

# State of the Bangladesh Economy FY03

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## Macro-economic Fundamentals Improve, Investment Stagnation Deepens

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### I. Introduction

At the beginning of the fiscal year 2001-2002 (FY02), benchmarking the initial conditions, the *Centre for Policy Dialogue* (CPD) in its annual *Independent Review of Bangladesh's Development* (IRBD) mentioned that “the economy is facing possibly the most severe exigency since the macro-economic crisis of the late 1980s. The twin shocks emanating from the yawning fiscal deficit and deteriorating balance of payment has exposed the entrenched vulnerabilities of the Bangladesh economy. Both the successes of the macro-economy, achieved during 1990s, viz. stability and growth are in peril”.

CPD-IRBD 2002 raised the question “whether the emerging negative trends in the macro-economy will lead to an expensive loss of employment and income for a protracted period, or whether the present predicaments are a short-term phenomenon to be overcome through prudent policy management and institutional reforms”.

At the end of the FY02, as part of its reaction to the National Budget for FY03, the CPD undertook an year-ending assessment of the economy. Three major observations were recorded in the said assessment on FY02. *First*, deterioration of fiscal balance has been harnessed. *Second*, pressure on balance of payment has been partly contained. *Third*, recessionary trends continue to afflict the economy. CPD's review underscored that inability to address the prevailing stagnation in the investment scenario may jeopardise the recent gains.

One wondered whether the Budget for FY03 will be able to do the trick of catalysing the investment growth. However, it was further stated in CPD's review that, in spite of all the positive measures taken under the Budget FY03, investment will still remain constrained due to

lack of reforms, particularly in trade-supportive infrastructure, financial sector, public administration, and last but not the least, because of deteriorating law and order situation.

More than four months have elapsed since the foregoing observations were made. During this period, the government has resorted to the non conventional measures to improve the law and order situation. A number of government committees are trying to give shape to reform measures in different areas of economic management. Now with the results of the first quarter of the FY03 in hand, we may seek to identify and interpret the initial signals.

It is in this context that the present paper reviews a set of major variables defining the state of Bangladesh economy. The analysis, based on official data, is divided into broad five parts. It sequentially addresses the developments in the fiscal sector, credit and monetary sector, real economy, and external sector. The review concludes by highlighting some issues which in the coming months will underwrite the performance of the economy.

## **II. Trends in Fiscal Sector**

**Revenue.** In FY02, a total amount Tk. 276.70 billion was collected as revenue, of which National Board of Revenue (NBR) tax component accounted for about 75 per cent, non-NBR tax – a little above 4 per cent, and non-tax revenue – around 21 per cent. The total collection, in spite of being about 7.9 per cent higher over the earlier year's receipt, was about 2.8 per cent short of the target.

The National Budget, with a projection of about 19.6 per cent growth, fixed a target of Tk. 330.84 billion to be collected as revenue in FY03. Highest growth is to take place in non-NBR tax revenue (45.8%), followed by non-tax revenue (32.1%).

Bangladesh has one of the lowest Revenue-GDP ratio, even amongst the low income countries. Full implementation of the target for FY03 is to push the said share of revenue in GDP to a little above 11 per cent.

Data for the period July-October, 2002 indicate that the fiscal year got a kick-start in terms of revenue collection. After a slow start in the month of July, the collection geared up in the subsequent months. Revenue receipts under the NBR was about 24.7 per cent above the collection during the matching period (July-October) of FY02. This was about 1.6 per cent higher than the target set.

However, information was not readily available for non-NBR tax revenue and non-tax revenue receipts over the corresponding period.

**Public Expenditure.** Public expenditure happens to be one of the major areas of government finance in Bangladesh for which real time data is almost totally absent. Revenue expenditure data becomes provisionally available only at the end of the fiscal year along with budget documents. Information on implementation of the *Annual Development Programme (ADP)* is actually available with three to four months time lag, only when the *Executive Committee of the National Economic Council (ECNEC)* endorses the report of the *Implementation, Monitoring and Evaluation Division (IMED)*.

Thus, in the context of the absence of any up to date information, one may recall that the budget for FY03 provides for a conservative revenue expenditure growth of 5.64 percent supplemented by an ambitious target of ADP expansion in the order of 23.3 per cent. The programmed ADP constitutes about 43 per cent of the total public expenditure outlay for FY03.

The total public expenditure in Bangladesh as a share of GDP is still low in comparison to other low income countries – programmed to be approximately 15.0% in FY03. Thus, it is not the overall size of the public expenditure, but its composition and quality which remain a matter of greater concern. *First*, the ADP is routinely under-achieved. The government slashed down the ADP for FY02 by Tk. 30 billion, and yet could not fully implement the scaled down figure. Thus, a development expenditure target of Tk. 192 billion for FY03 would be a daunting figure to chase. It may very well be possible that the proposed mid-term review of the budget will revise the original ADP target downward. *Second*, whatever may be the size of the ADP, it is the prioritisation and selection of the included projects as well as the quality of their envisaged

expenditure lines which have always remained suspect. *Third*, in the backdrop of low implementation of the ADP, the revenue expenditures have systematically crossed the budget limit. Structural features of the revenue expenditure-basket reveals its rigid nature. Indeed, three-quarter of the revenue budget is committed to salaries and allowances, subsidies and transfers, and interest payments.

However, indirect evidence, such as the trend in government borrowing (as discussed later) suggests that the government has been following a tight expenditure policy during the first quarter of FY03. In spite of the comfortable revenue collection situation, it is quite prudent on the part of the government to pursue such a conservative approach to budgetary management, given the softness in the foreign exchange reserve. In case of any exigency, this will also allow the government to cut back on expenditures (possibly ADP) to maintain the fiscal balance. However, this implies that a substantial part of the programmed expenditure will be back-loaded, taking away the smoothness in the expenditure trend.

Hopefully, inputs from the Public Expenditure Commission will come in time to bring about the necessary adjustments in revision of the governments' outlay for the rest of the current fiscal year.

***Fiscal Deficit.*** The crawling increase of the overall budget deficit as a share of GDP was harnessed in FY02 by bringing it down to around 4.4 per cent from about 7.0 per cent in FY01. This was largely done by slashing down public expenditure.

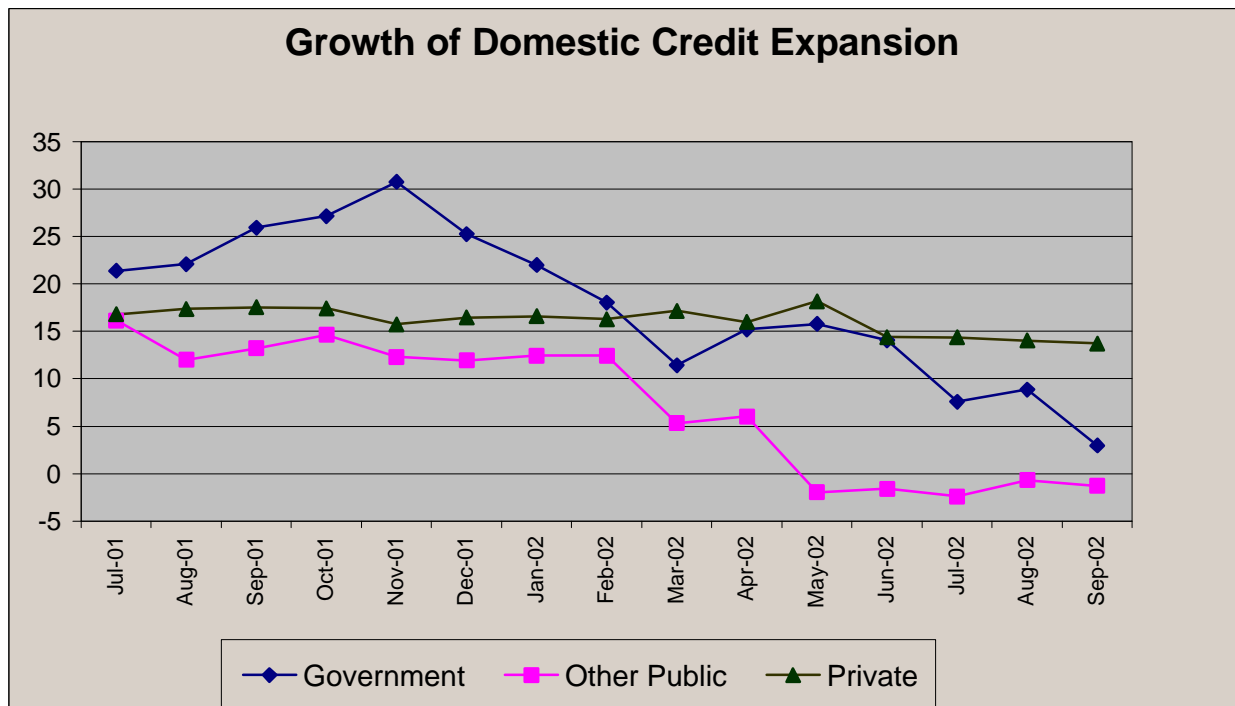
The budget for FY03 plans to bring down the share further to less than 4 per cent of which about 48 per cent will be financed from domestic source and the rest through foreign financing. As we shall see later, the government has been able to avoid, till date, borrowing from the banking sector to finance its fiscal deficit. It will be, however, very important to observe to what extent government will be successful in drawing down on its foreign aid pipeline to underwrite the deficit.

The foregoing review of the trends in the fiscal sector reveals that the process of consolidation, which set in FY02, has progressed further during the first quarter of the FY03. One may, however, raise the question whether such a tight public (development) expenditure policy is going to have any depressionary effect on the investment situation. It is by now largely accepted that quality investment from the government source “crowds in”, rather than “crowds out” private investment in developing economies.

Scrutiny of the trends in monetary sector presented in the following section would give us some clue about the obtaining situation in this regard.

### III. Developments in the Monetary Sector

**Domestic Credit Expansion.** Following expansion of domestic credit at the high rate of more than 17.6 per cent in FY01, domestic credit growth was brought down to below 13 per cent in FY02 as part of the overall strategy of fiscal consolidation. The most disturbing feature of the credit growth in FY01 had been greater increase in the government and quasi-government sector in comparison to the private sector. Thus, both the aggregate and inter-sectoral balance was largely restored in FY02.



Figures for the first quarter of FY03 reveals that the domestic credit flow has slowed down further recording an aggregate growth of 10.1%, which happens to be the lowest since FY94. Imposition of “hard budget constraint” on state-owned enterprises have resulted in a negative growth of 1.3 per cent for other public bodies, whereas credit growth was only 3 per cent in the government sector. In contrast, credit growth in the private sector has been about 13.7%.

The low offtake of credit by the government during July-September 2002 is indicative of low level of government expenditure in this period. However, a close look at the monthly data suggests that there had been a secular slowdown in credit growth rate in the private sector since May 2002. Our subsequent analysis of the latest figures on term loan disbursement will show that, this is a reflection of slowdown in private sector investment.

***Government Borrowing and Public Debt.*** High level of government borrowing from the Bangladesh Bank as well as from the scheduled bank dominated the macro-economic concerns since FY00. Total domestic outstanding debt as a share of GDP secularly rose from 13.0% in FY00 to 16.6% in FY02. During this period one observes a change in the fiscal stance of the government as it moved away, partly, from the borrowing from the banking system to raising of funds through sale of saving certificates to the public and treasury bonds to non-bank financial institutions. Latest figures (as of November 6, 2002) show that there had been a net reverse flow to the banking system (including both Bangladesh Bank and scheduled banks) from the government to the tune of Taka 1500 million.

Notwithstanding such positive trend in government borrowing from the banking sector, total domestic outstanding debt has increased as of August 2002, by about Tk. 62 billion on a point to point basis. This has happened due to incremental borrowing by the government through sale of National Savings Directorates (NSD) Certificates.

Outstanding borrowing of government through NSD Certificates at end September 2002 stood at about Tk. 264 billion, recording an increase of Tk. 45 billion over the same month of the preceding year. This implies that the reduction of rate of interest of the NSD Certificates in June 2002 had transitory effect on their sale and has started to pick up since August 2002. Such a

trend, once again, is expressive of the limited viable investment opportunities in the Bangladesh economy. This also implies that the government desire to push the small savers to the capital market through decreasing the rate of assured return on their savings has not yielded result as yet.

Whatsoever, since there is no effective ceiling on the sale of NSD Certificates, the government is ending up acquiring debt, even when it does not need it. Consequently, the government is using high cost borrowing to underwrite its domestic financing needs. Some would, however, maintain that this is better than mopping up liquidity in the banking sector by the government to the detriment of private sector investment.

***Agricultural Credit.*** Agricultural credit delivery system, since the post-1998 flood programmes, had been low on disbursement and high on recovery. This resulted in net outflow of resources from the rural areas through the institutional credit system.

During the period of July-September, 2002, against an approximate 10 per cent growth in agricultural credit disbursement, recovery grew by almost 12 per cent. This implies that, an amount of Tk. 1.64 billion was withdrawn from the rural economy. On the other hand, the rate of default with respect to agricultural loans worsened further reaching more than 63 per cent at the end of September, 2002.

***Industrial Term Loan.*** Curiously, in contrast to the agricultural credit, industrial term loan disbursement had been usually positive in net term. For instance, in FY02, against a disbursement of Tk. 35.05 billion, recovery was Tk. 32.13 billion. However, this trend was reversed during the first quarter of FY03.

In comparison to a 47 per cent increase during July-September 2001, term loan disbursement decreased by 18.4 per cent in the first quarter of FY03. The recovery has also slowed down in July-September, 2002, although at a lesser degree. Thus, one observes two emerging trends in the industrial credit at the beginning of FY03 – *first*, the inter-temporal growth in disbursement

rate has become negative; and, *second*, the reduced volume of disbursement is lower than the amount recovered during this period.

One could have drawn solace from the obtaining situation attributing it to higher collection of outstanding loans, if only the flow of fresh industrial loan had not fallen so drastically. However, such decline can be largely explained by the deepening of stagnation in the manufacturing sector. Our subsequent analysis of recent trend in import will validate such claim.

In the meantime, overdues as percentage of the outstanding industrial term loans have improved, decreased from about 38.6 per cent (July-September, 2001) to 34.2 per cent (July-September, 2002). One awaits to see to what extent the recommendations of the Committee set up to deal with defaulted loans will be successful in removing this structural impediment from the country's banking sector.

***Inflation.*** The recent trend of creeping growth of the inflation rate comes as a surprise in the backdrop of the contractionary monetary policy pursued by the government in the past months. One wonders whether the lagged response of inflationary pressure generated by the expansionary policy pursued in FY00 and FY01 is catching up with the Bangladesh economy.

The general inflation rate (on point to point basis) increased from less than 3 per cent in June, 2002 to about 4.7 per cent in September, 2002. However, two disturbing features of the recent rise in price level may be noted. *First*, the inflation rate during July-September, FY03 period had been higher in the rural area in comparison to its urban counterpart. *Second*, curiously, increase in food price during the abovementioned period had been again higher in the rural area.

Of course, there is no reason for panic because of the current level of inflation. Indeed some would say that a "little inflation" is good for stimulating investment.

However, the recent moderate rise in price level is largely a "cost push", rather than a "demand pull" phenomenon. Increase in price of fuel, public utility rates and exchange rate adjustment

may have been responsible for it. Temporary disruption in the domestic supply chain due to limited flood may have contributed to it as well.

In sum, it may be emphasised that in the backdrop of an overall conservative monetary policy, one observes low offtake of private sector credit, particularly industrial term loan. Whilst inflationary pressure remain moderate, one should not end up with the worst of the two worlds of stagnation and inflation, epitomised by “stagflation”.

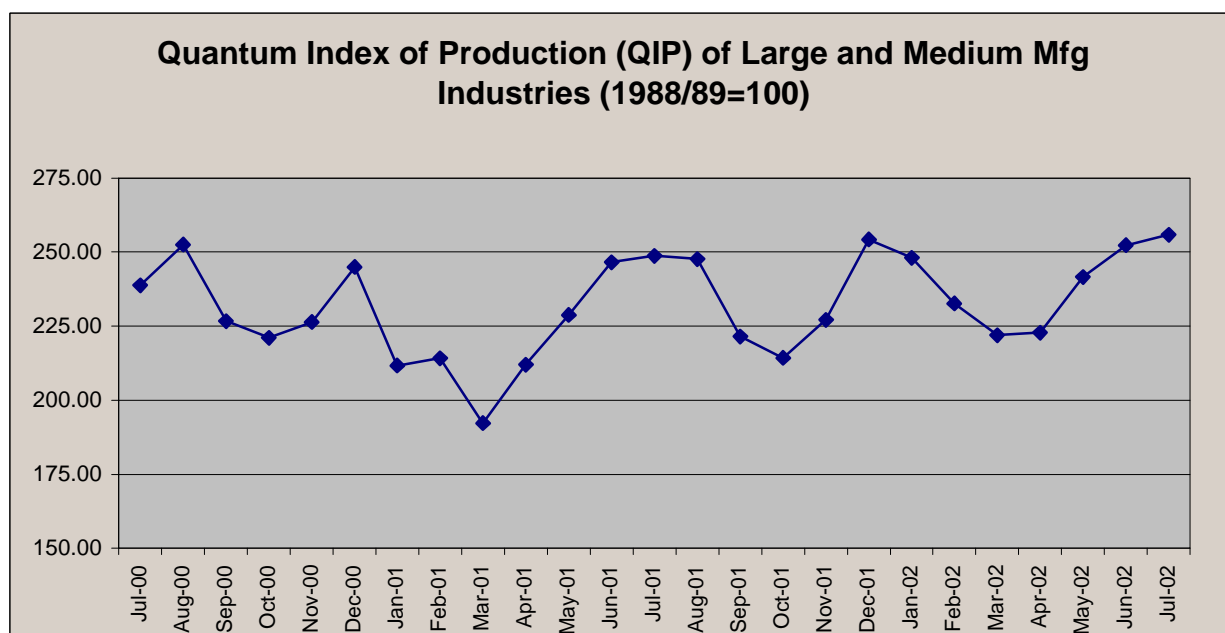
#### **IV. Performance of the Real Economy**

**Foodgrain Production.** Since the spectacular post-flood growth to the tune of 17 per cent in FY00, the foodgrain production growth rate come down in the subsequent years. In FY02, the country produced about 27.07 million metric ton of foodgrain, of which rice accounted for more than 93 per cent. In FY02, total foodgrain production recorded a growth of about 1.2%, while rice production increased by 0.52%.

Total food production target for FY03 has been refixed at 28.1 million metric ton. The recently harvested *aus* yielded a production of 1.94 million metric ton which is about 5.4 per cent more than that of the last year. However, it is the production of *aman* and *boro* which defines the food situation of the country as it accounts for more than 93 per cent of total annual rice production. The FY03 target for *aman* has been fixed at 6.9 per cent higher over the preceding year. Early forecast says that the production had been good, but whether it has achieved the target is yet to be ascertained. It may be pointed out that foodgrain import has increased significantly during the recent months. In FY03 (July-September), import of foodgrains amounted to 0.522 million metric ton, the matching figure for FY02 was 0.315 million metric ton, recording about 65 per cent increase.

**Manufacturing Production.** Since the floods of 1998, the manufacturing sector has slowly recovered recording 4.8 per cent, 6.3 per cent and 5.0 per cent growth in FY00, FY01 and FY02 respectively. In all these years, the growth of the large and medium scale industries were relatively subdued in comparison to the small and cottage sector.

The manufacturing sector during FY02 was greatly affected by the severe deceleration of the export-oriented apparels sector. The export sector marginally recovered in December 2001, with the ending of the RMG quota year; but the flicker did not translate into a trend. The Quantum Index of Production (QIP) of the medium and large scale units for FY02 was 3.35 per cent more than that of the previous year.



The clear winners of FY02, in terms of physical production growth included cement (29%), pharmaceuticals (16%), textile fabric (11%), jute sacking (10%). In contrast, fertilizer (-16%), jute hessian (-12%) and paper (-6.5%) pulled the manufacturing sector down in FY02.

For the current fiscal year, we have QIP only for the month of July 2002 which shows a very modest increase of 1.4 per cent over the preceding month. Improved performance of the export sector during the months of July-September, 2002 prompts us to suggest that the manufacturing sector may have experienced a better growth during this period. However, the slowdown in offtake of term loan coupled with fall in import of capital goods (discussed subsequently) do not make one very optimistic about the prospect of manufacturing growth in the near future.

**Foreign Investment.** According to CPD's estimate, Bangladesh received a net amount of \$114.71 million as foreign investment, of which \$65 million came as foreign direct investment

(FDI) in the domestic tariff area and another \$55.7 million in the EPZ. Reinforcing the earlier trend, portfolio investment recorded a net outflow of \$6 million.

Net flow of FDI experienced a fall of about 61 per cent in FY02. In contrast, foreign investment in the EPZ recorded a more than 15 per cent increase in FY02, continuing the recovery since the drop in FY00, consequent to the controversy surrounding the trade union rights issues in the country's EPZs.

Available figures indicate that a meagre \$7 million was received by Bangladesh as net FDI inflow during the months of July-August, FY03, which is 30 per cent less than the comparable figure for FY02 (which itself was disappointingly low).

Thus, in spite of all the pro-active policy procurements and expensive road-shows, foreign investment continues to shy away from Bangladesh. It is to be seen how much the recent reinvigorated efforts of the Board of Investment (BOI) yield result during the rest of the year.

**Capital Market.** The recovery of the capital market remains painfully slow since the boom and bust episode of the 1996. During the period January-September, 2002, the weighted average share price index of the Dhaka Stock Exchange (DSE) increased by only 0.5%. During this period, enlisted issues increased by 8 in number and market capitalisation increased by 14 per cent in taka term.

Whatsoever, the capital market in Bangladesh remains shallow, and is yet to emerge as a major source of equity financing in the industrialisation process. The disparate benefits offered in the budget for FY03 along with cuts in the interest ratio of the NSD certificates could not bring back the small investors to the secondary market of shares and securities.

## **V. External Sector Behaviour**

**Imports.** The slowdown of imports in FY02 was due to a combination of factors which included regulatory measures taken by the government to release pressure on the depleting foreign

exchange reserve and fall in import of raw materials from the RMG sector due to drastic fall of exports. Thus import payments recorded a negative growth of 8.9 per cent in the elapsed fiscal year.

Sluggishness in import trend seems to have continued during the first quarter of FY03. Import payments for July-August, 2002 had been 5.6 per cent less in comparison to the depressed benchmark of the matching period in FY02.

Growth in settlement of L/Cs for the period July-September 2002 had been only 1.4 per cent more than the matching figure for FY02. This marginal growth has been achieved largely due to robust growth of consumer goods import (43.6%) including high growth of foodgrain import (89.3%). Conversely, imports of capital machinery and intermediate goods, as per the L/C settlement figures for July-September, 2002, fell by 20.7 per cent and 21.1 per cent respectively.

Analysis of the figures relating to opening of new L/Cs suggests that import depression has accentuated further as evinced by its 2.9 per cent fall in value term. Whilst the capital machinery imports is to fall by another 21 per cent in the coming months, import of consumers good (169.6%) including import of foodgrain (407.3%) continue to boom.

In the backdrop of substantial recovery of the foreign exchange reserve and partial recovery of the RMG exports, one is tempted to attribute such fall in imports to stagnation in investment, which is corroborated by evidence on decline in term loan disbursement. Interestingly, the slowdown in import has come in FY02 and in early FY03 without any substantial devaluation of the national currency.

**Exports.** In FY02 exports declined by 7.4 per cent – first ever such decline in the last two decades. The fall in export earnings was experienced across the board, by almost all export items.

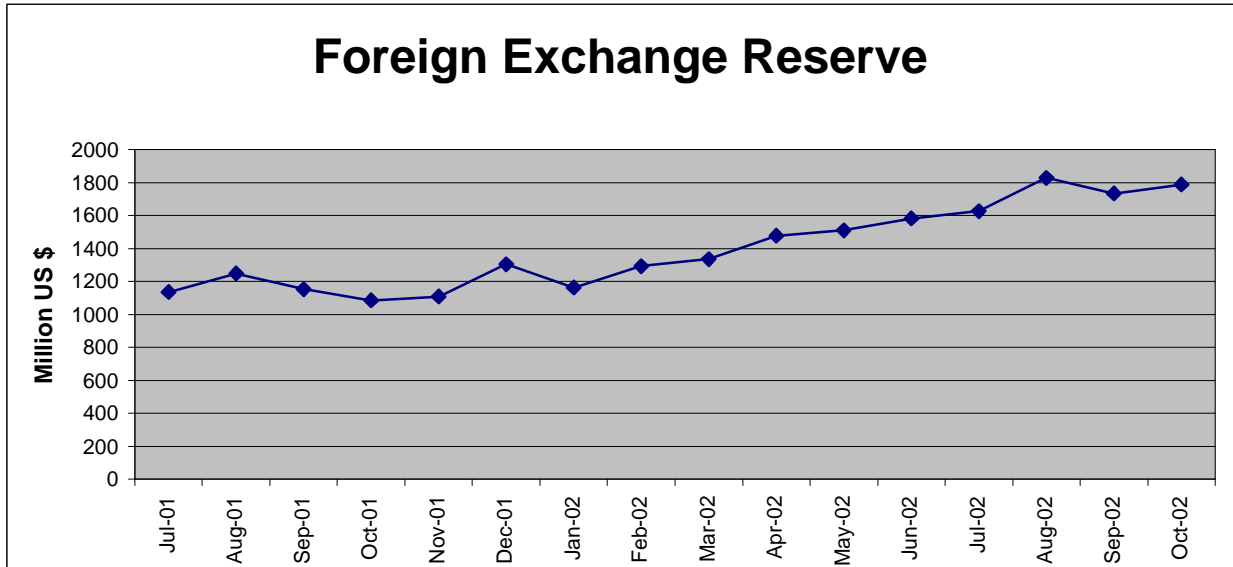
It is heartening to observe that exports during the first quarter of FY03 has recorded a comeback registering 7.54 per cent growth. This recovery was spearheaded particularly by knitwear and hosiery products, frozen food, raw jute and jute goods.

However, it is to be noted that the recent recovery of the export sectors is driven by increase in volume (about 19%) and underwritten by fall in price index (more than 12.6%). It will be a challenging task to continue with export growth in the coming months with a continuing deceleration in the price level.

**Remittances.** Remittances, in the recent past, has emerged as the saving grace of Bangladesh economy. In FY02, the country received the record inflow of more than \$2.5 billion registering an annual growth of about 33 per cent. Fortuitously, the buoyant trend in remittance inflow has sustained during the period July-September, 2002, when it recorded a growth of 32.2% over the matching period of the previous year.

Whilst some quarters attribute this recent surge in remittance inflow to the sequence of events which followed the 9/11 terrorist attacks on the USA, there are reasons to believe that this is largely due to the institutional and legislative measures taken in the country to redirect remittance flow to the official banking channel.

**Foreign Exchange Reserve.** The drawdown on the foreign exchange reserve which set in FY95 was reversed in FY02. The forex reserve bounced back to \$1.58 billion at the end of FY02 from \$1.11 billion in November 2001, registering a growth of 21.3 per cent.



The positive trend in the growth of foreign exchange reserve continued during July-October 2002 and reached \$1.79 billion at the end of the period. The point to point growth in October 2002 was as high as 64.8 per cent.

As it is evident from our foregoing analysis, further strengthening of the foreign exchange reserve has taken place in the early part of FY03 thanks to export resurgence, surge in workers' remittances and fall in imports. It needs to be appreciated that, given the obtaining situation, the country was able to avert serious balance of payment crisis, without any emergency foreign exchange support from the International Financial Institutions (IFIs).

**Balance of Payment.** Given the movement of various external sector variables described earlier, Bangladesh's balance of payment situation, during July-August, 2002 has also improved further. Trade balance recorded a smaller deficit of only US\$4 million, and current account recorded a higher surplus (US\$396 million) thanks mainly to workers' remittances. The overall balance of payment showed a surplus of US\$296 million against the deficit of US\$65 million in July-August 2001.

## VI. Concluding Observations

A brief review of the early signals of the FY03 allows us to conclude that the three major macro-economic trends observed by the CPD at the close of FY02 have strengthened further. Concretely they are as follows.

*First*, the fiscal balance has experienced further consolidation during July-October 2002 due to collection of revenue (NBR component) in line with the target set by the budget. This process was complemented by high control exercised by the government on public expenditure, particularly with respect to ADP. This has contributed to restrained borrowing by the government, albeit temporarily, from the banking system. Although borrowing from the public through sales of NSD Certificates has increased in the said period. In this connection, ability to incrementally to draw on foreign sources of financing for underwriting the fiscal deficit will provide necessary breathing space to the monetary policy.

*Second*, the country's balance of payment has also improved further due to continued high flow of foreign remittances, recovery in the export sector and negative growth in import payments. Consequently, foreign exchange reserve, although still not above the safe limit, has also demonstrated incremental growth. However, there is no scope to ignore the vulnerability of the external balance given the fragility of export resurgence and the unpredictability which generally characterises the remittance flow. Low disbursement of foreign aid and fizzling out of FDI has accentuated this vulnerability.

*Third*, signs of investment stagnation has become more manifest during the initial months of FY03. Deepening of investment stagnation is borne out by the fall in term industrial loan disbursement as well as import of capital machinery and intermediate inputs. It is symptomatic that excess liquidity of scheduled banks in end-September, 2002 stood at Tk. 75.10 billion, i.e. 14% more than that of end June, 2002. High demand for NSD Certificates and increase in time deposits in the schedule banks, in spite of interest rate rationalisation, suggest that investors' confidence level continues to be abysmally low. The moribund state of the stock market further reinforces this observation.

Thus, strengthening of the macro-economic fundamentals and the fiscal stimuli provided in the budget for FY03 have had no discernible effect in dynamising the micro-economic behaviour in Bangladesh during the period July-October, 2002.

One of the new developments of the first quarter of FY03 had been the creeping rise in inflation rate with its rural bias. Whilst the current inflation rate continues to remain moderate, it might become an issue if the government changes its fiscal stance.

Under the circumstances, how will the government respond with policy and institutional measures in the coming months to achieve its GDP growth target set at 6 per cent for FY03? It is maintained that given the fragility of the export scenario as well as the obtaining depression in the manufacturing sector, the government may have to consider taking measures to prop up domestic demand. However, attention to cultivate domestic demand does not have to come at the neglect of our export promotion.

Three major vehicles of augmenting domestic demand would be fiscal stimuli, credit expansion and public expenditure. The government has already exercised the first option (fiscal stimuli) through the National Budget for FY03. Regarding the second, our review has shown that trend in agricultural credit flow has remained quite lacklustre during the elapsed months. One possibly needs to recreate the successful experience of the rural credit delivery exercise undertaken following the devastating floods of 1998.

With respect to the use of public expenditure as a tool for rejuvenating domestic demand, it may be underscored that the government currently enjoys some elbow room for moderate expansionary policy, thanks to its conservative approach till date. However, if economy responds to such trigger mechanism, it will not only have the risk of losing grip on fiscal deficit situation, but also unleashing high pressure on the soft exchange reserve in response to an investment driven import pick-up.

Under the circumstances, one of the important factors defining the choice of macro-economic policy stance during the second half of FY03 will be the outcome of the *Interim Poverty Reduction Strategy Paper* (I-PRSP) preparation exercise. If the government can negotiate some soft term foreign financing at least by March FY03, then it will be in a relatively comfortable position regarding its development expenditures and the need for an accelerated private investment pick-up.

However, some of the pre-conditions set by the IFIs for accessing such funds are also fraught with high risk. The demand for free float of the exchange rate is a case in point. In this connection, the government will be well advised not opt for a tight package of policy conditionalities; rather should retain its flexibility by committing itself to desirable autonomous reform measures.

Whatever may be the case, the government, by end December, 2002 or early January, 2003, has to put its minds together to evolve a strategy to translate its recent macro-economic gains into micro-economic dividends.