	14.0	25.2	9.9
Remittance Growth (%)	7.7	-2.5	-14.5	5.0	15.8	-16.9
Current Account Balance (US\$ million)	2875.0	4262.0	-1480.0	-7368.4	-5347.0	-890.0
Overall Balance of Payments (US\$ million)	4373.0	5050.0	3169.0	..	-1034.0	2190.0
Reserves (Months of Import)	7.0	7.8	8.0	..	6.8	7.9
Exchange Rate (Taka per Dollar)	77.7	78.3	79.1	84.1	81.4	78.5
Total Revenue (% of GDP)	9.6	10.0	10.3	11.1	4.0*	4.5*
Total Expenditure (% of GDP)	13.5	13.8	13.4	16.5	4.2*	4.9*
ADP (% of GDP)	4.0	4.6	3.9	6.9	1.0*	1.1*
Fiscal Deficit (% of GDP)	3.9	3.8	3.1	5.4	0.3*	0.3*
ADP Utilization (% of ADP allocation)	91.4	91.7	33.4	33.0
M2 Growth (%)	12.4	16.3	10.9	13.3	10.1	14.0
Growth of Credit to Public Sector (%)	-2.6	2.6	-12.0	8.3	-11.7	-4.5
Growth of Credit to Private Sector (%)	13.2	16.8	15.7	16.8	18.4	15.6

¹ Projections are based on World Bank and government estimates

* July-December for relevant fiscal years

All growth rates are year-on-year

Source: Bangladesh Bank, Bangladesh Bureau of Statistics, Export Promotion Bureau, Ministry of Finance and WB staff estimate