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BANGLADESH

Quarterly Economic Update

March 2014

Asian Development Bank

Bangladesh Resident Mission
Asian Development Bank

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March 2014

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CONTENTS

NOTES

(i) The fiscal year (FY) of the government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2014 ends on 30 June 2014.

(ii) In this report, "$" refers to US dollars, and "Tk" refers to Bangladesh taka.

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MACROECONOMIC DEVELOPMENTS

Highlights

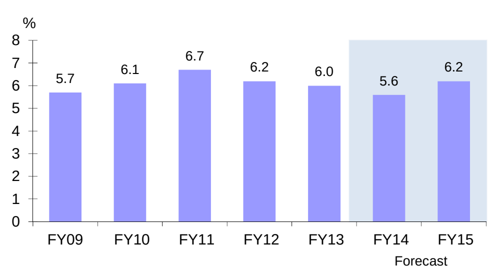
- GDP growth in FY2014 is expected to be lower at 5.6%
- Agriculture growth will be higher
- Industry growth will slow to 8.0% in FY2014 because of output lost to political unrest and weaker domestic demand
- Service sector growth will slip to 5.4% in FY2014 due to lost sales during pre-election unrest and slower industry activity
- Inflation is on the rise
- Revenue collection is lagging the target
- Private sector credit flows slowed due to weak business environment

Sector Performance and Economic Growth

GDP growth in FY2014 expected to slow to 5.6%

1. Gross domestic product (GDP) growth is expected to slow to 5.6% in FY2014, with remittances declining and export growth tapering during the remainder of the year because of fewer orders (Figure 1). Domestic demand was depressed in the first half of the year, as the prolonged political unrest ahead of the January elections lowered consumer and investor confidence. This is reflected in lower private credit growth, declining imports of consumer goods and capital machinery, and modest growth in the import of raw materials. Growth is expected to rebound to 6.2% in FY2015, aided by higher remittance and export growth, as growth prospects in the United States (US) improve and the eurozone posts a mild recovery. The likely rise in consumer and investor confidence as the political situation stabilizes is expected to stimulate demand and strengthen growth momentum.

Figure 1. GDP growth

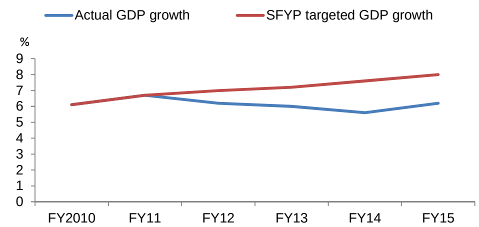


Macroeconomic policies have been sound

2. Macroeconomic policies are generally sound. With inflation showing a rising trend in recent months, the latest monetary policy statement of Bangladesh Bank (the central bank), issued in January 2014, adopted a more cautious policy stance in a bid to

keep inflationary pressures under control. The central bank also sought to encourage adequate credit flows to the private sector. Fiscal policy remains prudent, as the government seeks to keep unproductive spending in check, cut subsidies, and advance tax policy and tax administration reforms.[1] The current account of the external balance is however expected to move to a small deficit in FY2014, from a sizable surplus in the previous fiscal year, as import payments rise due to higher food-grain imports, while growth in export earnings slows and remittances decline. Foreign reserves are currently adequate because of higher export and remittance growth in FY2013, with imports remaining unchanged. The exchange rate has been stable, with periodic central bank interventions.

Figure 2. Actual vs. Sixth Five Year Plan (SFYP) targeted real GDP growth

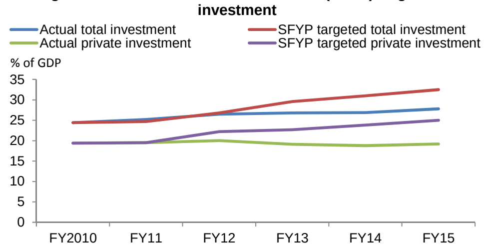


Note: Actual GDP growth for FY2014 and FY2015 have been estimated.

3. Although Bangladesh attained annual GDP growth rates of more than 6% during the last decade, actual GDP growth falls short of the Sixth Five Year Plan (FY2011–FY2015) targets (Figure 2). The government needs to boost investment in infrastructure and skills development to raise the economy's productive capacity and shift the economy to a 7%–8% growth trajectory. Investment has remained virtually stagnant at around 25%–26% of GDP; it needs to be raised to 32%–33% as envisaged in the Sixth Five Year Plan (Figure 3). Actual output closely follows the track of potential output, implying modest scope for increasing GDP growth without creating

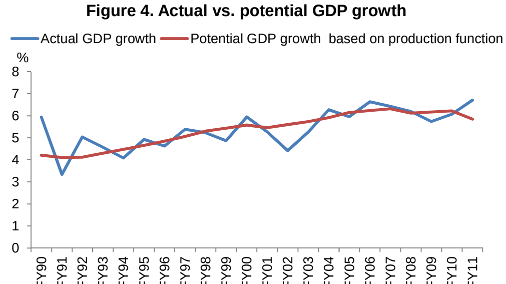
Expanding the country's productive capacity requires massive investment in infrastructure and skills development

Figure 3. Actual vs. Sixth Five Year Plan (SFYP) targeted investment



Note: Actual investments for FY2014 and FY2015 are estimates.

Figure 4. Actual vs. potential GDP growth



[1] International Monetary Fund (IMF). 2013. Bangladesh—Letter of Intent. In Staff Report for the 2013 Article IV Consultation and Third Review under the Extended Credit Facility. *IMF Country Report.* No. 13/357. Washington, DC.

inflationary pressures, unless potential GDP is raised through more investment (Figure 4).[2]

More resources are needed for financing public investment

4. More public resources need to be mobilized to finance large infrastructure investment in power, gas, ports, railways, roads, and urban services; and to enhance the skills base to help diversify the economy and raise global competitiveness. The country's tax effort (10.4% of GDP in FY2013) is low compared with other South Asian countries, and needs to be raised through tax policy and administrative reforms. The tax base needs to be expanded by reducing exemptions and exclusions, and improving tax administration through simplifying laws and procedures, improving logistics and automation, and reducing scope for evasion with the introduction of advanced auditing and enforcement techniques.

Increasing public sector project management capacity and implementing PPP operations are important requirements

5. Public sector capacity for project design and administration, procurement, audit, and financial management needs to be enhanced for more efficient project implementation. In addition to public sector investment in infrastructure, projects involving public–private partnership (PPP) need to be implemented to help reduce the large infrastructure deficits. The capacity of line agencies to design, bid, and award PPP contracts needs to be developed.

Banking governance needs to be strengthened

6. Banks continue to be the main financing source for private investment. Weak governance in state-owned commercial banks has undermined the strength and efficiency of banking. Vulnerability in the banking system must be addressed to remove weaknesses in asset quality, improve risk management, and strengthen internal audit and controls. In line with the latest memorandum of understanding between the country's banks and Bangladesh Bank, a stronger credit policy and credit risk management policy need to be adopted and prudent credit growth ceilings set, based on each bank's performance and financial soundness.

7. The ongoing capital market reforms to enhance market stability and governance need to be deepened to expand opportunities for larger private sector financing from the capital market. Efforts are needed to develop a liquid bond market.

Improving the business climate requires trade reforms and modernized trade logistics

8. To improve the business climate, the trade regime needs to be liberalized through tariff and nontariff reforms. Import duties need to be cut, and dispersion and average protection lowered to boost competitiveness and reduce anti-export biases. Trade infrastructure and logistics, including port services and

[2] S. Rahman, M. Z. Hossain, and S. Viswanathan. 2013. *Study on Estimation of Potential Output and Output Gap in Bangladesh (unpublished)*. Bangladesh Resident Mission, Asian Development Bank.

automation, need to be improved to lower transaction costs and facilitate faster clearance of goods.

9. Bangladesh has made steady and commendable progress in poverty reduction. In addition to being on track to achieve the Millennium Development Goal (MDG) target of reducing income poverty by half by 2015, the country has made impressive gains in other indicators of well-being. It is on course to meet the MDG target for infant and child mortality, and has already met the target for gender parity in primary and secondary schooling. Child health indicators have improved.

Steady progress made in poverty reduction

10. Several areas need accelerated attention if all MDGs are to be met, including higher primary school completion and adult literacy rates, more wage employment for women, reduced maternal mortality rate and increased presence of skilled health-care personnel at deliveries, broader comprehensive knowledge of HIV/AIDS, wider forest coverage, and greater penetration of information and communication technology. The country struggles to maintain protected areas and provide safe drinking water and sanitation, particularly in rural areas. In terms of addressing nonincome poverty, a key challenge is to reach the poorest groups and regions, including urban slums, hill tracts, coastal belts, and other ecologically vulnerable areas.

11. Income poverty incidence declined substantially during FY1992–FY2010. The poverty headcount index declined by more than 25 percentage points. The decline in income poverty was an outcome of sustained progress in ensuring inclusive economic growth. As the economy expanded by an average of 5.3% annually during FY1990–FY2010, per capita GDP in real terms grew by over 142%; poverty reduction accelerated, declining by 17.4 percentage points, compared with a decline of 7.7 percentage points during FY1992–FY2000. This can be attributed to more rapid GDP growth, faster urbanization, rising labor productivity and wages, and a shift from low-return agricultural labor to nonfarm employment and growth in export industries. A rising flow of remittances contributed to the accelerated poverty reduction. Equally important is the decline in fertility, which has lowered the number of dependents per household and led to higher labor force participation and educational attainment, particularly among women.

The national headcount poverty index declined by more than 25 percentage points during FY1992–FY2010

12. The extreme poor (people with incomes below the lower poverty line) benefited from progress in poverty reduction. During FY1990–FY2010, the incidence of extreme poverty decreased by 22.6 percentage points in rural areas and 15.9 percentage points in urban areas. Progress in reducing extreme poverty accelerated during FY2000–FY2010.

Extreme poverty fell by 22.6 percentage points during FY1990–FY2010

13. Poverty continues to be largely a rural phenomenon. In FY2010, rural poverty incidence was 35.2%, much more than the urban poverty rate of 21.3%. The extreme poverty rate was 21.1% in rural areas, nearly three times the 7.7% in urban areas. The 75% of the population that lives in rural areas includes 84% of the nation's poor.

Rural areas have higher poverty incidence

14. The absolute number of poor people, while decreasing over time, remains quite large because of population growth. In FY1992, an estimated 64 million were classified as poor. By FY2010, this had declined to 47 million. The number of extreme poor declined from 46.7 million to 25.7 million during the same period.

15. Income inequality in Bangladesh compares favorably with that of other South Asian countries. It rose in the 1990s, as reflected in the Gini coefficient, increasing nationally from moderate inequality at 0.39 in FY1992 to high inequality at 0.47 in FY2005, with the trend reversing slightly in 2010 to 0.46. Much of the high inequality nationally reflected a significant rural–urban income gap. While urban inequality declined from FY2005 to FY2010, rural inequality remained unchanged. This is reflected in a decrease in the Gini coefficient for urban areas from 0.50 in FY2005 to 0.45 in FY2010 and an unchanged Gini coefficient of 0.43 for rural areas.

Despite increasing in the 1990s, income inequality did not worsen during FY2005–FY2010

16. Poverty incidence is uneven across regions, with the western parts of the country showing the highest poverty. In FY2010, Rangpur Division had the highest incidence of poverty at 42.3%, followed by Rajshahi Division at 39.4% and Khulna Division at 32.1%. Chittagong Division had the lowest poverty incidence at 26.2%, followed by Sylhet Division at 28.1%, and Dhaka at 30.5%. The rapid growth of remittances has made an important contribution to poverty reduction in Chittagong and Sylhet.

Western region lags other regions in poverty reduction

17. To link economic growth and poverty reduction, the government is attaching importance to imparting skills training that targets external and domestic markets alike by activating technical training centers in all districts of the country, equipping them with trainers and equipment, and assisting with their logistics. The National Employment Policy, 2010 emphasizes protecting labor rights; improving living standards; and ensuring fair wages by determining an appropriate minimum wage and setting wages consistent with the cost of living, skill differences, and the nature of jobs. Gender parity in wages has been attained in most sectors.

The government emphasizes skills development to accelerate poverty reduction

18. Analysis of data from successive rounds of household income and expenditure surveys shows that poverty is more likely when a household has more dependents, little education, or a female as its head. Those engaged in daily wage work in informal

sectors are more likely to be poor than others. In rural areas, the larger the landholding, the less likely a household is to be poor.

19. The geographic location of a household influences its propensity to be poor. Remoteness from local markets and Dhaka and lack of access to infrastructure, including electricity and transport to local markets, are characteristics of poor areas. Households located in the western part of the country tend to be at higher risk for poverty; the two major rivers, the Ganges and Brahmaputra, significantly impair connectivity with the nation's main urban growth areas in Dhaka and Chittagong.

Lack of access to infrastructure and connectivity affects poverty reduction

20. A dearth of productive and remunerative employment is a major cause of poverty and vulnerability. The adult labor force increased from 19.7 million in 1974 to 54.1 million in 2010. But this represents only half of the working age population, indicating a very low rate of labor force participation by global standards. Average annual growth in the labor force increased from 2.8% in the 1980s and 1990s to 3.4% from 2005/06 to 2010 with demographic change and a rising share of women in the labor force. Employment growth has been slower than total labor force growth, leaving an open unemployment rate of 4.5% in 2010. Underemployment, or working less than desired or what would be considered full time, is the most serious challenge, afflicting 29% of the work force.

Slower employment growth challenges poverty reduction

21. Women are especially vulnerable to poverty. Households headed by women are among the poorest. The labor market continues to be highly segmented along gender lines. Women's participation in wage work is extremely low, and wage inequality persists. Women are significantly less likely than men to be self-employed off farm and are less qualified.

Women are more vulnerable to poverty

22. Agriculture growth and improved diets have helped reduce the proportion of underweight children below 5 years from 66% in 1990 to 43% in 2010. Malnutrition among poor women causes poor health in their children. Infant malnutrition can permanently harm health and learning ability, contributing to intergenerational transmission of poverty.

23. Limited human resource development confounds efforts to boost productivity and employment. Per capita public spending on health care and education, and the quality of public service provision are low, which, along with poor service delivery, disproportionately affect the poor. High rates of absenteeism are found in public health care facilities; those in rural areas, which are used more by the poor, are the worst affected. In education, high private spending compensates for low public outlays, but contributes to widening gaps in education outcomes between the poor and others.

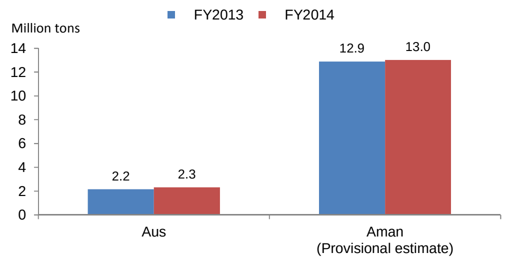
Agriculture

24. Agriculture growth is expected to rise to 3.0% in FY2014, aided by the favorable weather conditions and the previous year's low base. Disruptions to the distribution network during the pre-election political unrest affected marketing of agricultural products. Sector growth is expected to rise to 3.5% in FY2015.

Agriculture growth is expected to rise to 3.0% in FY2014 because of favorable weather and the low base in FY2013

25. The Department of Agriculture Extension's food-grain production target for FY2014 is 35.9 million tons (34.6 million tons of rice and 1.3 million tons of wheat), up by 2.3% from actual production in FY2013. According to final Bangladesh Bureau of Statistics estimates, *aus* (summer rice crop) production was 2.3 million tons from 1.1 million hectares, 4.5% higher than 2.2 million tons in FY2013. Although the cultivation area was unchanged, *aus* production rose in the current fiscal year due to higher yield. *Aman* (monsoon rice crop) production was estimated provisionally at 13.0 million tons with a cultivation area of 5.5 million hectares, 0.8% higher than actual production of 12.9 million tons in FY2013 (Figure 5). Although the total cultivation area decreased by 1.8% from the previous year because of the decline in area under local variety seeds, *aman* production rose in the current fiscal year due to the increased area planted with high-yielding variety seeds. The production target of the major *boro* rice crop was 18.9 million tons from 4.8 million hectares, 0.5% higher than actual production of 18.8 million tons in FY2013. The wheat production target of 1.3 million tons from 0.4 million hectares is unchanged from FY2013.

Figure 5. Production of *aus* (summer rice crop) and *aman* (monsoon rice crop)



Aus and aman rice crop production increased over the previous year

26. Agricultural development and sustainable rural natural resource management are critical for poverty reduction as the vast majority of the poor live in rural areas and depend on agriculture for their livelihoods. Agriculture generates close to half of employment, contributes 20% of GDP, and provides a secure supply of food to the whole population. Fostering agricultural development and sustainable natural resource management is taking on greater importance as policy maker's grapple with climate change and sudden spikes in global and domestic food prices.

Agricultural development and sustainable rural natural resource management are vital for poverty reduction

27. Growth drivers in rural areas are shifting from rice cultivation to high-value agricultural commodities and off-farm employment. Transforming subsistence to commercial agriculture is key to improving rural livelihoods, boosting rural economic

Transformation of subsistence to commercial agriculture is key to rural uplift

growth, and contributing to long-term food security. The government is seeking to promote diversification in agriculture by fostering private-sector-led agribusiness and improving rural infrastructure. The latter includes developing farm-to-market roads, providing access to affordable power, developing rural growth centers including marketplaces with women's sections, and building rural water supply and sanitation infrastructure.

28. With climate change risks growing, the provision of climate-resilient rural infrastructure assumes growing importance. In addition, rural institutions need to be developed to help ensure that better market access brings improved livelihoods and more rapid social development. All these issues have important gender-equality dimensions, and households headed by women can benefit. Accordingly, the provision of rural infrastructure has been linked with government and development partner efforts to foster greater participation of local communities in decision making, enhance gender equity, ensure proper operation and maintenance of rural assets, build technical skills and local government capacity, and raise awareness of rural road safety concerns. The participation of beneficiaries in small-scale irrigation and the broader sustainability of rural infrastructure are threatened by heavy dependence on central government budget transfers to meet maintenance requirements. Such transfers have only met about half of the upkeep and routine maintenance costs of rural roads.

Climate-resilient infrastructure is critical to address climate change risks

29. Strengthened integrated and strategic water resource management is urgently needed, including flood management and erosion control, improved and adaptive participatory water resource management, and strengthened policy implementation. Recurrent floods and aggravated riverbank erosion are major problems and causes of poverty in Bangladesh. Other water resource management problems include temporal variation in discharges (i.e., alternating flooding and winter drought), drainage congestion, drought, salinity intrusion in coastal areas, cyclones and tidal surges, arsenic contamination of groundwater, overexploitation of groundwater, and chemical and fertilizer contamination of water. Similarly, the nation's irrigation network is characterized by inefficient water utilization, inadequate maintenance, and a large backlog of needed repairs. Intertwined is the impact of climate change on the incidence and severity of disasters, necessitating more attention to managing disaster risk and adapting to climate change, including measures to control flooding and erosion. More effort is required to foster community participation, including women and the private sector, in the sustainable management of water resources, building on successes of small-scale water resource projects.

Strengthening integrated and strategic water resource management is crucial

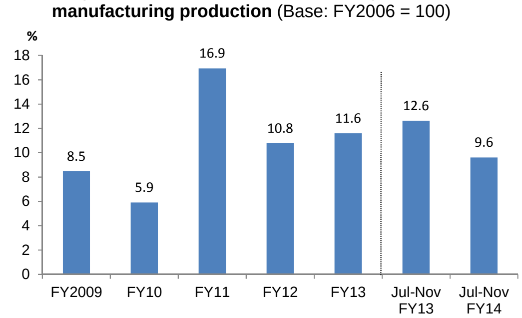
Industry

30. Industry growth is expected to slow to 8.0% in FY2014 because of output lost to political unrest in the first half of the year, and as weaker domestic demand depresses production. Production by the readymade garment industry may also be affected if foreign buyers postpone orders complaining about delays in implementing agreed fire and building safety standards to prevent recurrence of industrial accidents. Growing power and gas shortages could constrain industrial production; production costs could rise from the expected rise in power and fuel prices, and higher wages in the garment industry. The industry sector is expected to grow by 9.0% in FY2015 with increased domestic and external demand, better compliance and safety standards in garment factories, and a rise in power generation.

Industry growth is expected to decline to 8% in FY2014 due to output lost to political unrest and weak domestic demand

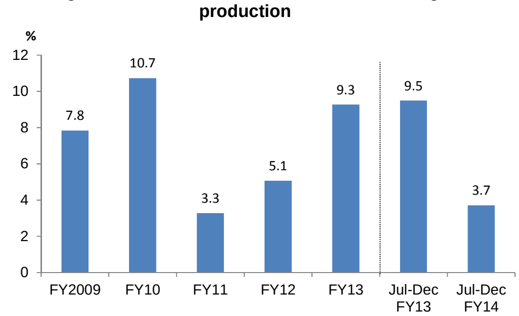
31. According to new base-year (FY2006) data recently published by Bangladesh Bureau of Statistics, the quantum index for medium- and large-scale manufacturing industries rose by 9.6% during July–November 2013 (Figure 6). Wearing apparel, the major industrial group, grew by 15.3%; food products by 11.5%; pharmaceuticals and medicinal chemicals by 11.6%; other nonmetallic mineral products by 1.5%; leather and leather products by 4.5%; basic metals by 7.0%; fabricated metal products, except machinery, by 2.4%; printing and reproduction of recorded media by 1.4%; electrical equipment by 2.0%; beverages by 39.9%; tobacco products by 7.5%; wood and cork products by 3.0%; machinery and equipment (not classified elsewhere) by 7.1%; computer, electronic, and optical products by 6.5%; rubber and plastic products by 1.1%; and other transport equipment by 8.3%. Coke and petroleum products fell by 29.1%, and textiles by 0.8%.

Figure 6. Growth of medium- and large-scale manufacturing production (Base: FY2006 = 100)



The quantum index for medium- and large-scale manufacturing industries rose by 9.6% during July–November 2013

Figure 7. Growth of small-scale manufacturing production



32. The general index for small-scale manufacturing (FY1996 base) rose by 3.7% during July–December 2014 (Figure 7). Food,

beverages, and tobacco rose by 0.8%; textiles, leather, and apparel by 17.4%; metal products and machinery by 11.4%; basic metal industries by 4.9%; paper, printing, and publishing by 5.9%; wood and wood products by 0.8%; and other manufacturing industries by 29.3%. Chemicals, rubber, and plastic fell by 1.0%; and nonmetallic products by 13.2%.

General index for small-scale manufacturing rose by 3.7% during July–December 2014

33. Bangladesh's garment industry is in transition. With 5,400 factories employing 4.0 million workers, mostly women, and with export earnings at $20 billion, or 16.6% of GDP in FY2013, the industry is the backbone of the economy and a major force for inclusive growth. However, it has a mixed safety history. Following major industrial accidents in 2012 and 2013, the industry in collaboration with the government, foreign buyers, and development partners agreed to and is in the process of adopting internationally accepted safety and compliance standards. Success in this endeavor will be a challenge, as it will require major changes and substantial financing. To comply with international standards, about half of the country's garment factories, mostly small and medium-sized ones that depend on subcontracting from large factories, will have difficulty adapting. Operating on small profit margins and lacking financial resources, many of these factories will likely need to close or be absorbed by larger companies.

The garment industry is undergoing a challenging transition

34. The government developed an operations manual, with the assistance of the International Labour Organization (ILO), for assessing structural integrity and fire and electrical safety. Factory inspections have begun under the Accord on Fire and Building Safety in Bangladesh; the signatories are European buyers and trade unions, and the Alliance for Bangladesh Worker Safety, an initiative of US buyers. In March, the first batch of detailed inspection results under the accord was made public. The two groups have pledged to provide loans to qualifying companies for safety upgrades. In January 2014, the Rana Plaza Donors Trust Fund was established and began receiving contributions from buyers and private donors to assist victims of the 2013 building collapse and their families.

Safety inspections in garment industry strengthened by ILO, European Union, and US support

35. Under the National Action Plan, development partners—Canada, the European Union, Japan, the United Kingdom, and the US—have started providing funds as part of their long-term initiatives to ensure labor safety and factory standards, while involving local and international nongovernment organizations and trade unions in their efforts. The Japan International Cooperation Agency and the International Finance Corporation are making low-cost loans available. In addition, the government has decided to cover 3 percentage points of commercial bank lending rates for export loans to enable garment factories affected by political unrest to decrease their losses.

Development partners assist in implementing the National Action Plan

36. The ILO and the International Finance Corporation have announced, in partnership with the government, the Better Work Program as a component of the Improving Working Conditions in the Ready-Made Garment Sector program. In addition to providing financial support to the victims and their families, and to ensuring treatment for injured workers, the government took initiatives to reemploy affected workers and implement suggestions for ensuring workplace safety.

37. The minimum wage was raised to Tk5,300 per month from Tk3,000 in November 2013. Even with this increase, Bangladesh will continue to be the most wage-competitive of major garment producers in Asia, having maintained the least-cost pattern from 2001 to 2011, according to recent research. Moreover, estimates place Bangladesh's labor productivity at 80% of that of the People's Republic of China (PRC). This suggests that unit labor costs are about half that of Cambodia and India, two main Asian competitors for production moving from the PRC to lower-cost venues.

Bangladesh retains price competitiveness despite rise in wages

38. The continued dynamism of Bangladesh's garment industry will depend on its ability to increase productivity, boost value addition, and move upmarket. Major challenges include upgrading safety standards to maintain strong buyer market access, improving inadequate electricity and transport-related infrastructure and logistics, and developing skilled candidates for middle and senior management needed to improve labor relations and to raise production efficiency through better quality control, labeling, and shipment.

Continued dynamism in the garment industry requires a rise in productivity, a boost in value addition, and a move to upmarket products

Services

39. Service sector growth in FY2014 is expected to slip to 5.4% due to the loss of output in the pre-election unrest and slower industry growth. Lower credit growth for trade; sluggish demand in retail and wholesale trade, hotels and restaurants, transport, and tourism; and the fall in commercial banks' operating profits are evidence of slower service sector growth. With an expected rebound in industry and agriculture outputs, service growth is expected to rise to 5.7% in FY2015.

Service sector growth in FY2014 is expected to be lower at 5.4%

40. The service sector accounts for the principal share of Bangladesh's output, employment, and growth. From 1974 to 2013, the service sector's share of GDP rose from 33.0% to 53.9%. Its share of employment rose from 17.0% in 1974 to 35.4% in 2010, while agriculture's share in employment declined from 77.0% to 47.6%, and manufacturing's share rose from 6.0% to 12.4%. Bangladesh is following a path of structural change similar to other Asian economies with agriculture giving way to industry and services taking the lead in the postindustrial phase. Services are expected to play an even bigger role in the coming

Service sector accounts for 53.9% of value added and 35.4% of total employment

years. In addition, with the rapid expansion of the country's middle class, a natural by-product is the growing demand for education, health care, communication, and financial and other services.

Service sector growth is vital for job creation

41. Developing the service sector can yield far-reaching benefits for the economy. Due to its labor-intensive nature, a large and growing service sector can generate millions of jobs for the country's huge workforce, and thus promote more inclusive growth. Employment elasticity is highest at 0.85 in the service sector followed by 0.78 in manufacturing and 0.5 in agriculture.

Potential synergies in modern services need to be tapped

42. Extensive synergies between the service and industry sectors mean that service sector development can lift productivity throughout the economy. Those synergies are all the more evident in modern, high value-added service industries such as finance, information and communication technology, and professional business services. In light of the growing tradability of services, partly a consequence of technological progress, upgrading service industries will augment Bangladesh's gains from international trade in services.

Transformation of the service sector requires skills and human capital development, and extensive connectivity within and outside the country

43. The quantitative expansion of the service sector does not, however, in and of itself guarantee that the sector will become an engine of growth. For the sector to play that role, it must become more productive, efficient, and innovative. The country's service industries currently are characterized by extremely low productivity—lower than other South Asian countries. To a large extent, this is because the country's service sector remains trapped in traditional, low-productivity industries mostly in the informal sector. The shift to modern services with higher productivity and that offer better wages will transform the sector into a genuine, dynamic engine of growth and will strengthen the link between services and inclusive growth. Such a shift requires overcoming a wide range of impediments. In particular, Bangladesh needs to develop skills, and expand and raise the quality of education and health care. Seamless connectivity within and outside the country can unleash innovation and create productive linkages and opportunities, which require a huge investment in physical and social infrastructure.

Inflation

Inflation is on the rise, driven by higher food prices stemming from supply disruptions

44. Year-on-year inflation fell from 8.0% in June 2013 to 7.0% in October because of lower food and commodity prices in domestic and international markets and lower credit demand. Inflation rose to 7.5% in March 2014, driven by higher food prices stemming from supply disruptions caused by the political unrest; inflation was 7.7% in March 2013 (Figure 8).

Food inflation remained elevated, while nonfood inflation declined

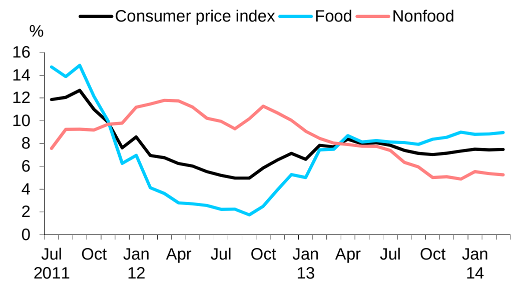
45. Year-on-year food inflation rose to 9.0% in March 2014 up from 7.5% in March 2013. Nonfood inflation dropped to 5.3% in

March 2014 from 8.0% in March 2013, responding mainly to monetary tightening by the central bank.

Urban inflation was higher than rural inflation

46. In rural areas, inflation was 7.2% in March 2014, virtually unchanged from March 2013. Rural food inflation was 8.5% up from 6.9% and nonfood inflation was 4.8% down from 7.7%. In urban areas, inflation stood at 8.0% in March 2014 lower than 8.8% in March 2013. Urban food inflation was 10.0%, compared with 9.0% in March 2013 and nonfood inflation was 5.9%, down from 8.6% in March 2013.

Figure 8. Inflation, point-to-point
(Base: FY2006 = 100)



Inflation is expected to rise to 7.5% in FY2014

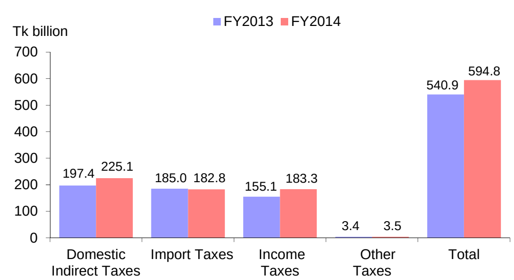
47. In FY2014, inflation is expected to rise to 7.5%, from 6.8% in FY2013 due to the effects of supply disruptions in the first half of the year, public and private sector wage increases, and expected increase in power and fuel prices. The central bank kept policy rates unchanged, instead of lowering them with the intention of dampening inflationary pressures.

Fiscal Management

Revenue collection by National Board of Revenue slowed to 10.0% during July–January FY2014

48. Pre-election political unrest and lower growth in dutiable imports affected revenue collection by the National Board of Revenue, as tax collection grew by only 10.0% during July–January FY2014 over the year earlier period (Figure 9). Income tax collection rose by 18.2%, while domestic indirect taxes grew by 14.0%.

Figure 9. Revenue collection by the National Board of Revenue (July–January)



Weaker performance of import-based taxes due to slower growth in dutiable imports

49. The collection of import-based taxes grew by only 1.1% during July–January FY2014. Tax collection from customs duties fell by 1.8%, import stage value-added tax rose by 1.7%, and supplementary duties declined by 7.9%.

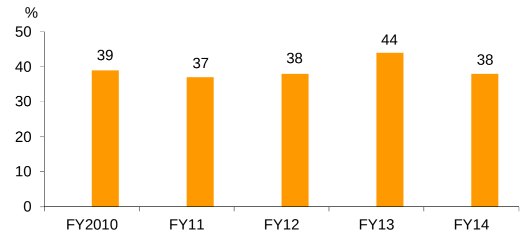
Current spending during July–January FY2014 amounted to 46.5% of the annual budget allocation

50. During July–January FY2014, current spending was 46.5% of the total FY2014 recurrent budget estimate, while development spending was 27.2% of the development budget. Interest payments (24%), accounted for the largest share of current spending, followed by education (16%), general public service

(13%), defense (13%), agriculture (10%), and public order and safety (9%).

51. Below par performance of annual development program (ADP) implementation continues to undermine efforts to develop the country's much-needed infrastructure. In the first 8 months of FY2014, ADP utilization stood at 38% compared with 44% in the same period of the previous year (Figure 10). Among the top 10 ministries/divisions, the Local Government Division (55%) had the best performance, followed by the Ministry of Primary and Mass Education (48%), the Ministry of Railway (44%), the Ministry of Health and Family Welfare (44%), the Roads Division (40%), the Ministry of Education (40%), the Energy and Mineral Resources Division (35%), the Power Division (33%), the Ministry of Housing and Public Works (13%), and the Bridges Division (5%).

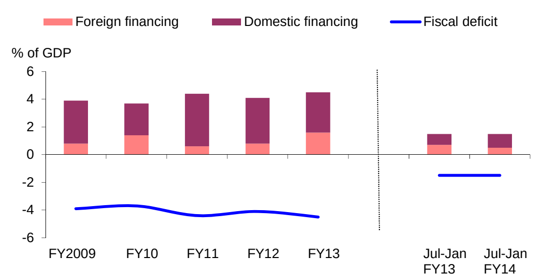
Figure 10. ADP implementation (July–February)



ADP implementation low at 38% in first 8 months of the fiscal year

52. During July–January FY2014, the overall fiscal deficit (excluding grants) stood at Tk176.1 billion (about 1.5% of projected GDP) (Figure 11). Net foreign borrowing declined to Tk60.6 billion from Tk76.5 billion during July–January FY2013. Net domestic borrowing surged to Tk115.4 billion from Tk79.7 billion in July–January FY2013. Net borrowing from the banking system declined from Tk64.3 billion to Tk51.9 billion, while financing from nonbank sources grew rapidly from Tk15.5 billion to Tk63.5 billion.

Figure 11: Fiscal deficit and financing



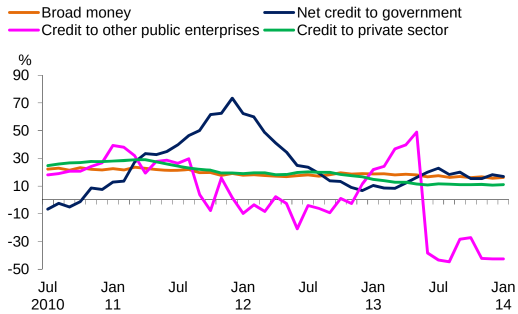
Government domestic borrowing surged as foreign financing dips

Monetary and Financial Developments

53. Broad money (M2) grew by 16.3% year-on-year in January 2014, down from 18.7% in January 2013, remaining lower than the FY2014 monetary program growth target of 17.0% (Figure 12). Slower growth of net foreign assets (36.4% compared with 43.9% in January 2013) as well as domestic credit (10.0% compared with 14.3% in January 2013) of the banking system contributed to the lower M2 growth. Net foreign asset growth was lower due to lower

Money supply growth remains lower than program target remittance inflows. Domestic credit growth remained lower than the FY2014 target of 17.8% due to lower credit demand from the private sector. The growth in private sector credit slowed to 11.1% in January 2014, and remained lower than the FY2014 target of 16.5% and actual growth of 14.8% a year earlier. The growth in net credit to the government rose to 16.9% in January 2014 from 10.4% in January 2013.

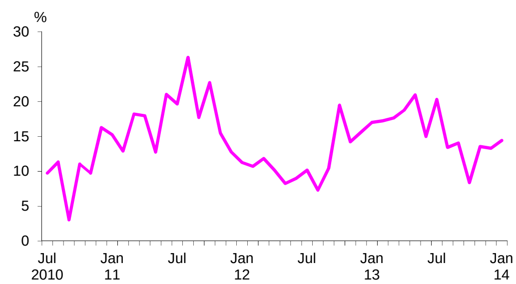
Figure 12. Growth of monetary indicators



54. Reserve money grew slowly by 14.4% year-on-year in January 2014 (lower than the FY2014 target of 16.2%), down from 17.0% in January 2013 due to the steeper decline in the central bank's net domestic asset (down by 126.8% compared with the 47.0% decline in January 2013) (Figure 13). The sharper decline in lending to the government and the commercial banks contributed. While lending to government (net) declined by 56.2% in January 2014 compared with the 13.3% decline in January 2013, lending to the commercial banks declined by 56.9% compared with the 17.8% decline in January 2013. With the decline in remittance inflows, growth in net foreign assets of Bangladesh Bank slowed to 38.4% in January 2014 from 47.2% in January 2013.

Reserve money growth was lower

Figure 13. Growth of reserve money



55. In conducting monetary policy, Bangladesh Bank relied mostly on open market operations through regular auctions of Treasury bills with appropriate adjustments in their yields, and repo and reverse repo operations to regulate liquidity growth in the banking system. Interest rates on Treasury bills continued to decline, reflecting higher demand for such instruments as private sector lending growth slowed. The weighted average yield of 91-day Treasury bills was 7.4% in February 2014, down from 9.7% in February 2013. Similarly, the yields on 182-day bills declined to 8.2% from 11.0%, and on 364-day bills to 8.8% from 11.5%. The weighted average yield on 30-day bills also declined to 7.0% in February 2014 from 8.4% in February 2013.

Yields on Treasury-bills fell

56. The interbank call money market rate remained stable, as credit demand was lower due to the weaker business environment. Bangladesh Bank's close monitoring of the day-to-day liquidity position in the money market also contributed. The interbank call money rate was 7.1%, on a weighted average basis in February 2014, down from 9.0% in February 2013.

Interbank call money rate remained stable

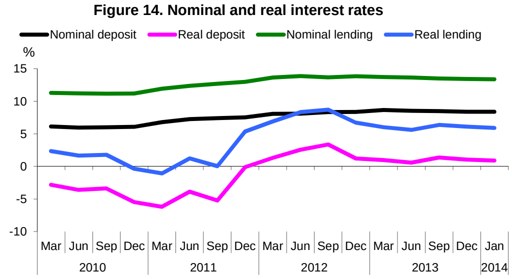
57. Scheduled banks' excess liquidity was higher at Tk948.5 billion at the end of January 2014 up from Tk599.5 billion at the end of January 2013. Subdued business activity reduced demand for credit, contributing to the buildup of liquidity in the banking system. The outstanding borrowing of the government through sales of national savings directorate certificates stood at Tk694.9 billion at the end of January 2014, up from Tk642.8 billion a year earlier.

Excess liquidity in the banking system rose

58. The weighted average lending rate declined slightly to 13.4% at the end of January 2014 from 13.7% at the end of January 2013. The deposit rate also declined slightly to 8.4% from 8.6% during the same period, becoming positive in real terms because of lower inflation. The interest rate spread of the banking system narrowed marginally to 5.0% in January 2014 from 5.1% in January 2013 (Figure 14).

Interest rate spread narrowed

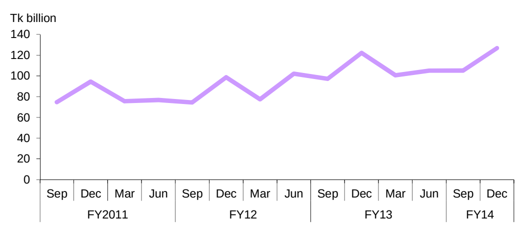
Figure 14. Nominal and real interest rates



59. The disbursement of industrial term lending grew. Disbursements stood at Tk232.0 billion in July–December 2013, 5.7% higher than the year earlier period (Figure 15). While disbursement to large-scale industries rose by 11.8% (accouting for 69.9% of total industrial term lending) and to small and cottage industries (8.0% of total funds) by 42.8%, disbursement to medium-sized industries declined by 16.6%.

Disbursements of industrial term loans grew

Figure 15. Disbursement of term loans by banks and nonbank financial institutions



60. Loans to agriculture and small and medium-sized enterprises (SMEs) were given priority, in line with Bangladesh Bank's policy directives. Of the Tk146.0 billion targeted for new credit disbursement to agriculture, Tk88.2 billion was actually disbursed in the first 7 months of FY2014, an increase of 14.2%

Loans to agriculture and SMEs are prioritized

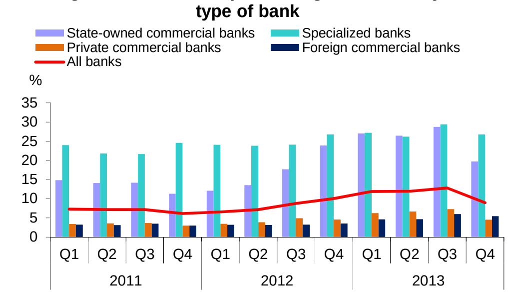
over the same period of FY2013. Outstanding loans to SMEs reached Tk1,158.8 billion in December 2013, 14.9% growth over December 2012. The ratio of SME loans to total loans in the banking system rose to 23.9% in December 2013 from 22.4% in December 2012.

61. The half-yearly monetary policy statement (MPS), January–June 2014 aims to bring down average inflation to 7.0%, while ensuring sufficient credit growth to stimulate economic growth. The MPS projects that year-on-year M2 growth will rise to 17.0% in June 2014 and private sector credit to 16.5%, in line with GDP growth targets. The unanticipated spending pressures arising from the provision of incentive packages, recently announced by the government to support industries affected by political disruptions, will be accommodated within the government's borrowing limit, as indicated in the MPS. The MPS also aims to preserve the country's external sector stability by supporting a market-based exchange rate while seeking to avoid excessive foreign exchange rate volatility.

The MPS aims to contain inflation while stimulating economic growth

62. Financial soundness indicators for the banking system slightly improved as the ratio of gross nonperforming loans (NPLs) to total loans in the banking system moderated slightly to 8.9% at the end of December 2013 from 10.0% at the end of December 2012 (Figure 16). The gross NPL ratio for state-owned commercial banks declined to 19.8% at the end of December 2013 from 23.9% at the end of December 2012, and for private commercial banks marginally to 4.5% from 4.6%, but the gross NPL ratio for specialized banks remained the same at 26.8% as at the end of December 2012. The gross NPL ratio for foreign banks rose to 5.5% from 3.5% during the same period. The net NPL ratios for all banks declined to 2.0% at the end of December 2013 from 4.4% at the end of December 2012.

Figure 16. Gross nonperforming loan ratios by type of bank



Financial soundness indicators slightly improved during the fourth quarter of 2013

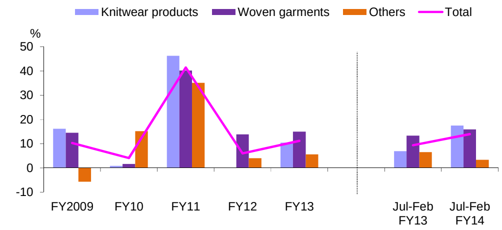
Balance of Payments

63. After growing rapidly by 21.2% in the first quarter of FY2014, export growth slowed to 16.6% for the first half. It continued to slow to 14.0% for July–February, but grew more rapidly than during the year earlier period (9.4%) (Figure 17). Strong garment export growth contributed to maintaining the still healthy export performance.

Exports grew by 14.0% during July–February FY2014

64. Garment exports—accounting for about 81.4% of total export earnings—grew by 16.7% during July–February FY2014, significantly higher than 10.1% growth in July–February FY2013. Exports of woven garments rose by 15.9%, and export earnings from knitwear increased by 17.5%. Garment exports to the European Union increased by 19.0% and to the US by 7.6%. Woven exports to the European Union rose by 18.1% and knitwear exports by 19.6%, while woven exports to the US increased by 6.8% and knitwear exports by 10.5%.

Figure 17. Growth in exports and components



Garment exports rose by 16.7% during July–February FY2014

65. Among other major export items, earnings from frozen food increased by 24.2%, leather 44.3%, and agriculture products 9.7%; while export earnings from jute goods declined by 13.0%, petroleum products by 51.9%, raw jute by 47.3%, and engineering products by 5.6%.

66. Export earnings from the European Union—the dominant source of the country's export earnings—grew by 19.0% in the first 8 months of FY2014 to $10.7 billion (54.1% of total export earnings) and from the US by 7.3% to $3.7 billion (18.8% of the total). Export earnings from newly discovered markets continue to rise significantly. In the first 8 months of FY2014, export earnings from 13 countries increased by 12.9% to $3.9 billion (19.6% of total export earnings);[3] garment export earnings rose by 21.7% to $2.6 billion (15.8% of total garment export earnings).

Export earnings from the European Union grew rapidly

67. In view of the declining trend in export growth, attaining the FY2014 export target of $30.5 billion (12.9% growth over FY2013) will be a challenge. Slow recovery in European Union and weaker garment export expansion in view of some unfavorable buyer reaction in the aftermath of the fatal factory fires and the factory collapse may disrupt further export opportunities. The US suspension of the Generalized System of Preference over inadequate worker rights is also likely to suppress exports, although garments are not covered by the scheme.

Attaining the export target will be a challenge

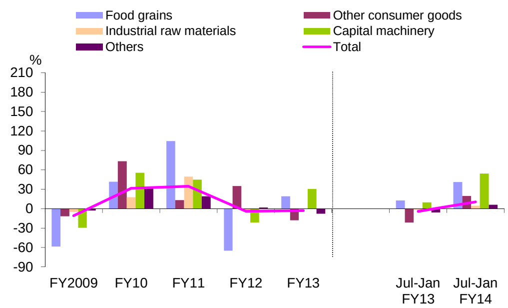
68. Import payments grew by 13.9% in the first half of FY2014 over the corresponding period of FY2013, mainly to pay for higher imports of rice and wheat, while imports of sugar, edible oil, machinery, fertilizer, and petroleum products declined.

Imports grew by 13.9% in July–December 2013

[3] Australia; Brazil; Canada; the People's Republic of China; Hong Kong, China; India; Japan; Republic of Korea; Russian Federation; South Africa; Thailand; Turkey; and the United Arab Emirates.

69. During July–January FY2014, the total value of import letters of credit opened rose by 10.6% because of an increase in letters of credit for petroleum and petroleum products (14.1%), capital machinery (54.3%), machinery for miscellaneous industries (10.8%), other consumer goods (19.8%), and food grains (41.1%) (Figure 18). The value of import letters of credit opened rose marginally for industrial raw materials (4.4%) and declined for intermediate goods (1.0%).

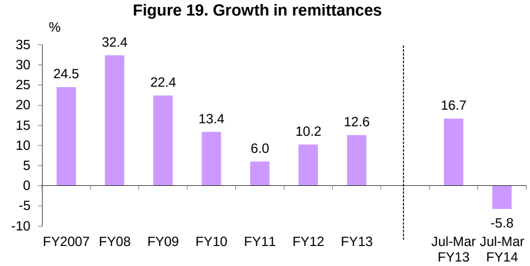
Figure 18. Growth in opening of import letters of credit



Import letters of credit rose by 10.6% in July–January FY2014

70. Remittance inflows declined by 5.8% to $10.5 billion during July–March FY2014 over the corresponding period of FY2013 when they totaled $11.1 billion (Figure 19). Remittance inflows declined mainly because of the large drop in out-of-country employment, especially in Middle Eastern countries. Actions against illegal workers in Saudi Arabia also contributed.

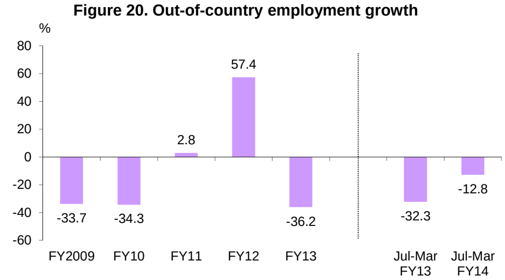
Figure 19. Growth in remittances



Remittance inflows declined by 5.8% during July–March FY2014

71. Out-of-country jobs for Bangladeshi workers fell by 12.8% in July–March of FY2014 indicating a likely slowdown in remittance inflows in the coming months (Figure 20). A total of 296,981 Bangladeshis found jobs outside the country during that period, compared with 340,587 in the corresponding period of FY2013. Although recruitment in Oman, Saudi Arabia, Singapore and the United Arab Emirates fell sharply, jobs for Bangladeshi workers rose in Qatar. Out-of-country employment of female workers declined sharply.

Figure 20. Out-of-country employment growth



Growth of out-of-country jobs for Bangladeshi workers decreased

72. Net foreign direct investment (FDI) inflows rose marginally, but net foreign aid inflows fell. Net FDI stood at $980.0 million in

FDI rose marginally, but foreign aid declined

the first 7 months of FY2014, up from $938 million in the first 7 months of FY2013. Net foreign assistance fell to $779.6 million in the first 7 months of FY2014, from $943.1 million in the first 7 months of FY2013.

Lower trade deficit helped enlarge the current account surplus

73. The trade deficit narrowed to $2.8 billion in the first 7 months of FY2014, from $4.3 billion in the first 7 months of FY2013. Lower deficits in the trade account and primary income during this period compared with a year earlier raised the current account to a surplus of $2.1 billion in the first 7 months of FY2014 up from a $1.4 million surplus in the first 7 months of FY2013.

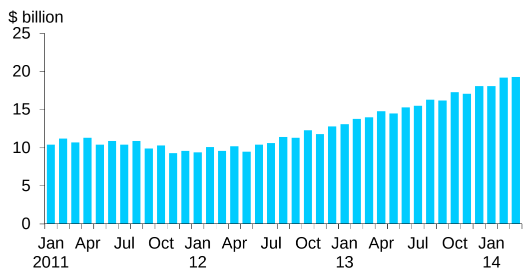
Overall balance shows a lower surplus

74. The combined capital and financial accounts surplus of $114.0 million in the first 7 months of FY2014 was significantly lower than the surplus of $2.6 billion in the first 7 months of FY2013 because of a much larger deficit for net trade credit. Despite the higher current account surplus, the lower capital and financial account surplus led the overall balance to show a lower surplus of $2.8 billion in the first 7 months of FY2014, down from the surplus of $2.9 billion in the first 7 months of FY2013.

Gross foreign exchange reserves rose sharply

75. Bangladesh Bank's gross foreign exchange reserves rose sharply to $19.3 billion (nearly 5 months of imports) at the end of March 2014 from $14.0 billion a year earlier (Figure 21). Bangladesh Bank accumulated a large amount of foreign exchange through purchases from commercial banks to prevent the taka from appreciating and causing erosion of the country's export competitiveness.

Figure 21. Gross foreign exchange reserves

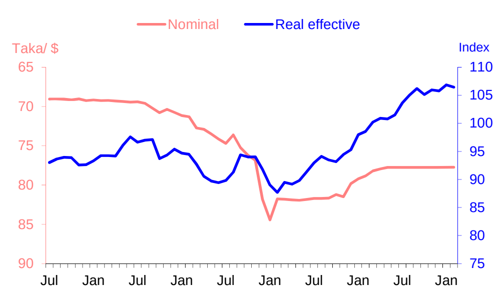


Exchange Rate

Both nominal and real effective exchange rates appreciated

76. The weighted average nominal (taka–dollar) exchange rate appreciated from Tk78.9 = $1.00 at the end of February 2013 to Tk77.7 = $1.00 at the end of February 2014 (an appreciation of about 1.4%) (Figure 22). Despite a decline in remittance inflows, taka appreciated as export growth was still strong. In February 2014, the nominal effective exchange rate

Figure 22. Exchange rates

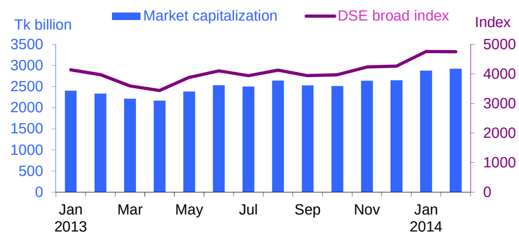


appreciated by 4.1% year-on-year. Because of the higher nominal appreciation and higher domestic inflation relative to that of trading partners, Bangladesh's real effective exchange rate appreciated by 8.0% year-on-year as of the end of February 2014, implying some erosion in export competitiveness.

Capital Market

77. The major stock indicators started to pick up. The Dhaka Stock Exchange (DSE) broad index grew by 19.5% in February 2014 over February 2013, reaching 4,749.9 points (Figure 23). The market price–earnings ratio rose to 16.9 in February 2014 from 11.5 in February 2013, reflecting some price recovery in the market. Since January 2013, 15 new companies have been listed in the DSE. DSE market capitalization rose by 25.1% in February 2014 over February 2013. Net foreign portfolio investment in July–January FY2014 was $337.0 million, up from $179.0 million in July–January FY2013.

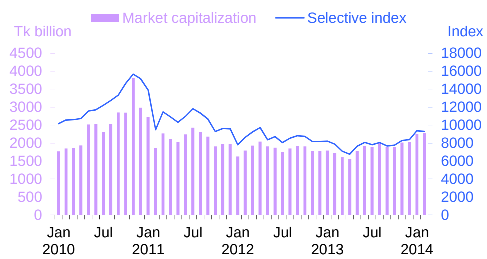
Figure 23. Dhaka Stock Exchange: Market capitalization and broad index



Major stock market indicators started to pick up

78. The Chittagong Stock Exchange (CSE) selected categories index largely followed the trends of the DSE broad index. By February 2014, it had risen by 17.8% over February 2013 (Figure 24). CSE market capitalization rose by 31.8% during the same period.

Figure 24. Chittagong Stock Exchange: Market capitalization and selective category index



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