State of the Bangladesh Economy in FY06: Early Signals and Immediate Outlook

Paper 55

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The Centre for Policy Dialogue (CPD), established in 1993, is a civil society initiative to promote an ongoing dialogue between the principal partners in the decision-making and implementing process. The dialogues are designed to address important policy issues and to seek constructive solutions to these problems. The Centre has already organised a series of such dialogues at local, regional and national levels. The CPD has also organised a number of South Asian bilateral and regional dialogues as well as some international dialogues. These dialogues have brought together ministers, opposition frontbenchers, MPs, business leaders, NGOs, donors, professionals and other functional group in civil society within a non-confrontational environment to promote focused discussions. The CPD seeks to create a national policy consciousness where members of civil society will be made aware of critical policy issues affecting their lives and will come together in support of particular policy agendas which they feel are conducive to the well being of the country.

In support of the dialogue process the Centre is engaged in research programmes which are both serviced by and are intended to serve as inputs for particular dialogues organised by the Centre throughout the year. Some of the major research programmes of the CPD include **The Independent Review of Bangladesh's Development (IRBD), Trade Related Research and Policy Development (TRRPD), Governance and Policy Reforms, Regional Cooperation and Integration, Investment Promotion and Enterprise Development, Agriculture and Rural Development, Ecosystems, Environmental Studies and Social Sectors and Youth Development Programme.** The CPD also conducts periodic public perception surveys on policy issues and issues of developmental concerns.

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The present paper titled ***Sate of the Bangladesh Economy in FY06: Early Signals and immediate Outlook*** has been prepared under the CPD programme on Independent Review of Bangladesh's Development (IRBD). The paper was prepared by *Debapriya Bhattacharya*, Executive Director, CPD, which was released to the press on 7 January, 2006 at the CPD Dialogue Room.

Assistant Editor: *Anisatul Fatema Yousuf*, Head (Dialogue & Communication), CPD.
Series Editor: *Debapriya Bhattacharya*, Executive Director, CPD.

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As part of the CPD-IRBD tradition, CPD organised a consultation meeting of an Expert Reference Group on 02 January 2006 at the CPD Dialogue Room to discuss the draft First Reading of the report on “State of the Bangladesh Economy in FY06”. A distinguished group of policymakers and professionals provided analytical and insightful feedbacks on the draft report at the meeting. *Professor Rehman Sobhan*, Chairman, CPD chaired the session.

A list of the participants of the meeting is provided below (in alphabetical order).

Dr Fakhruddin Ahmed	Managing Director, PKSF and Former Governor, Bangladesh Bank
Dr A M M Shawkat Ali	Former Secretary, Government of Bangladesh and Chairman, Shawkat & Associates Ltd.
Mr Siddiqur Rahman Choudhury	Secretary, Finance Division, Ministry of Finance Government of Bangladesh
Dr Mohammed Farashuddin	Former Governor, Bangladesh Bank President, Board of Directors and Vice Chancellor, East West University
Dr Saadat Husain	Former Cabinet Secretary, Government of Bangladesh and Chairman, Bangladesh NGO Foundation
Dr Mirza Azizul Islam	Chairman, Security Exchange Commission and former Director, UN-ESCAP, Bangkok
Mr Khondkar Ibrahim Khaled	Managing Director, Pubali Bank and former Deputy Governor, Bangladesh Bank
Professor Wahiduddin Mahmud	Department of Economics, University of Dhaka and former Finance Advisor to the Caretaker Government
Dr Masihur Rahman	Former Secretary, Government of Bangladesh and Managing Director Credit Rating Agency of Bangladesh (CRAB)
Mr M Syeduzzaman	Member, CPD Board of Trustees former Finance Minister and Chairman, Bank Asia
Dr Sajjad Zohir	Senior Research Fellow, BIDS and Executive Director, Economic Research Group (ERG)

The author gratefully acknowledges the valuable contributions of the experts for generously sharing their views and comments on the draft report. However the author remains solely responsible for the observations and analysis contained in the paper.

Abstract

This report has been prepared as part of CPD’s ongoing assessment of macro-economic performance of Bangladesh under CPD’s programme titled Independent Review of Bangladesh’s Development (IRBD). Based on data and information on the dynamics of major macroeconomic variables during July-December 2005, the analysis attempts to trace and track the movements of key macro economic performance indicators including in such areas as: public finance, monetary and financial sector, real economy and external balance. The discussion is contextualized by recalling the initial conditions of FY06 and budgetary measures envisaged to deal with the macroeconomic challenges of FY06. In presenting the analysis of some of the recent trends in the economy the review takes note of the robust trends in terms of private sector investment, good prospects of food grain production, moderate growth of exports and buoyant flow of remittances. However, in the absence significant rise in the net flow of foreign aid and mobilization of domestic resources, the report apprehends that quality of fiscal balance may deteriorate further in the coming months. The report points out that without augmentation of foreign aid flow, high export growth and sustained remittance flow the external balance may experience severe pressure in the second half of the fiscal year. The report highlights some of the emerging trends in the economy which may frustrate the overall economic growth prospect and undercut macroeconomic stability during the period of electoral transition. The interim IRBD 2006 report presents elements of a plausible scenario in view of the emerging situation. Thus the government is likely to accelerate its spending in the coming months under both revenue and ADP accounts. There is a possibility of slowdown in the private sector investment as well. The report makes a number of suggestions to address the policy challenges emanating from rising inflation, high interest rate, dwindling reserves and deteriorating balance of payment (BOP).

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1. Introduction

The First Reading of the *Independent Review of Bangladesh's Development* (IRBD) for 2005-06 (FY06) of the *Centre for Policy Dialogue* (CPD) seeks to analyse the early trends observed in the country's economy during the current fiscal year. The review essentially covers the first six months of the FY06 (July-December). However, depending on data availability, analyses have been extended upto November 2005 (and in rare cases upto December 2005).

The review has used the CPD-IRBD database for its analysis. This database keeps up-to-date account of the key indicators of the Bangladesh economy by regularly collating published and unpublished information from various official sources including the Bangladesh Bureau of Statistics (BBS), Bangladesh Bank, Board of Investment (BOI), National Board of Revenue (NBR), Finance Division, Economic Relations Division (ERD), Department of Agricultural Extension (DAE) and other relevant public agencies. CPD also collects primary data through sample surveys and key informant debriefing.

The present paper concentrates on four major areas of Bangladesh economy, *viz. public finance*, *monetary and financial sector*, *real economy* and *external balance.* The discussion has been contextualised by recalling the initial conditions of FY06 and the budgetary measures envisaged to deal with the macroeconomic challenges of FY06. The paper also raises the issue regarding the appropriate standards to assess the performance of FY06 in the context of operationalisation of the Poverty Reduction Strategy (PRS) by the Government of Bangladesh (GOB)[1]. The paper wraps up by highlighting some of the emerging trends which, if not adequately dealt with in the coming months, may frustrate the overall economic growth prospect as well as undercut the macroeconomic stability during the period of electoral transition.

2. Benchmark Conditions of FY06

The Bangladesh economy experienced a respectable growth rate of about 5.3 per cent during FY05 in spite of having to struggle with two exogenous shocks, i.e. floods of 2004 and phasing-out of apparel quota from 1 January 2005. However, the fiscal year FY05 ended with

[1] The formal name of the document is "Unlocking the Potential: National Strategy for Accelerated Poverty Reduction".

a macroeconomic situation that experienced a certain degree of pressure from multiple sources.

These pressures emanated from the failure to implement public investment programmes, coupled with poor revenue collection, particularly from non-NBR and non-tax components. The macroeconomic correlates were particularly strained due to stressed state of balance of payment as import greatly outpaced export growth. Further, fiscal balance got stretched in the face of high growth of revenue expenditure. The weakening of macroeconomic fundamentals was coupled with creeping rise in consumer price index.

A deepening state of weak governance with a still born Anti Corruption Commission and stagnation in the public administration and local government reforms undermined the overall economic management.

It may be recalled that the CPD in its IRBD for FY05 identified six major sources of fragility that the government should address in order to sustain the macro-stability and enhance economic growth. These fragilities of the economy were associated with the following.

(i) Inability to implement public investment programmes in the face of runaway growth in recurrent expenditures;

(ii) Slow progress in domestic revenue mobilisation with continuing dependence on international trade tax, with direct tax collection increasing at a pace that is slower than the domestic Value Added Tax (VAT);

(iii) Upsurge in inflation rate underwritten by cost-push factors, including high global prices of food, fuel, fertiliser and steel;

(iv) Delicate balance in external payments situation due to high import growth, notwithstanding the robust export and remittance growth;

(v) Failure to undertake complementary reforms to ensure improvement of micro-conditions for private investment, including improvement of governance in public infrastructural facilities and utilities, regulatory framework for capital and debt market, contract enforcement through judicial process and transparency in public expenditure; and

(vi) Widening disparity in income distribution which is limiting the growth prospect, including its sustainability.

These are some of the features which defined the benchmark conditions of FY06 and informed the immediate outlook for the current fiscal year. As may be seen later, a number of these fragilities persisted, if not accentuated, during the first half of FY06. We shall also observe some discrete cases of improvements.

3. The Budget and Targets for FY06

The national budget for FY06, remaining cognisant of the emerging macroeconomic situation, was prepared ostensibly under the three year framework of the Poverty Reduction Strategy Paper (PRSP). Some of the distinguishing objectives of the budget for FY06 are the following:

- The Medium Term Macroeconomic Framework (MTMF) of the PRSP set the growth target for FY06 at 6.5.
- The government will have to collect Taka 45,722 crores in FY06 (i.e.Taka 6520.0 crores, or 16.7 per cent more revenue compared to the performance of FY05). The incremental contribution of National Board of Revenue (NBR) revenue will be 79 per cent of the total revenue growth, while the rest 21 per cent will come from non-NBR and non-tax revenue.
- The growth target for public expenditure is 15.7 per cent, which is prudently lower than the projected growth of revenue earnings (as above). The revenue expenditure portfolio amount to Taka 38082.0 crores (i.e. 59.2 per cent of the total public expenditure).
- The target for the Annual Development Programme (ADP) for FY06 is ambitiously set at Tk 24,500 crore, which is respectively 11.4 per cent and 19.5 per cent higher than the original and revised ADP of FY05.
- The budget deficit is projected to remain unchanged (at 4.5 per cent of GDP) in the budget for FY06. The deficit is to be financed 55.3 per cent from foreign sources and the rest (44.7 per cent) from domestic sources.

As a whole, the government's initial fiscal stance for FY06 was to go for a bigger budget deficit mostly financed by foreign sources. Concurrently, to control the inflation and to minimize the inflationary impact of a higher ADP, the government went for a contractionary approach in its monetary stance. *It seemed that the government is more inclined to absorb the shocks through monetary policy. This raised the issue of compatibility of the designed fiscal and monetary stances.*

Table 1

Macroeconomic Indicators of Bangladesh Economy (FY05, FY06 and FY07)

Macroeconomic indicators	2005 (Actual)	2006 (PRSP)	2007 (PRSP)
Real GDP growth (per cent)	5.5	6.5	6.8
Gross Domestic investment (as per cent of GDP)	24.4	25.0	25.5
Private Investment (as per cent of GDP)	19.4	19.1	19.3
CPI Inflation (average)	6.5	6.5	6.0
Total Public Expenditure (as per cent of GDP)	13.9	15.5	15.7
Current expenditure (as per cent of GDP)	8.4	8.6	8.8
Annual Development Programme (as per cent of GDP)	5.0	5.9	6.2
Exports, f.o.b. (in million US$)	8579	9773	10946
	(14.0)*	(14.0)	(12.0)
Imports, f.o.b. (in million US$)	11870	13651	15493
	(20.6)*	(15.0)	(13.5)
Gross official reserves (in million US$)	3024	3250	3655
In months of imports of goods and services	2.6	2.5	2.5

Note: * Percentage changes are in parentheses.
Source: PRSP Documents and CPD-IRBD Database, 2005

It is in this context, CPD-IRBD 2005 indicated that no single policy instrument can fully diffuse the clouds gathering on the macroeconomic horizon. To this end the following monetary and fiscal instruments need to be deployed. It was suggested that a combination of three major approaches would be necessary to adapt domestic demand, external demand and aggregate demand to their allowable maximum limits

(i) Adjustment of nominal interest rate in line with the inflation rate to make the real rate marginally positive;

(ii) Downward revision of the exchange rate of Taka to attain its equilibrium value; and

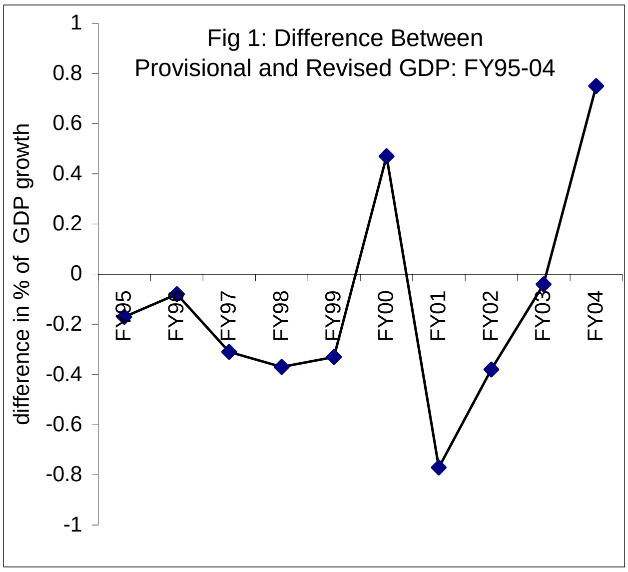
(iii) Moratorium on government’s recurrent expenditures and streamlining of ADP.

Record shows that the government (and the Bangladesh Bank) did encourage increase of the interest rate as well as orderly depreciation of Taka during the early months of the fiscal year 2006. There appear to be some initiatives as well to improve the quality of the public expenditure.

4. Measuring the Performance of FY06

4.1 The Growth Rhetoric

The Accounting Problem. Revising the provisional GDP to a significant extent has now become a recent tradition in Bangladesh's national income accounting. The latest instance of this trend was the large (0.75 per cent of GDP) upward revision in GDP growth rate estimate of FY04 which renewed the discussions about the empirical basis, estimation methodology and process transparency of the National Income Accounts of Bangladesh. The revision also attracted attention as it provided the first ever above 6 per cent growth in Bangladesh economy. It may be recalled in 2000-01, after the change of the then political regime, provisional estimate of GDP growth rate was significantly revised downward (0.77 per cent of GDP) from 6.04 per cent to 5.27 per cent.



Source: CPD-IRBD Database, 2005.

One needs to be sure that identical estimation procedure is followed by the BBS in generating the provisional and final GDP figures. Without transparency as regards the estimation methodology, reliability and usefulness of GDP data will be constantly questioned. Since budgetary measures and the Mid-Term Macroeconomic Framework (MTMF) are projected on the basis of provisional data, it will be difficult to monitor the performance of FY06 if the same trend continues. One wonders whether the Committee set up by the government in early 2005 to scrutinise the national income accounts will be able to sort out this issue at the earliest. Otherwise, it may very well be anticipated that the provisional GDP growth figure for FY06 will face a wide range of criticism.

Distributional Dilemma. Even if we assume that the growth figures are accounted right and the fact that the growth momentum of the Bangladesh economy has been sustained during the past five years with a modest five per cent plus growth, it is indisputable that the poor has failed to proportionately benefit from this incremental growth for the inequitable distributional consequences of the GDP growth. CPD has been emphasising the fact for some time that the incremental growth does not automatically benefit the poor in Bangladesh. It has been also established in literature that increasing inequality slows down poverty reduction rate. It seems that Bangladesh with its relatively high growth and increasing inequality is gradually compromising its faster poverty reduction prospect.

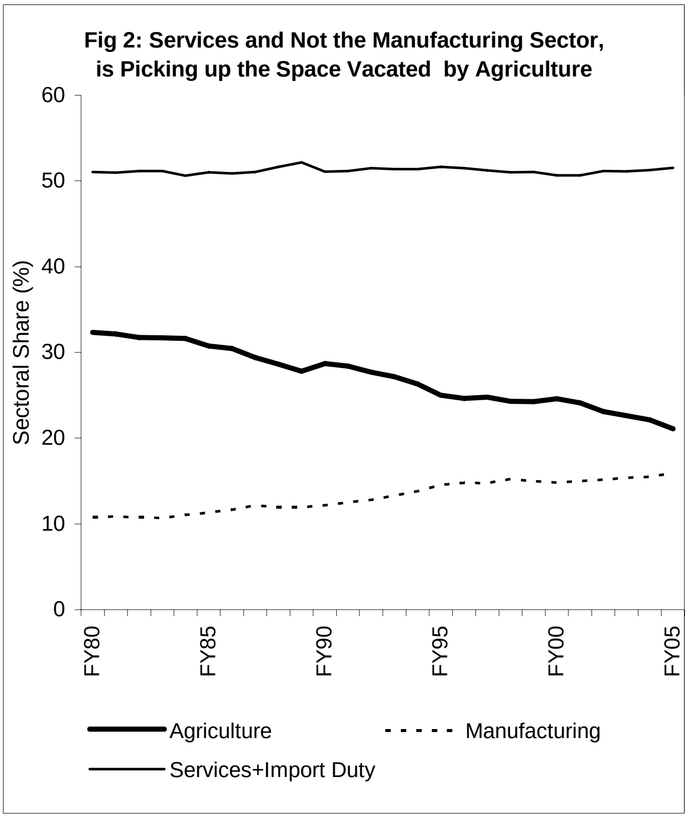
While the economy was growing at a faster pace during the 1990s, compared to 1980s, inequality was growing even more rapidly. In one hand, average GDP growth increased from 3.5 per cent during the 1980s to more than 5 per cent during the 1990s; on the other hand, Gini coefficient increased from 0.348 to 0.417 during this period indicating a serious deterioration in income inequality. Most recent figures show that this income inequality at the national level has increased further at a significant level. Between 1999 and 2004, national income attributable to the poorest 10 per cent of Bangladesh's population declined from the miniscule proportion of 1.7 per cent to 1.5 per cent. Conversely, the control on the national income by the richest 10 per cent of the population increased from 33.9 per cent in 1999 to 36.5 per cent in 2004. In other words, the income differential between the poorest and the richest 10 per cent increased from 20.0 times in 1999 to 24.5 times in 2004. It can be recalled that in 1995-96 this multiple was 15.5 times. There is no evidence which suggests that this trend will reverse in the upcoming years. Hence, without taking a redistributive policy approach, a 6 per cent or even 7 per cent growth will have limited value from the perspective of income equality and, consequently, poverty reduction.

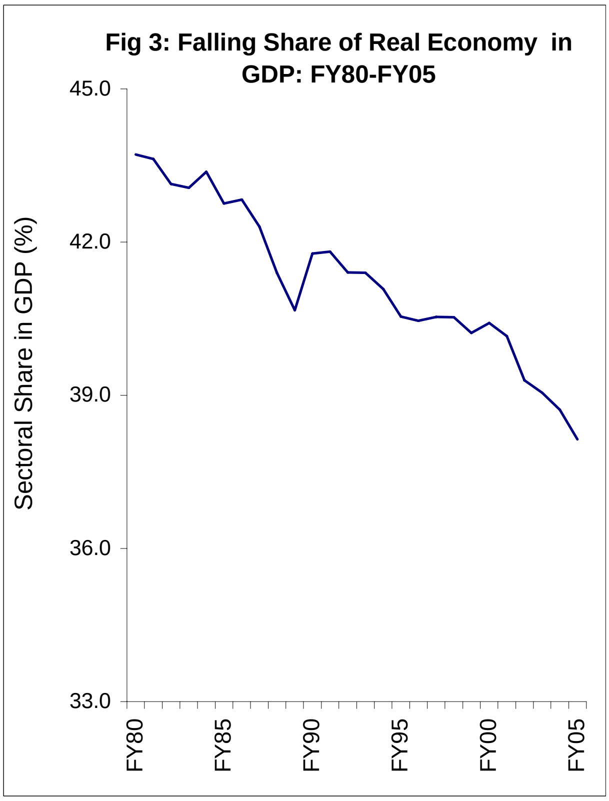
We shall see later that Bangladesh has largely experienced a non-agricultural and non-manufacturing sectors driven growth. The modern service sector activities, those developed in the urban areas, are not usually labour-intensive and it requires certain educational qualification that the poor segment lacks. The magnitude of growth of the export-oriented sector could not significantly absorb the unemployed rural workforce. Besides, the difference between wages of skilled and non-skilled workers in the non-farm sector has also widened, resulting in increase of income disparity. Foreign remittances have further aggravated the situation.

The de minimis Growth. Bangladesh has been experiencing a lopsided structural transformation in the national economy – with a falling share of the real economic sectors[2],

[2] These include Agriculture (crop, fisheries and livestock), Manufacturing and Mining & Quarrying.

in the backdrop of increasing contribution of the service sector. In 2004-05, the share of the real economic sector was 38.1 per cent, whereas a decade before the matching figure was 40.5 per cent.





Source: CPD-IRBD Database, 2005.

There is usually a complementary relation between the decreasing share of agriculture and increasing share of industry sector in any transitional developing economy. However, the space left behind by the agriculture sector was not adequately picked up by the manufacturing sector in Bangladesh. Instead, the share of construction and supplies of gas, water and electricity doubled (from 5.2% in FY80 to 10.3% in FY05) over the last two and half decade. As a result, the contribution of real economic sectors kept falling over the period.

Figures show that the annual growth of the real economic sector in FY05 was only 3.8 per cent, while the service sector experienced a higher growth of 6 per cent. While the contribution of the real economic sectors to incremental growth declined from 33.6 per cent in FY04 to 27.3 per cent in FY05, incremental contribution of service sector in real GDP growth increased significantly from 44.6 per cent in FY04 to 60.9 per cent in FY05.

Source: CPD-IRBD Database, 2005.

Since half of the GDP is attributable to service sector, a moderate expansion of this sector can regularly post a respectable GDP growth rate notwithstanding a stagnant real economic sector growth. CPD estimates suggest that, even though the *real economic sectors* (agriculture, manufacturing, mining & quarrying) remains stagnant at the level of FY05, the overall GDP will grow by an average 3.7 per cent in FY06. And if the real economy manages to grow by only 1 per cent, the overall GDP growth will not be less than 4 per cent. In other words, it seems that the current structure of the national income accounts is such that, under normal circumstances Bangladesh will never achieve a less than 4 per cent growth. Moreover, a modest growth of the real economic sectors will catapult the growth rate beyond 5 per cent regularly. *In other words, while analysing the GDP, one will have to focus unwilling on the growth of the real economic activities such as agriculture and manufacturing instead of the GSP growth rate per se.*

In sum, from both accounting and analytical reasons, there is need to come out from this recent "hype" with high economic growth and redirect our attention to the nature of the growth and its consequences for employment and income of the poor.

4.2 Measuring Upto the PRS Objectives and Targets

Since FY06 is the first year for implementation of the Poverty Reduction Strategy (PRS) in Bangladesh, obviously the major targets set in the PRS will be the most important performance indicators of the current fiscal year. The analytical part of the PRS document provides a set of policy guidelines and offers some measurable indicators to assess the "pro-poor" attributes of economic performance. From a wide range of macro and micro level monitoring indicators, we have selected eight crucial promises of PRS to assess the performance of FY06 (see Table 2).

The PRSP aims to adopt a “pro-poor” growth strategy instead of a “growth maximization” approach to achieve faster decline of poverty. In reality, achieving a higher growth *per se* became the main target of current development discourse. While MTMF projected a 6.5 per cent growth in FY06, the Finance Minister himself (followed by different government and foreign agencies) are already speculating a 7 per cent plus growth for FY06.

To ensure a pro-poor growth process, PRSP suggests taking actions on income distribution that will provide adequate purchasing power in the hands of the poor and ensure effective food security for them. As a matter of fact, existing income inequality has only widened during the recent past. For instance, national income attributable to the poorest 10 per cent of the population declined from the miniscule proportion of 1.7 per cent in 1999 to 1.5 per cent in 2004. The Gini-coefficient also deteriorated from 0.42 to 0.45 during this period.

During the period FY05-FY07, some 8.02 million new jobs are estimated to be created in the economy by promoting employment generating growth process. In other words, around 2.7 million new jobs have to be created annually to match this target. While no operational modality exists in existing document for measuring new jobs created, the achievement of FY05 was also not reported in any government document. There is no data available on the recent developments of FY06 as well. Besides the growth process is still service sector dominated which obstructs the entrance of poor in the job market. There is no indication that this trend will change soon.

The PRSP predicted that the future prospect of employment generation depends mostly upon employment-friendly growth of the private sector. On the contrary, the MTMF of the PRSP projected a negative (-0.3 per cent of GDP) growth in the private sector investment. Recent government initiatives also went against the spirit of PRSP. Heavy government borrowing during the first six months of FY06 squeezed the share of private sector credit. Higher lending rate also kept negative pressure on the growth prospect of private sector.

Table 2

Assessing the Performance of FY06 from PRS Requisites

PRSP Targets	Development Till December 2005
1. Adoption of a “pro-poor” growth strategy is favoured over “growth maximization” as a means of achieving faster decline of poverty (p. 19).	• While MTMF projected a 6.5 per cent growth in FY06; • Achieving a higher growth per se becomes the main target; • There is no mechanism to relate the growth figure to improvement of livelihood conditions of the poor.
2. The long-term strategy for food security requires actions on income distribution that provides adequate purchasing power in the hands of the poor (p. 99).	• National income attributable to the poorest 10 per cent declined from the miniscule proportion of 1.7 per cent in 1999 to 1.5 per cent in 2004; • Gini-coefficient deteriorated from 0.42 in 1999 to 0.45 in 2004; • Indirect taxes, such as VAT, which is not mean-tested is growing at a rate faster than direct taxes; • Recent growth of direct tax (income tax) due to the contribution of middle and upper middle class wage earners, while corporate and top business people remain heavily underreported.
3. The future growth process must generate employment opportunities for the poorer sections of the population and the returns from employment must generate adequate earnings for them so that they can break out of poverty (p. 76).	• Growth process is still service sector dominated, which fails to generate employment opportunities for the poorer sections of the population.
4. With the increasing role of the private sector in the economy, the future prospect of employment generation depends mostly upon employment-friendly growth of the private sector (p. 77).	• The MTMF on the contrary projects a negative (-0.3 per cent of GDP) growth in the private sector investment; • Heavy government borrowing squeezed the share of private sector credit; • Higher lending rate may retard private sector growth.
5. During the PRSP period (FY05-FY07), 8.02 million new jobs are estimated to be created in the economy with 5.39 million in rural and 2.63 million in urban areas (p. 80).	• Annual target of 2.7 million incremental employments; • Achievement of FY05 was not reported in any government document; • There is no mechanism to estimate the number of jobs created in a year and how much of that went to the poor.
6. The development of an appropriate regulatory framework which empowers the micro-credit sector to further improve its performance (p. 49).	• Proposed regulatory framework for the micro-credit sector is yet to be enacted.
7. Discouraging land-grabbing and better utilization of urban *khas* land for community objectives is also a priority (p. 57).	• Illegal land grabbing has intensified; • Poor people have been uprooted from many government *khas* lands by many real estate agents and corrupt land grabbers.
8. Effective policy initiative on a holistic approach to social protection will require a sharper profiling of risks such as *monga* and seasonal poverty (p. 59).	• A fund was allocated in the budget of FY06 to aid the seasonally disadvantaged poor; • The fund remains unused till date; • Even the modality of expenditure has not been finalised yet.

Among other micro level targets, the PRSP suggests development of an appropriate regulatory framework for the micro-credit sector, discouraging land-grabbing in urban areas and taking holistic approach to reduce social risks such as *monga* and seasonal poverty.

Latest available information shows that, the government failed to implement most of these targets as well. For instance, illegal land grabbing has intensified and poor people have been uprooted from many government *khas* lands by many real estate agents. The proposed regulatory framework for the micro-credit sector is yet to be enacted. A fund was allocated in the budget of FY06 to aid the seasonally disadvantaged poor. Till date it remained unused and even the modality of expenditure has not been finalised.

Given the state of data availability, one is not sure that the government is well equipped to report on the progress of implementation of these PRS objectives during the Finance Minister's budget speech in June, 2006. It is not clear what changes have been brought about in the macroeconomic framework to improve its "pro-poor" features. On the contrary, there is a fixation to "produce" higher GDP growth remaining insensitive to income distributional consequences. However, whatever indirect information is available, they suggests that progress in these areas is not so exciting. Rather, in some cases, retrogression is evident.

5. Tracking the Early Trends of FY06

This core chapter of the review addresses the following four major areas of Bangladesh economy: public finance, monetary and financial sector, real economy and external balance.

5.1 Public Finance

Revenue. The low revenue-GDP ratio of Bangladesh economy remained stagnant at 10.64 per cent in FY05. As the humble target of PRS (i.e. 10.7 per cent) was not achieved in FY05, the target for FY06 was set at 10.96 per cent, which is lower than the corresponding PRS projection. Earnings from both tax and non-tax revenue fell short of corresponding PRS targets in FY05. The government also scaled down the PRS targets in case of tax and non-tax revenue earnings.

Data covering the first five months (July-November) of FY06 reveal that the collection by the NBR remains on track recording 14.5 per cent growth over the matching period of FY05. Among the major heads, high growth (i.e. 22.1 per cent) was observed in the case of *Income Tax* collection followed by *Excise Duty* which grew by 18.9 per cent. *Domestic VAT* and *Domestic Supplementary Duty* (SD) grew by robust 17.8 per cent and 19.1 per cent respectively. In the case of international trade taxes, collection of *VAT (Import)* and *SD (Import)* increased by 15.7 per cent and 8.5 per cent respectively.

However, one is surprised to observe that, notwithstanding the very high growth of import demand (see later), collection from *Custom Duty* grew by a modest 6.8 per cent. It possibly means that the overwhelming part of the import is coming in either duty free or at a very low tariff which is partly the result of recent tariff reduction. Concurrently, one may also suspect wide prevalence of misreporting.

As we know that NBR accounts for a little above three-fourth of total revenue receipt of the government. The rest one fourth is accruable to non-NBR taxes (4 per cent) and non-tax revenue (18 per cent) sources. Thus, it is important to have a consolidated picture, particularly when targets for non-NBR taxes and non-tax revenue remain regularly underachieved. *Admittedly, there is huge discrepancy between the NBR and Finance Division data as regards the revenue collection figure of NBR. While NBR itself reports its revenue collection growth during the first quarter of FY06 as 16.1 per cent, the Finance Division shows an inflated growth performance of 39.9 per cent for the same period.*

To streamline these inconsistencies and to generate a consolidated estimate, we have used the data collected by NBR from the NBR itself, whereas data on non-NBR and non-tax from the Finance Division. The consolidated picture for revenue for the first quarter (July-September) of FY06 indicates an aggregate high growth of 16.7 per cent. *In terms of specific components, NBR account grew by 16 per cent, non-NBR by 14.9 per cent and non-tax revenue by 19.4 per cent. These growth rates of revenue collection performance compare favourably with those of FY05.*

In sum, the overall revenue mobilisation effort has started on a strong footing. The issue is whether these buoyant trends will be sustained for the rest of the year. It goes without saying that if economic activities get affected by the ongoing bomb attacks by the militants as well as the ensuing political agitation, revenue collection will also be affected in the coming months.

Public Expenditure. For macroeconomic stability as well as for a redistributive fiscal approach, revenue earnings need to grow at a faster rate than the public expenditure. During the recent five years (FY01-05), average annual growth of revenue earnings (about 12.9 per cent) has been higher than that of average public expenditure (8.2 per cent) – this has happened largely by default as ADP remained severely underimplemented. Interestingly, in FY05, for the first time in the recent past, total revenue earning grew by only 7.9 per cent as against 12.7 per cent growth in public expenditure.

For FY06, the target for growth of public expenditure has been set at 15.7 per cent, which is lower than the projected growth of revenue earnings (19.5 per cent). With the national election approaching, it is a matter of high interest, to observe to what extent the government will be able to stick to this fiscal discipline.

It may be recalled that Bangladesh is distinguished by low public expenditure-GDP ratio (13.5 per cent) among comparable countries (where the matching share is about 18-20 per cent in other South Asian countries). So there is a need to enhance the level of public expenditure. This has to be certainly without compromising its quality and the fiscal stability. It is well known that a significant part of the ADP portfolio constitute politically motivated projects which are not demand driven.

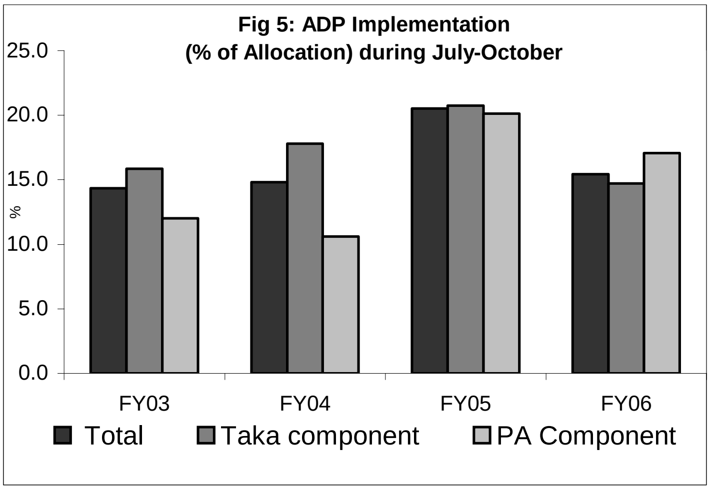
Revenue Expenditure. <u>Data for the first quarter (July-September) of FY06 suggest that the revenue expenditure has been under harness as only 16 per cent of the total allocation was spent during this period.</u> Among the major heads, off-take under Pay and Allowances has been about 20.5 per cent of annual allocation. This low share is explained by the fact that only 16.8 per cent of the allocation for Allowances was spent as no amount was drawn from the budgeted Eid Bonuses during the period under reporting. In the case of Subsidies and Current Transfers (aggregate off-take is 14.6 per cent), one observes low disbursement of subsidies (9.5 per cent). As a large part of these subsidies are used for underwriting fertiliser price, one may expect that the expenditure under this head will increase as expenditure for the *aman* is accounted for and financing of the *boro* season has started.

Interestingly, expenditures on accounts of Block Allocations (about Tk 2550 crore) and Acquisition of Assets and Works (Tk 1826 crore) were minimal during the first quarter of FY06 – only 0.6 per cent and 2.0 per cent of their respective allocation. <u>It is very heartening to observe that the government till date has exercised great restraint in using these scarce resources. However, there is a valid concern as to whether the government will be able to exert this self-discipline during the second half of the current fiscal</u>.

One area where the revenue expenditure has crossed the pro-rata limit relates to Interest Payment (25.8 per cent), particularly on account of Domestic Interest (27.8 per cent). As we shall discuss later that the recent trend of financing fiscal deficit has led the government to borrow heavily from the banking sector (and more recently from non-banking sector). This has contributed to the rise in domestic debt servicing liability (DSL). *One may only expect to see further increase in expenditure on account of domestic DSL as the fiscal year draws to a close*.

Annual Development Programme. A total number of 859 projects amounting to Tk. 24,500 crores are being financed under the ADP in FY06.

Admittedly, first couple of months of the fiscal year usually constitute a slack season in terms of ADP implementation. However, although four months of the current fiscal year have elapsed, ADP implementation is yet to gather momentum – even in the routine sense of the term. It has been pointed out emphatically in CPD-IRBD for FY2005 that without an enthusiastic early start it will not be possible to realise the challenging ADP target for FY06. Indeed, it seems that the opposite has happened.

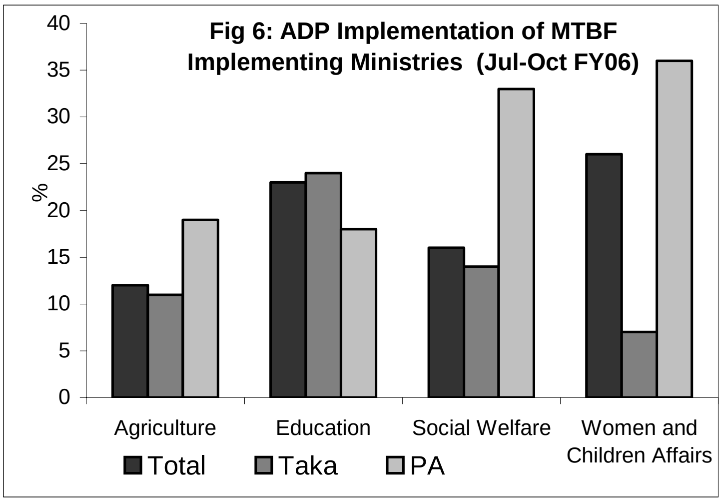


Source: CPD-IRBD Database, 2005.

Expenditure record shows that only 15.4 per cent of the total allocation for ADP was spent during the first four months of FY06 (July-October), which is 16.3 per cent lower than the amount spent during the comparable period in the preceding year. *While both Taka expenditure and Project Aid expenditure were less than that of the previous year's off-take (expenditure), utilisation of the local currency appears to be slower*.

It needs to be noted that the expenditure rate (14.7 per cent) of Taka component was substantially lower than its release rate (26.1 per cent).

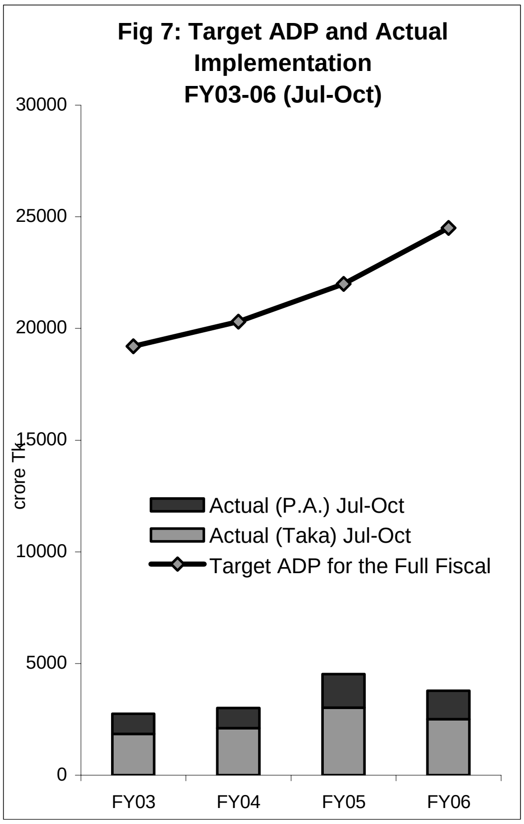
However, on all counts, release of Taka for ADP implementation till first four months of FY06 remains the poorest among that of the last four years. One wonders as to what extent this is an expression of overall restraint exercised by the government to maintain fiscal stability. The observations made by the Finance Minister in the recent monitoring meeting (4 January 2006) do not support this contention.

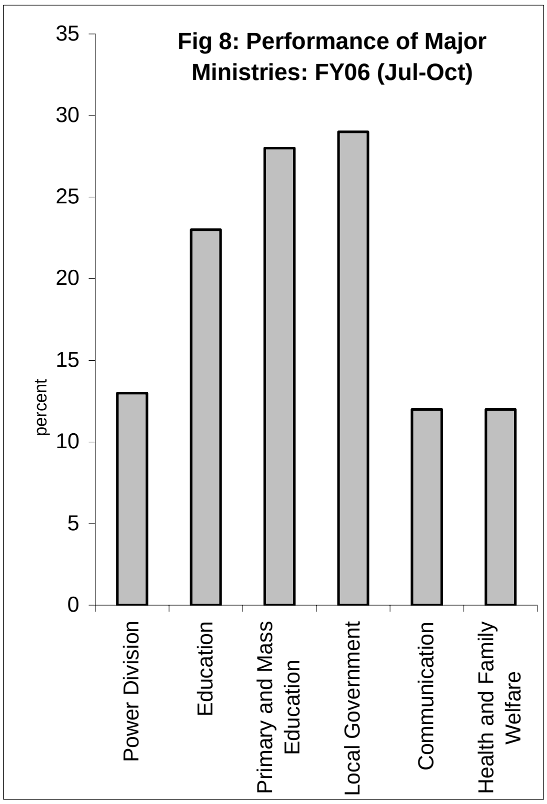


Source: CPD-IRBD Database, 2005.

<u>On the other hand, only 56.3 per cent of the released Taka amount was actually spent during the first four months of FY06, while the rate was 68 per cent during the comparable period of the earlier year (FY05)</u>. It could also be due to the inability of the implementing ministries to absorb the incremental resources that have been made automatically available during the first quarter of the fiscal year. Is the pre-election intertia of the bureaucracy frustrating the governments' enthusiastic spending design?

Among the ministries/divisions which received the highest allocation in the target ADP, the M/O Communication, M/O Health and Family Welfare and the Power Division spent the least only 12 per cent, 12 per cent and 13 per cent of their respective allocations during the first four months of the FY06. On the other hand, Local Government Division spent the most, about 29 per cent of its allocation. Among other top performers, M/O Education spent 23 per cent and M/O Primary and Mass Education spent 28 per cent of their ADP allocation during this period.





Source: CPD-IRBD Database, 2005.

Interestingly, other than the Ministry of Agriculture which implemented only 12 per cent of its ADP, most of the ministries which developed their own budget under the Medium Term Budgetary Framework (MTBF) of the PRSP, demonstrated modest performance during the reporting period. Ministry of Education, Ministry of Social Welfare, and the Ministry of Women and Children Affairs implemented 23 per cent, 16 per cent and 26 per cent of their respective ADP allocations.

<u>However, the prospect of having a respectable implementation level of ADP in FY06 seems to be a remote possibility</u>.

Fig 9: Annual Development Programme (FY91-FY06)

Source: CPD-IRBD Database, 2005.
Note: Revised and Actual ADP of FY06 has been estimated on the basis of past trend.

CPD estimate projects that the current ADP will be revised downward to about Tk 22,000 – 22,500 crores, i.e. 9 per cent of its original size. The actual implementation will be even lower, between Tk 19,500 crore to Tk 20,000 crore, which will be about 83 per cent of the original target. While the projected implementation value of the ADP for FY06 will be close to the actual implemented value of FY05 (Tk. 18,726 crores), in terms of share of GDP it will be lower (4.8 per cent – for the first time below 5 per cent of GDP since 1991).

Budget Deficit. Fiscal deficit figure as of end September 2005 reveals a very interesting as well as a worrying story. *First*, the overall deficit was lower (at -1.10 per cent of GDP) at the end of the first quarter (July-September) of FY06 compared to -1.3 per cent during the matching period of FY05.

Second, net foreign financing was negative (-) 0.3 per cent of GDP (in comparison to 2.2 per cent of GDP in FY05). This implies that the foreign debt servicing liability during this period had been two times more than the foreign aid receipt.

Third, the trend in net domestic financing has reverted as well from negative (-) 0.9 per cent (in July-September 2005) to 1.4 per cent during the comparable period in FY06. As net foreign financing became negative, the government has to heavily lean on the domestic source of deficit financing.

Fourth, bank borrowing has emerged as the major source of domestic resources. In FY05 (July-September 2005) it was negative i.e. (-) 2.1 per cent of GDP and in the comparable period in FY06 it was 1.1 per cent of GDP.

Fifth, contribution of non-banking sources remains modest, 0.3 per cent of GDP in comparison to 1.2 per cent of GDP in FY05.

According to the latest available figures[3], total budget deficit during the July-October period of FY06 stood at 3.1 per cent of GDP, compared to that of 2.3 per cent during the corresponding period of FY05. As a result of a drastic shortfall in foreign financing, domestic sources contributed to 90.6 per cent of the overall deficit financing, while the rest 9.4 per cent came as foreign financing. During the comparable period of FY05, the scenario was totally opposite with a domestic and foreign financing ratio of (-) 23:123 per cent.

Table 3

Deficit Financing During FY06 Jul-Sep

Items	**Jul-Sept FY05**		**Jul-Sept FY06**	
	Actual	**As % of GDP**	**Actual**	**As % of GDP**
Net Foreign Financing	**1678.20**	**2.18**	**-281.50**	**-0.33**
Grant	66.60	0.09	10.10	0.01
Loan	1944.80	2.52	253.00	0.30
Amortisation	333.20	0.43	544.70	0.64
Domestic Financing	**-672.30**	**-0.87**	**1221.10**	**1.43**
Non-Bank Borrowing	937.80	1.22	264.10	0.31
Bank Borrowing	-1616.30	-2.10	953.00	1.11
Privatisation Receipts	6.20	0.01	4.00	0.00
Total Financing	**1005.90**	**1.30**	**939.50**	**1.10**

Since the major shock came from the delayed disbursement of foreign aid and low off-take of national savings certificate (NSC) during the first five months of the fiscal year, the current

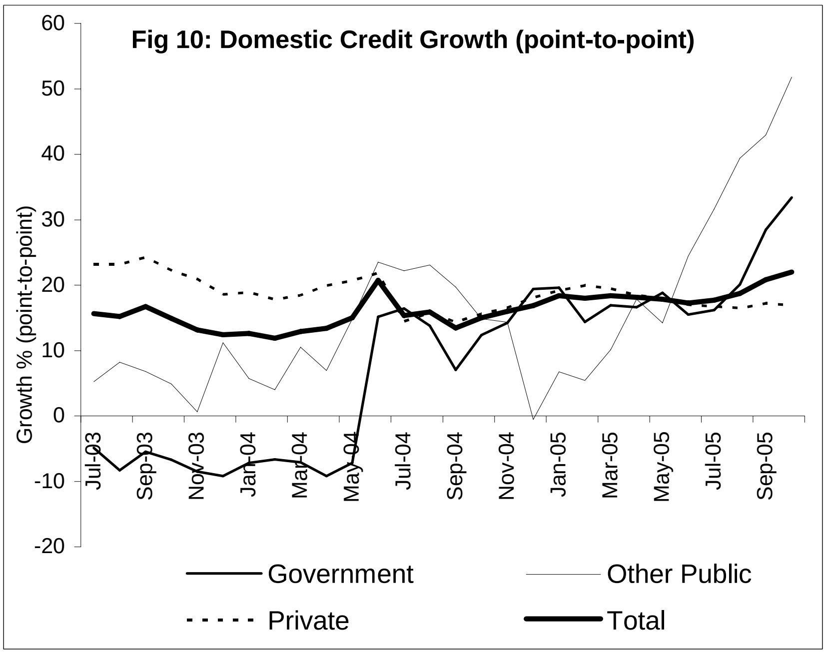
[3] There is a wide discrepancy between the Finance Division and Bangladesh Bank in reporting of the deficit financing figures. Since Finance Division is the ultimate budget monitoring body, quarterly figures used in this analysis were taken from Finance Division sources. However, for the latest update, the July-October figures have been taken from Bangladesh Bank.

nature of budget deficit financing may very well be a transitionary phenomenon. The Development Support Credit (DSC) III of the World Bank amounting $200 mln has been disbursed at the end of December 2005, which may ease the situation for the moment. [We return to the issue of foreign financing later in connection with the state of Balance of Payment.]

On the other hand, with the yield rates of different NSC going up, it appears that the government is going to tap this source increasingly in the coming months. Hence, in the coming months, one needs to follow not so much the level, but the modes of financing of the fiscal deficit.

5.2 Monetary and Financial Sector Developments

Domestic Credit Expansion. The period July-October 2005 is characterised by high domestic credit growth, to the tune of 22.03 per cent. *Understandably this is an unsustainable rate and one needs to identify the window of borrowing which is contributing most to this trend.* On a point to point basis, in October 2005 credit off-take by the public sector increased by 38.77 per cent, within which the government's (net) increase was 33.39 per cent and *Other Public Sector* grew by a whopping 51.80 per cent. Conversely, credit growth in *Private Sector* had been in a comparatively lower range of 16.93 per cent.



Source: CPD-IRBD Database, 2005.

During this period (July-October 2005), net foreign assets of banking system declined by (-) 7.84 per cent. It has been mentioned earlier that the government has been resorting to heavy borrowing from the banking sector (notwithstanding good revenue collection and low public expenditure) in the face of net negative flow of foreign assistance. However the sudden increase of borrowing by the other public sector cannot be explained. It seems that this huge borrowing by the public sector had been partly for underwriting the incremental incurred by the Bangladesh Petroleum Corporation (BPC) due to the increase in global price for petroleum products.

The credit growth in the private sector reflects a healthy investment demand which is expected to dampen in the coming months as credit becomes costlier. This will also possibly lead to slowdown in import growth. However, private sector credit growth is a key source of economic growth. Hence, scaling down the credit growth, which is already under pressure by the excessive borrowing of government sector, may negatively impact the growth prospect of the country.

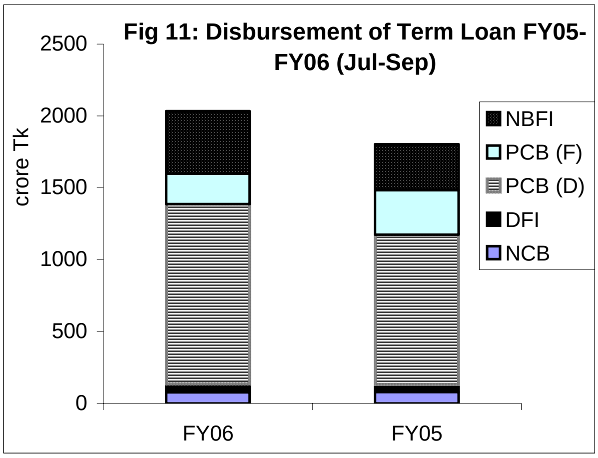
Under the circumstances, instead of across the board back on private sector credit, the government may opt for credit rationing with sectoral priorities. To slowdown import the government may use such measures as increased margin for Letters of Credit (L/C) and higher replatory duties for “non essential” goods for a certain period. However, the government may not be able to exercise such options as the international lending agencies will not agree to this.

Industrial Loan. In line with the robust domestic credit expansion in the private sector, disbursement of industrial loan (both term loan and working capital) also experienced a modest growth during July-September 2005.

Term Loan. During the first quarter of FY06, as against the sanction of Tk 2455.14 crore, an amount of Tk 2033.71 crore was disbursed as term loan, registering a 12.83 per cent growth over the corresponding periods of the previous year. An amount of Tk 1499.84 crore was recovered during the period, resulting Tk 533.87 crore as net outflow. Since the recovery rate was much higher in the preceding year, the net outflow of term loan is about 12 times of its corresponding figure of FY05[4].

[4] Data on industrial credit reported in this analysis have been taken from the Agricultural Credit and Special Programmes Department of Bangladesh Bank. Interestingly, the November and December issues of the Bangladesh Bank's *Major Economic Indicators* came up with totally different figures on term loan disbursement. According to the November report, the total disbursement has experienced a decline of more than 4.6 percent during July-September 2005 over the corresponding period of 2004. On the contrary, the December issue of the same document showed a 17 per cent growth in term loan disbursement.

Loan disbursement by NCBs during this period declined by (-) 4.06 per cent, while the loan sanctioned was (-) 19.14 per cent lower than the July-September period of FY05. Loan disbursement from PCB (Domestic) shows a growth rate of 19.96 per cent, which has also emerged decisively as the largest contributor (61.51 per cent) to total industrial loan disbursement. NCBs accounted for 3.79 per cent of the total term loan disbursement, while DFI and PCB (F) contributed 2.93 per cent and 10.33 per cent to the total respectively. *The rest 21.45 per cent of the term loan was contributed by NBFIs during the first three months of FY05, making them the second largest contributors in industrial financing.*

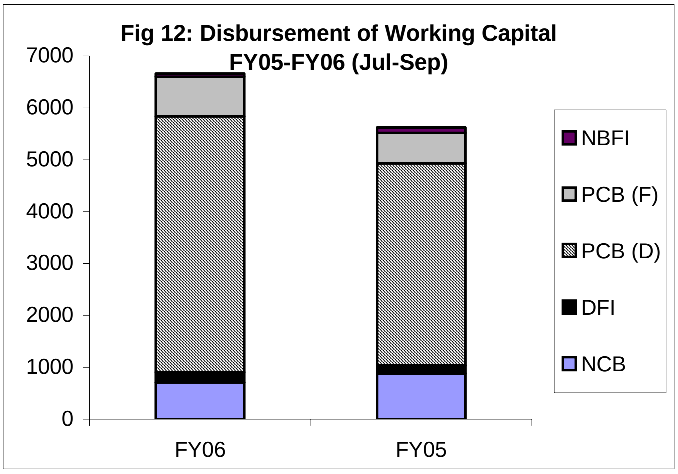


Source: CPD-IRBD Database, 2005.

Curiously, while the recovery of term loans decreased by 14.8 per cent between the first quarter of FY05 and FY06, the share of overdue term loans in total outstanding term loan declined from 26.3 per cent (in September FY05) to 14.3 per cent (in September FY06). It may be recalled in this context that the share of classified loans in total outstanding loans (all categories) did increase between FY04 and FY05 from 15.8 per cent to 21.3 per cent.

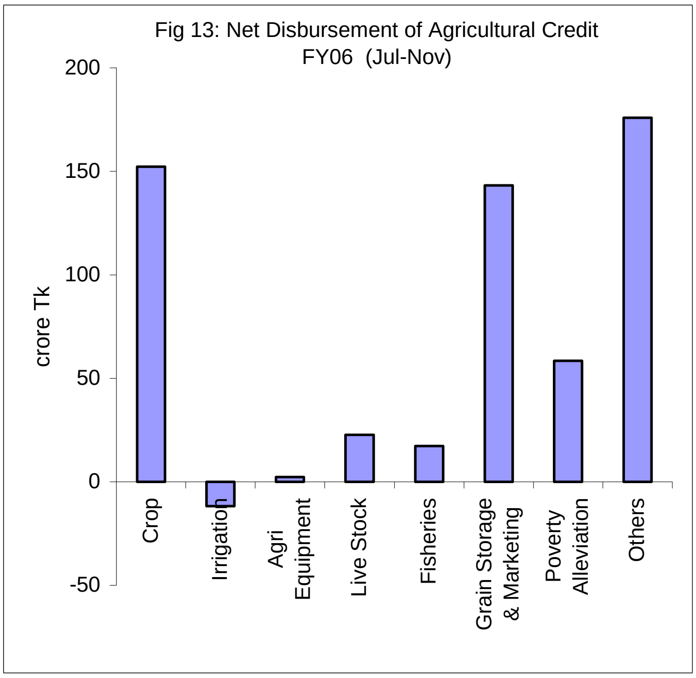
Working Capital. The disbursement of working capital during the first three months of FY06 recorded a noteworthy growth of 18.41 per cent, though the sanction of working capital registered a negative (-) 11.04 per cent growth during this period over the July-September figures of FY05. During this period an amount of Tk 6658.82 crore was disbursed against the sanctioned amount of Tk 4744.82 crore for the same period. In terms of disbursement, PCBs (Domestic), which control three-fourth share in total disbursement of working capital, registered an expansion of 26.79 per cent. While the disbursement by the DFIs increased by 24.44 per cent, NCBs registered a negative (-) 19.42 per cent growth during the first quarter of FY06 over the corresponding period of the preceding fiscal year.

NCBs accounted for 10.67 per cent of the total working capital disbursement as the DFIs and PCBs (Foreign) contributed 2.96 per cent and 11.40 per cent share, respectively during the first quarter of FY06. The rest 0.89 per cent of the working capital was contributed by NBFIs during the period under report.



Source: CPD-IRBD Database, 2005.

Agricultural Credit. Credit disbursement to the agricultural sector stood at Tk 1917.0 crore at the end of November FY06, which is 16.3 per cent higher than the disbursement of the matching period of the previous year (FY05). Against the recovery of an amount of Tk 1356.4 crore, a net Tk 560.6 crore was out flowed to the rural economy during this period. Crop loan followed by "Poverty Alleviation" received the highest amount of credit with disbursement of Tk 719.7 crore and Tk 486.0 crore respectively.



Source: CPD-IRBD Database, 2005.

However, on the account of net disbursement of agricultural credit, the first five months of FY06 actually experienced a negative (-) 33 per cent growth over the matching period of FY05. This is due to the high disbursement and low recovery stance of government, which out-flowed a net amount of Tk 810.7 crore as agricultural credit in the post-flood scenario of FY05.

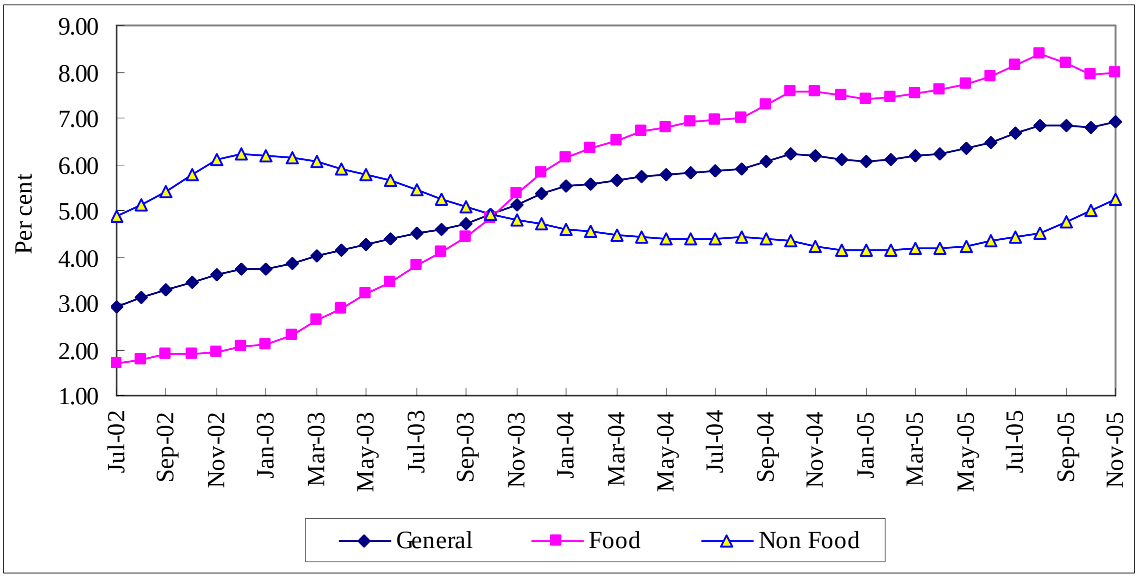
Consumer Price Index (CPI). Inflation rate at the national level continued to show a rising trend during the FY06. The inflation rate (on point to point basis) recorded in November

2005 i.e. 7.95 per cent, was the highest in last 77 months. However, moving average inflation increased from 5.9 per cent to 6.5 per cent during the matched period. CPI will be the most important outcome variable for the government in FY06.

Since June 2005, national inflation rate on point to point basis has remained above 7 per cent. After a recent high of 7.9 per cent in August 2005, the rate slipped marginally to 7.0 per cent in September 2005. However, latest figure shows that the inflation rate has again started to rise, and is approaching a double digit number.

The 12-month moving average inflation rate stood at 6.8 per cent in September 2005, from 6.5 per cent in June 2005 and continued to increase to 6.9 per cent in November 2005.

Fig 14: 12-Month Average CPI Inflation (July FY03-November FY06)



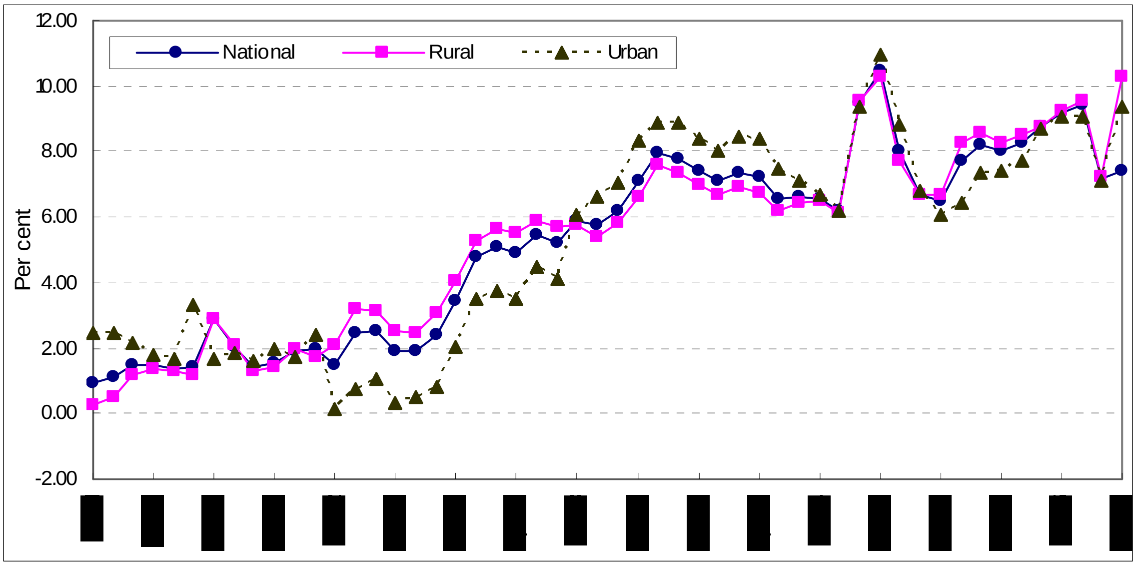
Source: CPD-IRBD Database, 2006.

The two major features of the recent inflation trend have become more pronounced. *First*, the food inflation had been higher than non-food inflation. It may be recalled that general inflation in the rural areas (8.7 per cent in November 2005) remains higher than that of urban areas (4.96 per cent in November 2005). *Second*, price increase rate had been higher in the rural area compared to the urban area.

The food inflation on point to point basis in FY05 was 8.7 per cent. Although it started to accelerate during the first two months of the current fiscal year, it dropped to 8.6 per cent at the national level in November 2005 (after Aman harvest). On the other hand, non-food prices continued to rise throughout the first five months of FY06 and reached 7.0 per cent in November 2005. One needs to take a closer look to ascertain the contribution of the recent global price rise of commodities.

The rural food inflation on point to point basis increased to 9.6 per cent in August 2005 from 8.7 per cent in June 2005 and then dropped to 7.2 per cent in September 2005. The inflation rate in rural food items again jumped to 10.3 per cent in October 2005.

Fig 15: The Point to Point Food Inflation
(July FY01-October FY05)



Source: CPD-IRBD Database, 2006.

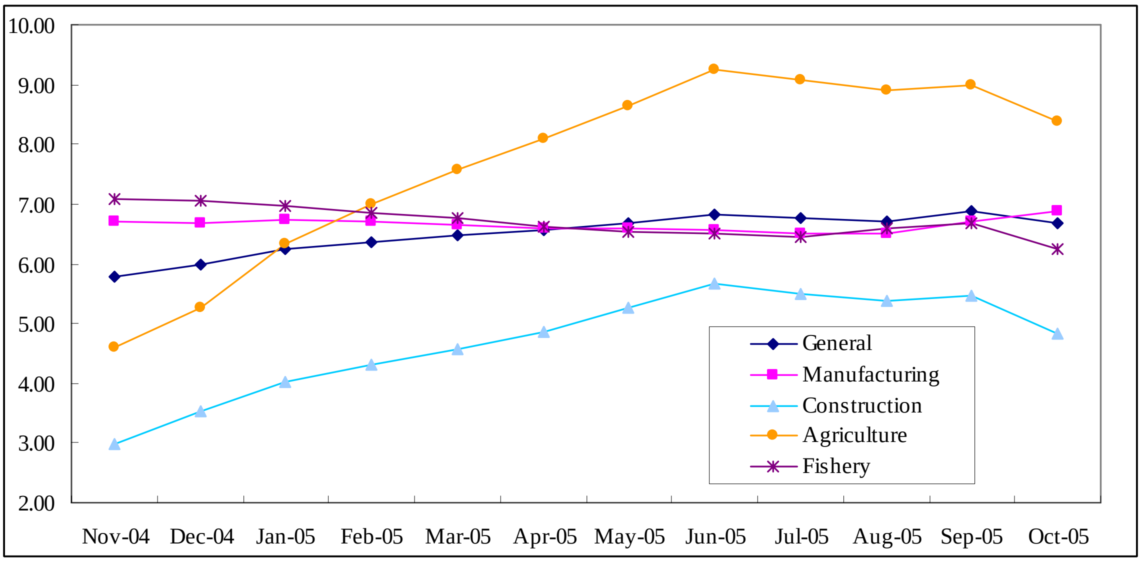
The Monetary Policy Framework of the Bangladesh Bank talks about a band rate of 4 - 6 per cent (5 per cent on average) for national inflation level. Evidently, the economy is experiencing a price inflation higher than the target rate. It has been well documented that the current rise in inflation rate is induced by cost push factors manifested largely through higher global price of energy, fertilizer, steel and food. Thus, one may question the rationale of pursuing a contractionary policy in this context which may only subdue the investment demand (and consequently economic growth), while the major source of inflation would remain beyond reach.

CPD's analysis on the current inflationary trend indicates that deposit rate and exchange rate are the two variables which have statistical significance in case of movement of the inflation rate. Other variables such as commercial lending rate, money supply, international petroleum price, international and local rice price are not associated in a statistically significant way. This implies that to control inflation the government may go for increasing deposit rate (and consequently lending rate or vis versa) and/or may try to hold back further depreciation of Taka.

Given the nature of Bangladesh's inflation, which is largely supply driven, only monetary intervention such as up-scaling the interest rate cannot be a very effective tool. Interest rate is more of a demand management tool and it has a high cost. On the other hand, holding back the exchange rate will need higher inflow of foreign exchange receipts. As all other items of foreign exchange receipts (e.g. exports and remittances) are experiencing a robust growth, it is only through further mobilisation of foreign aid, one can strengthen the Taka.

Wage Inflation. In October 2005, general wage rate index has reached 6.66 per cent (highest in the last 15 months). Since January 2005, the wage rate index has secularly remained above 6 per cent (but less than 7 per cent inflation rate), i.e. one percentage point less than that of the consumer price index growth. May be the wage rate is gradually catching up with the national inflation rate. Thus, notwithstanding such increase, the real wage rate has experienced steady erosion in the recent past. This is particularly true for the manufacturing sector (where labour market is quite rigid and responds with a time lag) and the construction sector (which has a flexible supply of labour). Interestingly, agricultural wages could protect its real value by registering wage increase above the price inflation rate.

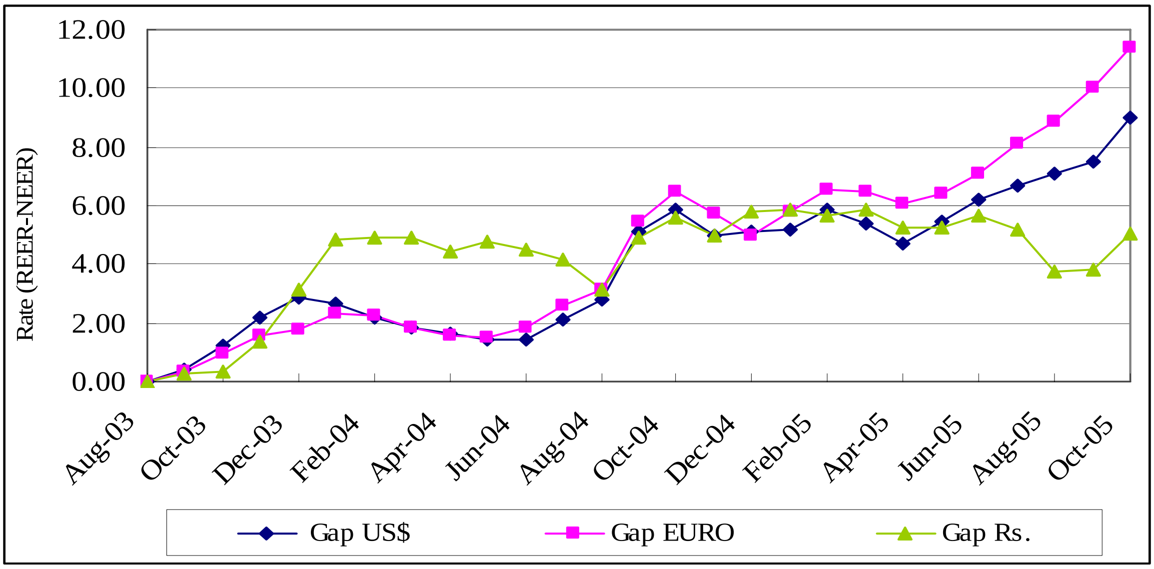
Fig 16: Wage Inflation



Source: CPD-IRBD Database, 2006.

Exchange Rate Situation. Taka has depreciated against the US$ by 3.19 per cent and against the Euro by 2.74 per cent between June 2005 and October 2005. However, during the said period Taka did not depreciate against Indian Rupee. In nominal terms, the weighted average exchange rate of Taka against the US $ increased to Tk. 65.7/$ from Tk. 63.67/$; against the Euro Taka increased to Tk. 79.59/Euro from Tk. 77.27/Euro. Against the Indian Rupee it was set at Tk. 1.47/Rupee during the initial and terminal point (with dips in between).

Fig 17: Gap between REER and NEER for USD, Euro and India Rs.



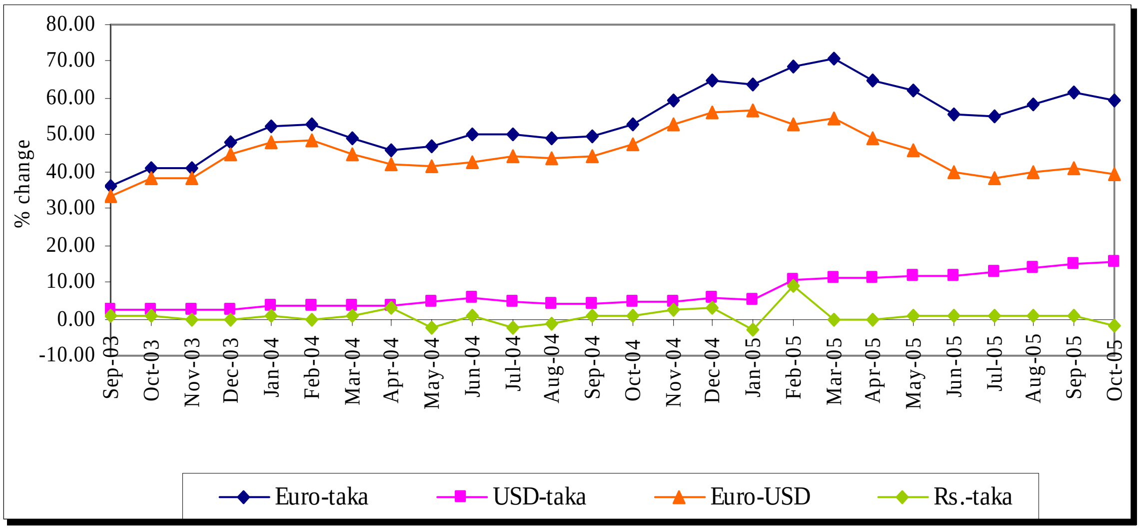
Source: CPD-IRBD Database, 2006.

Taka continued to remain marginally overvalued against all currencies mentioned above, i.e. US$, Euro and IRs after the adoption of floating exchange rate system. For example, in October 2005, Taka was overvalued by 12 per cent against Euro, 9 per cent against US$, and 5 per cent against IRs.

Depreciation trends of Taka against US$, Euro and IRs suggest that Taka is depreciated more against Euro compared to US$. Movement of Taka against Euro is predicted by the movement of Euro against US$ in the international market. However, the gap between Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) depicts that movements of the variability in REER and NEER for USD and EURO are almost similar, whereas no consistent variability between REER and NEER has been observed for IRs.

It is important to have an orderly depreciation of Taka, instead of sharp declines.

Fig 18: Depreciation of Some Selected Currencies (Base period: August 2003)



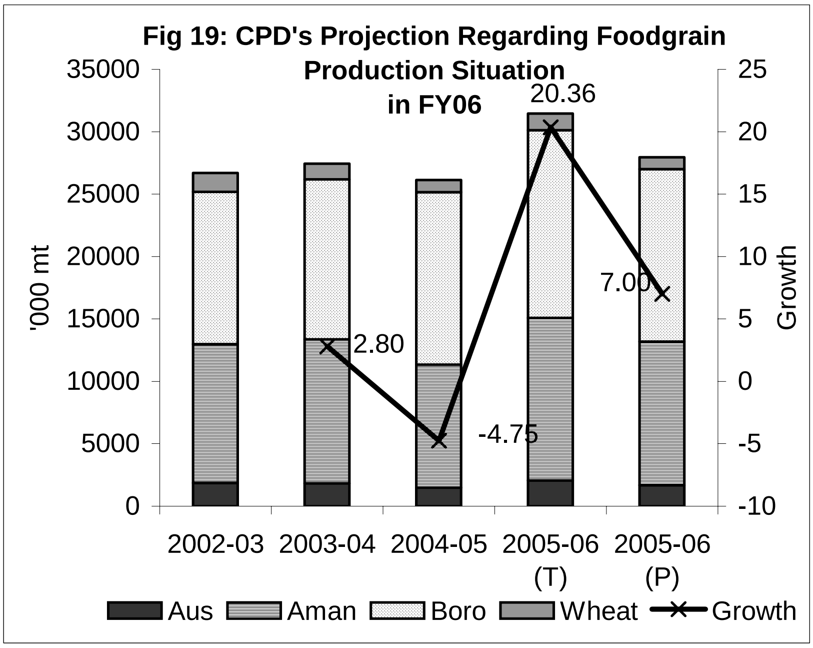
Source: CPD-IRBD Database, 2006.

5.3 Real Economy

Foodgrains. According to the final estimates of the Bangladesh Bureau of Statistics (BBS), actual foodgrains (rice and wheat) production in FY05 was 26.13 million metric tonnes (MT) which was 4.77 per cent lower than that of FY04. Total foodgrains production in FY05 decreased because of decrease in both rice and wheat production.

According to the Department of Agricultural Extension (DAE), the operational target for foodgrains production in FY06 has been set at 31.45 million MT (Aus 2.06 million MT, Aman 13.02 million MT, Boro 15.05 million MT and wheat 1.32 million MT) which is 20.36 per cent higher than the actual production in FY05. The preliminary estimate of BBS suggests that the production of Aus in FY06 would be 1.68 million MT, thus, the target of Aus production (2.06 million MT) will not be achieved. According to the DAE, about 5.76 million hectares were actually planted against the targeted Aman acreage of 5.85 million hectares for FY06. Harvest of Aman rice is yet to be completed. The Aman production target is fixed at 13.02 million MT. Since the weather was favourable for Aman cultivation, Aman production is likely to be higher than that of last year, but lower than the target of FY06.

Special care in the form of credit delivery, diesel pricing and fertilizer subsidisation need to be taken to achieve the targeted *boro* production. On the other hand, wheat production has been gradually decreasing since 1999/00. Therefore, achievement of wheat production target of 1.32 million MT in FY06 may be difficult unless special efforts are undertaken.



Source: CPD-IRBD Database, 2005.

According to CPD estimates, total food gain production in FY06 is likely to be in the range of 27.5 million mt to 28.0 million mt. That is, likely production during the FY06 would be about 7 per cent higher than the actual production figure of FY05. *This may however cause an 11.0 per cent shortfall from the targeted production for the current fiscal year.*

Fertiliser Distribution Crisis. Recently Bangladesh faced a fertilizer distribution crisis which relates to the supply of imported fertilizers (TSP, DAP, MoP) by private sectors to fertilizer dealers. Private sector stopped selling their imported fertilizer to the dealers on the ground that the government has not released the promised subsidy (Tk 97 crore due) to the private traders as per commitments made in FY05. Private sector commenced selling fertilizers to the dealers after the Ministry of Finance agreed to release Tk 66 crore as subsidy to the traders; rest of the outstanding amount is to be released after careful scrutiny of the necessary importation documents. In the last fiscal year (FY05) the government introduced a 25 per cent subsidy on fertilizer imports, for both urea and non-urea fertilizers - Triple Super Phosphate (TSP), Muriate of Potash (MoP), and Di-ammonium Phosphate (DAP). Before last year, the government used to provide subsidy on urea fertilizer only to cover the gap between domestic and international price of urea. Production cost of fertilizer in Bangladesh is lower than the international market price. However, Bangladesh's production capacity is lower than the domestic demand for fertilizer. In earlier years, government agencies used to import urea and then sell it to the dealers at subsidized rate.

An analysis of fertilizer price trends in the international market revealed that prices of different fertilizers have been increasing at the international market since early 2002. International price of urea, TSP and DAP in November 2005 was respectively 11.28%, 7.5% and 12.36% higher than those of November 2004. On the other hand, international price of urea, TSP and DAP in November 2005 was respectively 49.19%, 31.69% and 45.67% higher than that of November 2003. In case of MoP, international prices in November 2005 was 19.29% and 78.94% higher than those of November 2004 and November 2003, respectively.

Considering the realities in domestic and international markets, we suggest that the government should import fertilizers (urea and non-urea) through their agencies, and then sell those to private traders and dealers with subsidy so that farmers get the benefits of fertilizer subsidy.

Food Aid and Commercial Import. Foodgrains are imported to Bangladesh from two sources: food aid and commercial imports. The latter comes through both government and private channels. During July-December of FY06, total *rice* import (rice aid and commercial imports) was 209 thousand MT out of which only 2 thousand MT was food aid and rest of the amount was through private sector import. It may be noted that private sector import during the comparable months of FY05 was 507 thousand MT. On the other hand, *wheat* import by private sector during July-December of FY06 was 788 thousand MT against 835 thousand MT in comparable months of FY05.

Total import of foodgrains during July-December of FY06 was about 23% less than that of comparable months in FY05. *It may be pointed out that import data indicate a drop in import payment on account of foodgrains during July-December 2005.*

Table 4
Food Import

(in '000 metric tons)

	FY05 (July-December)			FY06 (July-December)		
	Rice	Wheat	Total Foodgrains	Rice	Wheat	Total Foodgrains
Food Aid	13	185	198	2	91	93
Public Commercial Import	0	10	10	--	103	103
Private Import	507	835	1342	207	788	995
TOTAL	520	1030	1550	209	982	1191

Rice Price. Since the beginning of FY06 (i.e., July 2005) the price of rice has been much higher compared to the previous year's price. In July 2005, the national average wholesale price for coarse rice was Tk. 16,040 per tonne, compared to Tk. 13,440 per tonne in July 2004 i.e. almost 12% more. Wholesale price of coarse rice has declined marginally in over the subsequent months but remained at about Tk 16000 per metric tonnes.

A comparison of Bangladesh’s (Dhaka) monthly wholesale price with the import parity price of New Delhi (India), and Bangkok (Thailand) reveals that in general price of coarse rice in Bangladesh was higher than the import parity price of India and Thailand; however, the price has been lower in Bangladesh since December 2003. Therefore, it is unlikely that Bangladesh's private sector will import rice from Thailand and India which are of comparable to the coarse rice of Bangladesh. Taking into consideration of this possibility, we have discussed this issue with rice traders of several markets in Dhaka (Badamtali Ghat, Karwan Bazar, and Mohammedpur Krishi Market). It is known from the rice traders that Indian rice which are being sold at present in Bangladesh are generally of fine quality (Miniket, Swarna, Ratna, Mompalish). Department of Agricultural Marketing (DAM) has also taken this reality into cognizance in their daily and weekly price reporting. Since 2003, DAM is also reporting wholesale price of *Miniket* rice in Dhaka city markets.

A comparison of wholesale prices of *Miniket* rice and Coarse rice in Bangladesh with import parity price of rice in Delhi and Bangkok revealed that price of coarse rice is lower in Dhaka, but price of fine rice is higher than import parity price. This possibly explains why the Bangladesh private sector is importing rice.

Livestock. According to the Directorate of Livestock Services (DLS) in FY05, actual production of milk, meat and eggs exceeded the production target by 5.42 per cent, 10.42 per cent and 8.99 per cent, respectively.

Industrial Production. Quantum Index of Production (QIP) of medium and large scale manufacturing industries indicated a significant 10.2 per cent annual growth in industrial production during the July-September period of FY06.

Weighted average growth in terms of physical volume in major industries however shows a very low growth at 2.8 per cent, mostly because of the drastic fall in the production of *fertilizer* (- 29.7 per cent) and *jute textiles* (- 18.26 per cent) during the July-September period of the current fiscal year. Other than these two items, most of the major industry sector experienced a modest to high growth rate during the first quarter of FY06. Among others, *vegetable oil, salt, cotton textile* and *cement* production registered high growth figures of 36.7 per cent, 26.5 per cent, 26.7 per cent and 19.7 per cent respectively.

The performance of large and medium industries was followed by the small scale manufacturing which recorded a 9.5 per cent growth rate during the first quarter of FY06 over the matching period of the preceding year. While most of its sub-sectors showed positive growth, non-metallic production and paper and paper production registered significant growth rates of 28.3 per cent and 16.1 per cent respectively during the period under reporting.

Taking note of recent investment trend, expressed through term loan disbursement and capital machines imports, one may venture to project a moderate manufacturing growth in the coming months. However, fall in the export demand and contractionary monetary policy may very well discount this prospect.

Foreign Direct Investment. Bangladesh Bank's latest available data (collected by Survey method) shows that during the July-October of FY06, Bangladesh received a net amount of US$200 million as foreign investment, which is US$15 million lower compared to the same period in the previous year. However, a considerable amount of FDI has been invested in the last half of the FY2005 (January-June) amounting to

Box 1: What is the Contribution of Foreign Investment to the BOP?

Policymakers of Bangladesh are all eager to link increasing FDI flow with strengthening of the balance of payment (BOP), employment generation, and growth dynamics. Experience suggests that these optimism can be on the high side. For example, how important was FDI for backstopping the BOP in FY06? According to the BOP statement, during January-September 2005, Bangladesh has received about $447 million as foreign investment, but at the same time about US$270 million has been remitted from the country as profit and, to a lesser extent, as royalties and dividends. *Accordingly net (direct investment and portfolio investment) contribution of foreign investment to the BOP is as low as US$180 million* (see Table 5).

One observes an increasing tendency of large scale investors (e.g. in telecom sector) to transfer their profits, which is often creating pressure on the BOP as well as on the country's overall foreign exchange reserve. If some of the foreign companies did not reinvest their earnings in Bangladesh, the pressure would have been even higher.

If there is not a steady flow of FDI and if some FDI is not directed to the export market, the pressure on the BOP on account of capital transfer will be a systemic concern for Bangladesh in the future.

Table 5
Contribution of Foreign Investment to the Balance of Payment

(US$ Million)

	Jan-Mar 2005	April-June 2005	July-Sept 2005	**Jan-Sept 2005**
A. Foreign Investment				
A1. Net FDI	**122.5**	**115.7**	**208.2**	**446.4**
Inflow	123.7	116.5	208.2	448.4
Outflow	1.2	0.8	0.0	2.0
A2. Net Portfolio Investment	**0.0**	**0.0**	**0.7**	**0.7**
Inflow	0.0	0.0	0.7	0.7
Outflow	0.0	0.0	0.1	0.1
B. NET Foreign Investment (A1 + A2)	**122.5**	**115.7**	**208.9**	**447.1**
C. Transfer of Income by FDI	**57.4**	**45.7**	**163.8**	**266.9**
Royalties	1.0	2.0	0.6	3.5
Profit	56.5	43.6	163.2	263.3
Dividends	0.0	0.1	0.0	0.1
D. Contribution to BOP (B-C)	**65.1**	**70.0**	**45.1**	**180.2**

Source: Prepared from the BOP Statement of the Bangladesh Bank

US$453 million, recording a growth rate of more than 200 per cent over the comparable period of the previous year. This rise in investment is primarily due to investment by some telecom companies, e.g. new investment by SingTel, reinvestment by Orascom, registration fee of Warid Telecome etc. Thus up to October of the calendar year 2005, Bangladesh has received a total of US$654 million. It is to be seen whether this trend would continue for the rest of the year. It seems that Tata's investment (about $2.5 billion) will not come on-stream before 2007.

Table 6

Targets and Inflows of FDI in Bangladesh: Which one is correct?

	FDI Flow (in million US$)			
	2002	2003	2004	2005
Targets of FDI (As set by the Board of Investment)	**300**	**400**	**600**	**800**
Inflows of FDI				
Board of Investment (BOI), 2005	328.2	441.4	660.8	
World Investment Report, 2005	52.0 **	268.0	460.0	
Bangladesh Bank Survey Data	328.3	350.2	460.4	653.7*
Bangladesh Bank BOP Data	49.1**	265.4	391.7	435.0*
Difference between Targets and Inflows				
Board of Investment (BOI), 2005	+28.2	+41.4	+60.8	
World Investment Report, 2005	-248.0	-132.0	-140.0	
Bangladesh Bank Survey Data	+28.3	-49.8	-139.6	-146.3*
Bangladesh Bank BOP Data	-250.9**	-134.6	-208.3	-365.0*

Note: *up to October, 2005 (10 months data); ** FDI estimated in traditional method

However, inconsistency on FDI accounting continues to plague a credible discussion on the issue. FDI data provided by Bangladesh Bank in the Balance of Payment Statement could not be matched with the one generated by the Bank's own Survey. It seems that the Bangladesh Bank Survey data is not properly consolidated in the BOP account. Similarly, BOI's Survey data is systematically found higher than other estimates, both in the case of EPZ and non-EPZ. Analysing methodologies followed by different institutions, CPD has suggested for a single survey under the supervision of Bangladesh Bank to avoid the inconsistency in FDI accounting.

Capital Market. During the first six months of FY06 the Dhaka Stock Exchange (DSE) observed a slow decrease in all of its share price indices. The All Share Price Index (ASPI) declined from 1310.62 in June 2005 to 1292.18 on 5 December 2006. The General Index AB also declined from 1713.17 to 1695.91 during the same period. Surprisingly, the major shock came from the top ranked companies as the DSE20 index also declined from 1872.57 in June 2005 to 1585.62 on 05 January 2006, registering a negative (-) 15.3 per cent growth.

Notwithstanding the deceleration of ASPI, and the fact that most of the companies do not provide annual dividend to their share holders, the oversubscription of IPO remained buoyant. During the first half of FY06, an amount of Tk. 12 billion was over subscribed as against the 13 new IPOs that entered into the market during this period. Total 19 IPOs came to market during the last six months (9 securities, 9 companies and 1 mutual funds) (highest number of IPO entry in recent times). However, the capital market continues to remain both shallow and skewed in Bangladesh as current market capitalisation in DSE (December 2005) is below 6.0 per cent of GDP and most of the IPOs are from financial sector (that also mandated) and not from the real sector.

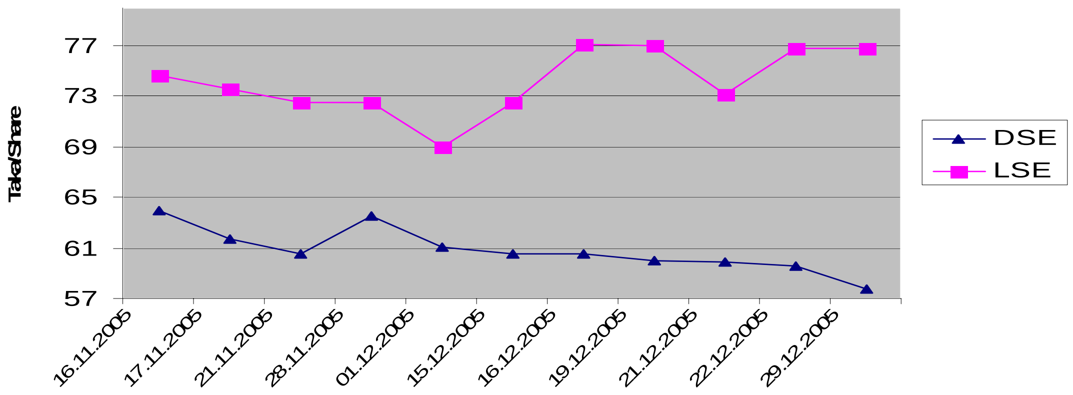
Box 2: Beximco Pharmaceutical's Launching of GDR in the LSE

The Beximco Pharmaceutical's initiative to explore international capital market in October 2005 through Global Depository Receipts (GDR) from the London Stock Market (LSE) is the first ever attempt by a local company to raise large amount of global fund for its operation. In view of a favourable international intellectual property and regulatory environment, Beximco Pharmaceuticals undertook the initiative and was able to raise about 45 per cent (i.e. $ 21 million) of its target amount $ 46.7 million.

Curiously, while the share price of the company remains more or less at the same level in the LSE following the floatation it has fell significantly in the Dhaka Stock Exchange (DSE) during the same time (See Figure 20). For example, in the LSE, price of every share (in taka equivalent) was Tk.77.1 (67.5 pence) at the time of floatation in 21 October, 2005 and after a slight fall it has reached Tk.76.8 (67 pence) in 29 December, 2005. Conversely in the DSE, the price of the share was Tk.74.9 in 20 October, 2005 but it has reached at Tk.58 in 29 December, 2005. The differential movement of stock prices in the LSE and DSE demands a closer look.

It has been observed that at the time of launching of the GDR of the Beximco Pharmaceuticals in the LSE, price deflection between the two markets was less than 3%, but after two months it has increased to about 32%. It was further observed that the share price in the DSE has gradually increased in two months (August and September, 2005) preceding the launch and have subsequently declined. Such a movement of price might have happened due to investors' high expectation regarding the company's bright prospect, which may have declined due to less than expected international response. Alternatively, the price deflection between the LSE and the DSE may have occurred due to the problem of asymmetric information between the two markets. May be the investors should now buy Beximco Pharmaceutical's share from the DSE and sell those in the LSE!

Fig 20: Share Price of Beximco Pharma at LSE and DSE



Source: CPD-IRBD Database, 2005.

5.4 External Sector

Export Sector. During July-October of FY06, export earnings stood at $3,346 million, registering a growth of 12.47 per cent over the corresponding period of FY05. The export value of *woven garments* failed to reach its strategic target by (-) 1.81 per cent, recording a marginal 0.18 per cent growth during the first four months of FY06. However, the growth of *knitwear* registered an impressive 25.82 per cent expansion during the same period. Among other commodities, export of *jute goods* and *leather* also recorded inspiring growth of 21.44 per cent and 16.01 per cent, while exports of *frozen foods* declined by 6.00 per cent.

Manufacturing products showed a notable performance during the reported period with 13.02 per cent growth, while primary commodities recorded a growth of 6.18 per cent.

Major reason behind the achieved growth in export relates to the growth in the volume index by 16.36 per cent, while price index actually fell by (-) 3.89 per cent. While both primary and manufacturing products experienced price fall by (-) 10.97 per cent and (-) 3.31 per cent, impressive growth of 17.15 per cent and 16.33 per cent in the volume index helped to retain the growth.

Import. Total imports during the period of July-October FY06 amounted to $4492.4 million, showing a substantial growth of 11.26 per cent compared to the corresponding period of the previous fiscal year (38.95 per cent during July-September). In fact, significant import increase was observed in the case of all items. Of the total import payments during July-October, 2005 imports under Cash and for EPZ stood at US$4260.60 million, under

Loans/Grants US$32.40 million, import under direct investment US$19.60 million and short term loan by BPC US$179.80 million.

However, we have data available at the disaggregated level upto September only, which also showed a very robust increase in import payments. Among the major increase, in value terms, significant growth in imports was registered *POL* (110.74 per cent), and *Crude petroleum* (80.15 per cent), *Textiles and articles thereof* (32.9 per cent), *Iron and steel* and other base metal (98.93 per cent) and *Fertiliser* (230 per cent). In terms of share in total imports, textile and articles contributed the highest.

Imports by EPZ registered a substantial growth of 51.91 per cent. Indeed, the composition of import growth reveals that it is underpinned by either increase in investment demand or rise in global commodity prices.

During the period under review, downward trends of growth in imports were observed in *Rice* (-63.4 per cent) and *Capital machineries* (-36.2 per cent). Curiously, in value terms, the single largest increase was ($400 million) observed in the case of "Others" category. Previously, in the reporting of Imports Payments, capital machineries were a sub-head under *Capital Goods. Now, Capital Goods Other than Capital machineries* are reported under "Others" head. Thus, one needs to take a closer look at what sort of capital goods are experiencing import growth, in the backdrop of negative growth in imports of capital machineries. It has been speculated that these "Others" include defense equipments, vehicles, furniture etc.

Letter of credits (LCs) worth about $4,264.81 million was settled, registering a growth of 5.0 per cent during July-October FY06 over the corresponding period of the last year. The data on fresh openings of import LCs during July-November of FY06 suggest a subdued growth of imports (3.2 per cent) in the coming months.

Settlement and opening of LCs for foodgrains decreased by 11.7 per cent and 36.4 per cent respectively. The settlement and opening of LCs for intermediate goods also indicate negative growth rates of (-) 18.48 per cent and (-) 6.9 per cent respectively. However, LCs settlement of capital machineries, and of petroleum and petroleum products registered a growth of 39.1 per cent and 17.9 per cent respectively followed by a growth of 21.9 per cent and 28.51 per cent respectively, in the case of fresh LCs opening. It seems that fall in growth of import of investment goods experienced during the first quarter may be reverted in the subsequent quarters.

Foreign Aid. The foreign aid inflow showed an upward trend in FY05 recording a growth rate of 32.1 per cent as the amount of foreign aid disbursed increased to $1,259.50 million from that of $953.50 million in FY04. The net flow of foreign aid disbursement also increased to $810 million in FY05 from $557 million in FY04.

Flow of foreign aid has decreased drastically in terms of disbursement during July-October of FY06. Disbursement of foreign aid during the July-October period of FY05 was $689.96 million. Disbursement of foreign aid during the July-October period of FY06 stood at a modest level of $199.29 million (-71.12 per cent growth over FY05's figure) against a commitment of $383.02 million over the same period.

Low off-take foreign aid has created severe pressure on domestic sources of borrowing during the early part of FY06. The disbursement of $200 mln by the World Bank under the Development Support Credit (DSC III) will ease the situation, albeit, temporarily. Nonetheless, one needs to take an in-depth look at the factors hindering disbursement of committed foreign aid. More importantly, there is a need to monitor the PRS implementation related flow of aid (new aid flow).

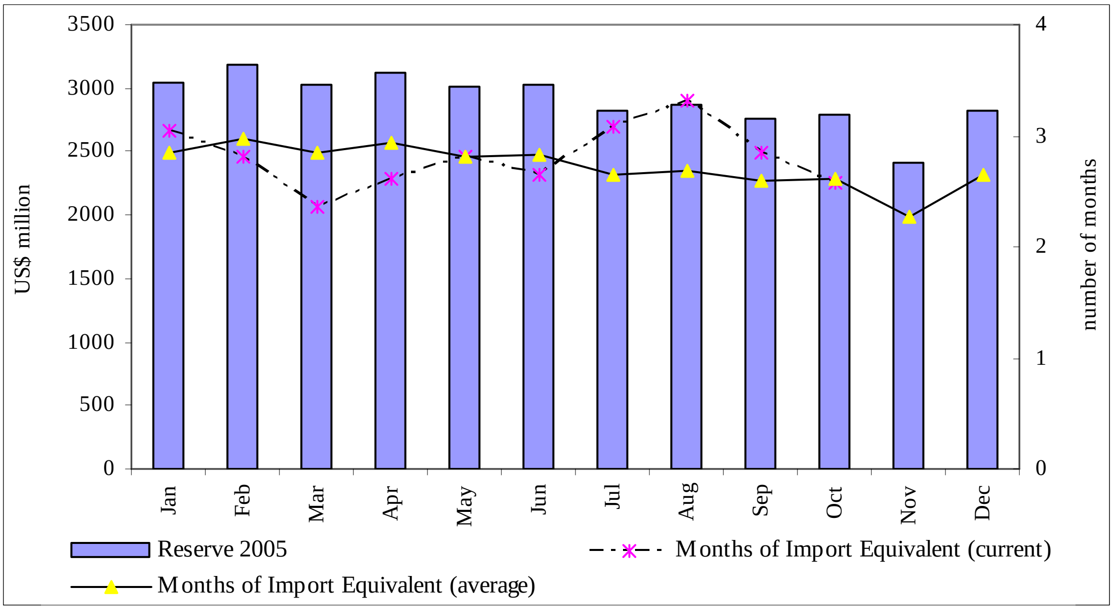
According to the budgetary targets, more than $2.0 billion (i.e. 3.2 per cent of GDP) will be necessary to underwrite the programmed fiscal deficit. Of this amount, $0.5 billion will come as grant and $1.5 billion as loan. Incidentally, the projection done by the IMF indicates that Bangladesh may receive around $1.2 billion during FY06. Thus, it is obvious that there will be a shortfall of foreign aid inflow during the current fiscal year. It needs to be also noted that it is not the aggregate shortfall in foreign aid inflow which matters most for the government's point of view. The government is most interested to receive foreign aid in the form of budgetary support. *Incidentally, in the remaining part of the year such support may be forthcoming to the tune of $300 million including $100 mln from the World Bank for Education Sector Adjustment Loan, $70 mln from the IMF as flood tranche of the PRGF loan and $50 million from the ADB.*

Under the circumstances, the government would emphasise more on quick disbursing budgetary support such as DSC IV (around $100 million), which is on the table for consideration at the moment. However our best figures suggest that this will not be disbursed before July 2006. To sum up, foreign aid flow is emerging as the Achille's Heel of the macroeconomic framework. Without addressing this variable, it will be difficult to restrain a domino effect on other correlates.

Remittances. An impressive performance of remittances has been registered with 22.6 per cent growth during the first half of FY06 over the corresponding period of the previous fiscal year. Total workers' remittance during July-December of FY06 crossed $2 billion mark. Provisional estimates of the Bangladesh Bank showed that remittance inflow during this period reached to $ 2.17 billion, which was 1.77 billion dollars during the same period of the previous fiscal year. December inflow ($ 413.6 million) is the highest remittance earnings in a single month in the recent past. Interestingly, this high inflow took place in the backdrop of the fact that the number of workers going abroad for employment decreased during the first couple of months of FY06 to 43,857 from 51,254 recorded during the same period of FY05.

Foreign Exchange Reserves. Foreign exchange reserves came under pressure from the beginning of FY06, and continued to decrease since August 05. The foreign exchange reserves were lower in August, September and October 2005 by 8.4 per cent, 10.2 per cent and 14.57 per cent respectively compared to the matching figures for FY05. At the end of November of FY06, foreign exchange reserves further declined to $2,416.80 million which is 23.48 per cent lower than that of the corresponding month of the previous year. This amount is equivalent of 2.11 months' import of the country. The major factors which contributed to this draw down on revenues are increasing export-import imbalance and high outflow during the first five months of FY06.

Fig 21: Foreign Exchange Reserves and Months of Import Equivalent, 2005



Source: CPD-IRBD Database, 2005.

The latest available figure shows that foreign exchange reserves stood at $2.8 billion at the end of December of FY06 after the World Bank released the Development Support Credit (DSC) III. However, the reserve level is again expected to go down as the government will have to pay off an import bill of around $300 million to the Asian Clearing Union (ACU) in early January of 2006.

Balance of Payments. Trade balance during the period of July-October of FY06 deteriorated significantly compared to the corresponding period of FY05. The trade deficit increased to $739 million (January-October 2006) from $696 million during the same period of FY05. However, the surplus in Current Account increased to $270 million in October of the current fiscal year, from $51 million as recorded in the corresponding month of the previous fiscal year.

On the other hand, the Financial Account balance has sharply decreased to (-) $245 million during first four months of FY06 from a supply of $611 million during the same period of FY05. Notwithstanding a surplus current account balance, with significant deficit in trade balance and financial account leads to a deficit in the overall balance of (-) $123 million during July-October of FY06 as against a surplus of $490 million during the same period of FY05.

Thus, the overall balance of payment situation has deteriorated significantly during the early months of FY06. Slowdown of imports, continued high flow of workers' remittances and episodic disbursement of foreign aid may ease the situation temporarily. Since the export is picking up and import is slowing down, the external balance may experience a breathing space in the upcoming months. Nevertheless, addressing the BOP situation remains one of the major macroeconomic concerns for the remaining part of FY06.

6. Outlook for Rest of FY06

The foregoing analysis reveals that the factors contributing to the fragility of the Bangladesh economy during the early part of FY06, have either accentuated or acquired new forms. This has happened in spite of the fact that the government undertook, as suggested in CPD-IRBD 2005, measures such as streamlining nominal interest rate and orderly adjustment of exchange rate. Furthermore, the government has made an effort to harness the recurrent expenditure as well as accelerate ADP implementation. One also notices some dynamism in revenue collection. Indeed, apparently, a business-as-usual situation prevails in the economy with robust trend in private sector investment, good prospect of foodgrain production, moderate growth of exports, and buoyant flow of remittances.

However, fact remains that the weakness of both of fiscal balance and balance of payment during the early months of FY06 still persist. The common thread of concern for both the balances remains less than programmed inflow of foreign aid. Among the outcome variables, relatively high inflation rates (particularly for food price) is the other major concern for the remainder part of the current fiscal year. Signs of a problematic macro-economic situation are becoming evident. Indeed, it has created an apprehension that MTMF of the PRS may get scuttled in the very first year of its implementation. We take a closer look at some of the issues to understand the emerging situation.

First, the fiscal balance has been weakened in the backdrop of robust revenue growth, harnessed recurrent expenditure and all time low implementation of ADP, and negative flow of net foreign financing. Thus, while fiscal deficit remains as low as 1.1 per cent of GDP, net domestic financing rose to 1.4 per cent with bank borrowing playing a dominant role. Such method of financing of fiscal deficit, on the one hand, is gradually creating a heavy public debt with high domestic DSL. On the other hand, inordinate borrowing by the government and by other public sectors is pushing the domestic credit expansion rate to an inordinate high level and a crowding out private sector.

In the absence of significant rise in the net flow of foreign aid and sustained high collection of revenue, there is an apprehension that the quality of fiscal balance may deteriorate further. This apprehension remains potent as it is expected that pressures on public expenditures will be backloaded.

Second, the strains on balance of payment and drawdown on forex reserve have increased significantly in the recent past due to slowdown of export, high growth of import, high outflow on account of foreign debt servicing and transfer of profits by foreign investors. In fact, energetic flow of remittances remains the only saving grace for stopping the back sliding of the BOP situation. It is widely held that the current high growth of remittance inflow will gradually taper off. On the other hand, making both import and borrowing costlier, the government is trying to slowdown import growth as well as private demand for credit. But without augmentation of foreign aid flow, high export growth and sustained remittance flow the external balance may experience severe pressure in the immediate future.

In this context, one may fundamentally question the rationale of pursuing a contractionary monetary and credit policy to contain the emerging situation. As mentioned earlier, the current creeping inflation is not a monetary phenomenon, and credit expansion in the private sector is driven by effective demand for investment. Accordingly, control of money supply (other than control of credit to government) and the parastatals will only affect growth prospect of the economy.

Indeed, in order to confront the situation, one needs to sustain high level of economic growth. One may have to revisit the growth-stability trade-off only when there is low response from all external sources (i.e. foreign aid, export, remittances and FDI).

Third, one needs to recall that the target growth for FY06 is 6.5 per cent. The Finance Minister has raised the bar (and confusion) by stating that the economy may clock 7 per cent growth in this fiscal year. According to the PRSP, to achieve the target growth rate of 6.5 per cent, gross domestic investment rate has to increase from 24.6 per cent in FY05 to 25 per cent of GDP in FY06 (assuming a very favourable incremental capital output ratio (ICOR) of 3.7). *Although CPD's estimate shows that for attaining 6.5 per cent growth one would need an* *investment rate which is 29 per cent of GDP (assuming the historical ICOR of 4.4), unless radical productivity growth takes place in a short span of time*.

To achieve the targetted GDP growth of 6.5 per cent in FY06, Bangladesh has to achieve public and private investment rates of 5.9 per cent (5.0 per cent in FY05) and 19.1 per cent (19.4 per cent in FY05) respectively during FY06. As may be observed that the government, according to the PRSP guidelines, is supposed to more incrementally draw on public investment for sustaining growth in FY06. To this end, the government will have to augment its effort to implement ADP and ensure debt and equity flow to the private sector.

In fine, it seems that the government will have to weigh between two options in terms of fiscal and monetary stance. Both the options have their own virtues and risks.

Under the first option the government may have to consider a moderated growth rate (say 5 per cent plus) predicated by lower monetary expansion and managed public investment. This slowdown will ease the pressure on both the fiscal balance and BOP. This may also have, at the margin, sobering impact on the inflation rate. This will also entail higher interest rate, cutback on credit to private sector and decline in imports (particularly capital and intermediate goods). *This option may not be a politically viable one as there will be increasing pressure on pre-election public spending.*

Alternatively, the government may opt to ride over the situation with a high spending-high growth approach. To this end, the government will have to expedite the ADP implementation process and may release more money to the private sector. For this option to materialise, the government will have to improve its immediate access to foreign financing (budgetary support) from concessional and non-concessional sources in the absence of which they will have to resort to high domestic borrowing. *This approach runs the risk of precipitating a fiscal instability and increase in inflation rate (from the short to medium term).*

Elements of A Plausible Scenario. Indeed, reality check suggests that the government will be more inclined to opt for the second option with some modifications. With the closing in of the electoral frontier, a "historic" GDP high growth figure and a back loaded public spending will become a compulsion. An elaboration of the four major components of this most expected scenario is provided below.

(i) The government will accelerate its spending in the coming months under both revenue and ADP accounts. On revenue account, we may observe not only release of the discretionary funds (e.g. Block Grants, Transfer and Subsidies), but also higher domestic DSL. Indeed, the government may have to spend more than the programmed amount on account of enhanced security measures (e.g. raising new battalions for RAB and BDR and import of security related modern machineries and equipments). In case of ADP, while the aggregate level of implementation may be about 20 per cent or so less of the original, some ministries endowed with projects which are subject to low level of performance accountability (e.g. rural roads repair and maintenance) may experience high level of off-take. It is, however, highly desirable that the integrity of the ADP is maintained by pruning non-aided low quality projects. *It may be emphasised that the current macroeconomic pressures have to be absorbed partly by the fiscal policy as monetary policy will not be able to carry the full burden.*

(ii) Regarding private sector investment, there will be a slowdown for a number of reasons. The recent spate of bomb attacks are going to affect both domestic and foreign investors' confidence in the short to medium term. The effective demand for private investment will be also reigned in by an increasing interest rate (lending and, partly, deposit rate). This, in its own turn, will reduce the import pressure on the BOP. In earlier occasions before the elections, one has observed high level of loan disbursement to private sector through the NCBs. This opportunity has limited value in the current context of the financial sector. Alternatively, some privileged private sector companies may get improved access to the enhanced public expenditure portfolio. However, agriculture credit disbursement by the NCBs and specialised banks and government supported micro-finance programmes may experience some increase.

(iii) The government has to take a strong effort to bring down the price level, particularly of food products. This may be attempted through improved production (e.g. better *boro* harvest) and liberal imports. Contractionary monetary policy underpinned by higher interest rate (and may be higher SLR and CRR) will also favourably affect the inflation rate. Most importantly, the government will be seriously disinclined to further (and faster) depreciation of the national currency as it may further enhance price level. It will also try (may be unsuccessfully in the face of donor resistance) not to pass the incremental fuel price on to the consumers.

(iv) At the end of the day, holding back further deterioration of the BOP will be the prime challenge. Notwithstanding various import growth controlling measures, the government will still need a sizeable package of foreign financing to implement its ADP and sustain the normal activities of the economy. To this end, the government may pursue a *six channel approach*.

(a) Faster disbursement of the project aid which are tied up in the pipeline to facilitate implementation of the ADP.

(b) Organising faster disbursement of a number of reform-related budgetary support commitments from the international financial institutions (IFIs) The target value of which will be in the range of $350 – 500 million.

(c) Putting together energyspecial foreign aid packages for targeted use, e.g. for expansion of the sector or modernisation of Chittagong Port.

(d) Improving the foreign exchange reserve by inducing the friendly Middle Eastern countries to keep a couple of billion dollars with the Bangladesh Bank at a reasonable interest rate.

However, in extreme situation the government may opt for the following two extreme cases for foreign exchange mobilisation.

(e) The government may resort to borrowing foreign currency from foreign commercial banks. One has to justify this borrowing in terms of high value productive investment in the public sector. *This avenue entails high level of DSL in foreign currency*.

(f) In a bid to attract foreign remittances, the government may liberalise its foreign exchange regulations and allow receipt in and holding of foreign currency accounts by resident Bangladeshis. *One may wonder how far this step will be considered compatible with the current emphasis on Anti-Money Laundering Act.*

Whatsoever, the key to the current problematic macroeconomic situation is held by the level and nature of the net foreign financing which Bangladesh would receive in the next 3 - 4 months. One will have to see to what extent the recent setting-up of the Joint Task of the GOB and the international development partners for monitoring the PRS implementation is going to facilitate the process of accessing foreign aid.

As the current fiscal year crosses the mid-year work, the government definitely needs to revisit its budgetary and PRSP targets at the earliest to evolve a pragmatic package.

Admittedly, the policy autonomy enjoyed by the government remains heavily constrained as the economy is pre-designed to function under adjustment loans of the IFIs. Nonetheless, this package has to lay a stable and secured foundation for the transitional government which is expected to take charge in the early part of FY07.

January 7, 2006