ADB

BANGLADESH

Quarterly Economic Update

December 2009

Asian Development Bank

Bangladesh Resident Mission
Asian Development Bank

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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., FY2009 ends on 30 June 2009.

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

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MACROECONOMIC DEVELOPMENTS

Highlights

- Decreasing exports and continuing weak investment will slow the economy's return to the pre-crisis growth trajectory.

- Growth is projected to slow to 5.5% in FY2010.

- Agriculture sector growth is expected to moderate but will remain strong due to broad-based government policy support.

- Industry sector growth is constrained by weak external demand along with acute shortages in power and energy supply.

- Services sector growth will gradually increase as trade activity and the industry sector recover.

- Excess liquidity in the banking system and rising global commodity prices are likely to push up the inflation rate.

- Bangladesh needs to rebalance its sources of growth by diversifying productive activities, particularly its export base.

- Attaining higher long-term growth will depend on increasing domestic and foreign investment, especially for infrastructure.

- Increasing the tax–GDP ratio and scaling up ADP implementation are the major fiscal challenges.

Sector Performance and Economic Growth

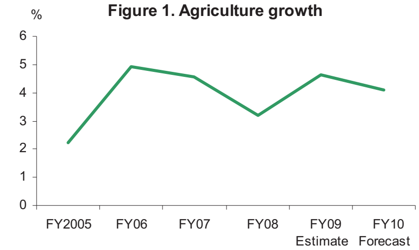
1. The late unfolding of the impacts of the global economic recession affected performance of the Bangladesh economy in the first half (July–December) of FY2010. Investment remained sluggish, and exports—one of the key drivers of growth—performed badly, posting a decline. Remittances, the other major growth driver, held up well, but in this case also, the growth rate declined. Although signs of a rebound can be read from a pickup in the opening of import letters of credit (L/Cs) and higher growth in private sector credit, signaling better performance in the second half, growth in FY2010 is expected to slip to 5.5% from 5.9% in FY2009. In

agriculture, while the aus (summer) crop was seriously affected by drought, broad-based support from the government helped to at least partly offset the adverse effects of weather on the aman (monsoon) crop. Weather permitting, another good boro (winter) crop may be expected. But given the combination of agriculture's small (below 20.0%) share of GDP and its traditional low growth, the sector is not expected to contribute significantly to overall economic growth. The performance of the industry sector continues to be affected by power and gas shortages. Subdued trade, transport, and real estate activities affected the performance of the service sector in the first half of FY2010. To reduce the economy's susceptibility to global economic shocks, the government needs to rebalance the country's growth by diversifying the productive base. To attain higher growth over the medium term, it needs to identify new drivers of growth. To improve short-term growth prospects, the government must take immediate actions to mitigate the acute power[1] and gas shortages. It needs to improve the country's investment climate to encourage domestic and foreign investment; and develop the capacity of key line agencies to boost investment in the public sector and encourage higher private investment. In addition, it needs to give attention to creating jobs to make growth more inclusive and aid a faster decline in poverty.

Agriculture

2. During the first half of FY2010, the government increased the subsidy for irrigation, fertilizers, and the supply of seeds. Bangladesh Bank introduced innovative measures to enhance farmer access to formal sector credit. Agriculture growth in FY2010 is nevertheless expected to be lower (4.1%) than the 4.6% growth in FY2009 (Figure 1) because of the adverse effects of weather on the summer and monsoon crops and farmers' supply response to lower farmgate prices after last year's harvesting season. Production of rice and wheat for FY2010 is targeted at 34.5 million tons (rice 33.5 million tons, and wheat 1 million tons), a 7.2% rise from actual production in FY2009. The authorities are optimistic about

Figure 1. Agriculture growth



[1] Recently, the Power Development Board signed agreements with two companies from the People's Republic of China to establish two 150 megawatt combined-cycle power plants in Bangladesh. A Memorandum of Understanding (MOU) was signed between the Governments of Bangladesh and India on 11 January 2010 for cooperation in the fields of power exchange, power generation and connectivity, energy efficiency and development of renewable energy. Another MOU was signed on 20 February 2010 between Bangladesh and India to install a 1,320 MW coal-fired power plant in Bangladesh.

good harvests of maize, wheat, and potatoes in FY2010. The prospects for the various noncrop subsectors appear good. The fishery subsector performed well because of growing domestic demand, and the poultry and livestock subsectors are expected to perform well given the growing domestic and foreign demand.

3. Production of aus is recorded at 1.7 million tons, down by 9.8% from the previous year, because of the decreased planting area. The government has set an ambitious production target for aman rice at 12.7 million tons against the actual production of 11.6 million tons in FY2009, up by 9.7%. The production target for boro is similarly increased to 19 million tons up by 6.7% from the actual production of 17.8 million tons in FY2009. The production target for wheat is set at 1 million tons against the actual production of 0.9 million tons in FY2009.

4. To enhance food security, the government has set a higher target for public procurement of food grains. In FY2010, the food grain procurement target is 1.6 million tons, higher by 7.9% than actual procurement of 1.5 million tons in FY2009. The target for government food grain import is set at 1.1 million tons, an increase of 54.4% over the actual import of 0.7 million tons in FY2009. The private sector import target for food grains is set at 2.5 million tons compared with actual import of 2.2 million tons, up by 12.8%. The target for distribution of food grains is set at 2.7 million tons against 2.1 million tons in FY2009, an increase of 25.7%.

5. Increasing agricultural productivity by intensifying and diversifying crop production is critical to enhancing agriculture's contribution to inclusive growth. Raising agricultural productivity is a strategic pillar of the government’s rural development strategy. Given a declining land base along with a growing population, upgrading available production technologies is crucial to attain the goal of food security. Sustained improvement in productivity is key to augmenting agriculture's competitiveness in the context of rising commercialization and globalization. Thus, the country's agriculture research and extension services need to be reoriented to promote generation and dissemination of appropriate technologies for increasing productivity in crop and noncrop sectors.

6. Over the past three decades, the Bangladesh Rice Research Institute and Bangladesh Agricultural Research Institute, in collaboration with the International Rice Research Institute and International Center for Wheat and Maize Improvement have played a commendable role in

increasing agricultural crop yields. In particular, rice yields, which received disproportionately favorable attention, rose dramatically through the application of green revolution technologies, development of improved varieties, expansion of irrigation, and intensive use of fertilizers, as well as from increased cultivation of irrigated high-yielding boro rice. Nevertheless, the country's prevailing agriculture research and extension capacity is inadequate to generate new and viable technologies appropriate to changing needs, stemming from demographic pressures and market demands. The government needs to address the major barriers to agriculture research, which include lack of adequate funds for agriculture research and extension, poor governance, limited access to new frontiers of research, fragile institutional networking, and underinvestment in and declining quality of human resources.

7. Homestead agriculture[2]—popularly known as homestead agroforestry or home gardening—has been playing an important role in the rural economy of Bangladesh, especially for the resource poor. Homestead agriculture relates to integrated production of all farming activities, including crops, trees, and/or livestock in the household's residence and its surrounding areas based on household needs, resource endowments, preferences, and knowledge. Homestead agriculture meets the diversified needs of households, including for food, nutrition, and energy security. Commercial sales of homestead agricultural outputs contribute to increasing household income and savings, and to creating employment opportunities, particularly for women. Income generated through homestead agriculture is utilized to purchase additional food items, enhancing diversification of the diet. Homestead agriculture is especially important in overcoming seasonal unavailability of staple foods, and promotes household self-sufficiency. Collectively, the homestead production system contributes about 70.0% of fruit, 40% of vegetables, 70.0% of timber, and 90.0% of firewood and bamboo requirements of the country. The cultivation of improved crop/plant varieties, optimum management of resources, efficient processing, and marketing of products could contribute significantly to developing homestead agriculture.

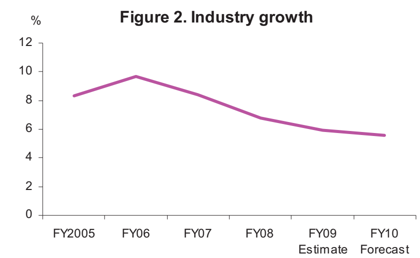
[2] This section draws on M. G. Miah and M. J. Hossain. 2008. Homestead Agroforestry: A Potential Resource for Bangladesh. In *Sociology, Organic Farming, Climate Change and Soil Science*. Amsterdam. Netherlands: Springer Publishers.

8. The rural nonfarm (RNF)[3] sector, which is driven primarily by agriculture through backward and forward linkages, accounts for about 33.0% of GDP. It accounts for approximately 46.0% of rural employment and 50.0% of rural household income. RNF activities provide a viable avenue for diversification of the rural economy. Primarily using agricultural outputs as inputs, the RNF sector is the source of rural industry, especially for agroprocessing and value addition of products. The sector also plays a key role in trading activities in rural areas. Aided by microcredit and agricultural credit from formal and nongovernment sources, the sector is thriving, which is evident by its rising share of GDP. Nevertheless, both agriculture and the RNF sectors are important for reducing rural poverty, increasing rural employment, improving the quality of life of rural citizens, and improving the country's development prospects. A strong RNF economy can help increase agricultural productivity, given proactive government policy support. More productive linkages between agriculture and the RNF sector will be critical for diversifying the economy and creating employment in rural areas. In particular, promotion of the RNF sector has promising potential for mitigating seasonal unemployment and underemployment, and curbing intra- and interregional underdevelopment and inequality.

Industry

9. The global economic recession's greatest impact has been on the country's industry. With the slowdown in export of readymade garments (RMG), which accounts for about 40.0% of the industrial value added, along with the decline in leather, frozen food, and other manufacturing export items (except for jute, jute goods, and light engineering), the industry sector recorded lower growth of 5.9% in FY2009 compared with 6.8% in FY2008. The decline in the export of RMG and other major export products is expected to affect industry sector growth in the first half of FY2010. However, manufacturing activities are expected to pick up during the second half of 2010, supported by acceleration in investment and trade activities. The global economic crisis is also affecting domestic import-substituting industries and nontradeables because of moderating demand. In addition, supply-side bottlenecks, stemming from the country's fragile investment climate have lowered the industry sector's growth outlook. In particular, the acute shortage of power and gas acts as a key constraint against growth. As a

Figure 2. Industry growth



[3] This section draws on J. Gareett and S. Chowdhury. 2007. Urban-Rural Links and Transformation in Bangladesh. *Discussion Paper*. Washington, DC: Care.

result, industry sector growth in FY2010 is set to decelerate to 5.6% (Figure 2).

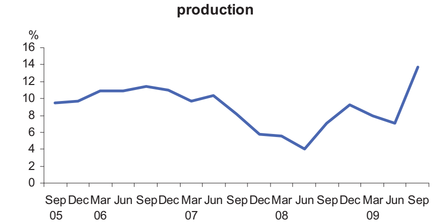
Figure 3. Growth of medium- and large-scale manufacturing production

10. To rebalance the country's growth to cushion against internal and external shocks, Bangladesh needs to diversify its industry sector over the medium term. The country's narrow export base poses a potential danger of becoming a victim to external shocks. Diversification of the sector (paras. 58-83) is critical for responding to higher demand in domestic and foreign markets. With the country's abundant supply of unskilled and semiskilled labor, labor intensive industries need to be developed. Developing productive linkages between agriculture and industry by promoting agroprocessing by small- and medium-sized industries should be actively pursued. The rural market needs to be expanded and the quality of rural infrastructure enhanced.

11. The general index of industrial production (medium- and large-scale manufacturing) rose by 2.5% during July–September FY2010, over the corresponding period of FY2009 (Figure 3). The growth rate of chemicals, petroleum, and rubber, which comprise 24.0% of the industrial index, was 20.4%; food, beverages, and tobacco with a weight of 22.1% rose by 8.4%; fabricated metal (5.9%) grew by 5.6%; paper and paper products (4.7%) were up by 4.2%; nonmetallic products (2.8%) rose by 1.8%; wood products including furniture (0.2%) were up by 1.8%; while jute, cotton, wearing apparel, and leather (38.2%) reported a decline of 4.7% due to the continued slowdown in RMG, textiles, and leather products (although jute alone recorded higher export growth). Basic metal products (2.1%) also fell by 44.2% during the period.

12. The general index for small-scale manufacturing rose by 13.7% during July–September FY2010, over the corresponding period of FY2009 (Figure 4). Food, beverages, and tobacco, which comprise 38.9% of the industrial index, grew by 38.8%; wood and wood products (30.4%) rose by 3.0%; textiles, leather, and apparel (7.7%) were up by 12.0%; metal products and machinery (12.1%) grew by 9.1%; other manufacturing industries (3.1%) were up by 8.4%; chemicals, rubber, and plastic (1.5%) rose by 3.4%; basic metal industries (0.7%) grew by 18.9%; nonmetallic products (0.4%) were up by 23.6%; while paper, printing, and publishing (5.3%) declined 0.2%.

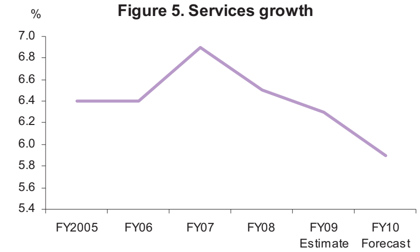
Figure 4. Growth of small-scale manufacturing production



Services

13. The service sector accounts for over half of the country's GDP. Over the years, growing dependence of domestic services on remittance inflows increased the service sector's linkages with the external world. Sector performance is integrally connected to the performance in agriculture and industry through both forward and backward linkages. A deceleration in income growth due to the global recession, particularly the moderation in trade flows and industrial performance, affected the performance of the service sector during the first half of FY2010. Among the leading services, transport appears to have been the most severely affected by decreased trade and industrial activity. The effect on the real estate sector is also quite pronounced. Growth in telecommunications is slowing due to the higher base, and slowdown in horizontal and vertical market expansion, while wholesale and retail trade has been affected by compressed demand. The banking and insurance sector, despite earning moderate profits, could not return to the precrisis scenario, mainly due to lack of investment demand coupled with income contraction and dampened trading activities. As a result, service sector growth is projected at 5.9% in FY2010, down from 6.3% in FY2009 (Figure 5).

Figure 5. Services growth



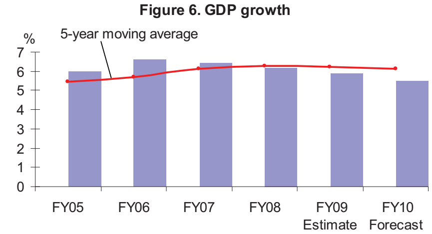
Economic Growth

14. Compared with most Asian developing countries, Bangladesh attained a reasonably healthy economic growth of 5.9% in FY2009. At the initial stage, lower integration of the country’s financial sector with the global financial system and the absence of any exposure of the banking system to toxic assets, kept the economy insulated from the adverse effects of the global financial meltdown. Although Bangladesh’s two main growth drivers—exports and remittances—are directly linked to the health of the global economy, they too remained relatively unaffected in the first year of the global crisis. The country’s export concentration at the low-end of the RMG product market protected Bangladesh, as demand for these products was not seriously affected in the initial phase. The appreciation of the yuan and the graduation of the People’s Republic of China from this market segment also allowed Bangladesh to maintain healthy growth of the predominantly RMG exports. The government's adoption of the first stimulus package in April 2009 to support the export of non-RMG products also seems to have contributed to slowing their pace of decline. The growth in remittances was less affected as Bangladesh relies on oil-rich middle-eastern countries for more than 60.0% of

remittance inflows. These countries were able to maintain the bulk of their construction activities as oil prices remained high through most of the crisis period. In addition, the large outflow of workers in 2007 and 2008 was helpful in maintaining the reasonably high growth in remittances, as these new workers began to send remittances after an initial period of settling down. The better services provided by the banks along with offering attractive interest rates and the likely transfer of past savings also contributed to maintaining the still robust growth in remittances as did the favorable taka exchange rate.

15. After the April 2009 stimulus package, which included support to agriculture, exports, power, and social safety net programs, the government introduced, through the FY2010 budget in June 2009, measures to stimulate domestic demand and increase supply-side competitiveness. The government also announced a vastly higher annual development plan (ADP) and introduced a new public–private partnership scheme to encourage private participation in infrastructure finance. In addition, the government further expanded the safety net programs and added some new programs to create jobs and enhance income of vulnerable groups. These later measures along with the enhanced assistance to agriculture appear to have contributed to maintaining food security and strengthened social protection. With the slow investment response,[4] continued decline in RMG and other export items, slower remittance growth, acute power and gas shortages, and slower implementation of the ADP, the country's growth for FY2010 is projected at 5.5% (Figure 6).

Figure 6. GDP growth

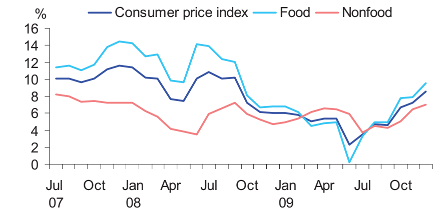


16. Over the medium term, the government wants to attain GDP growth of 6.7% in FY2011, and 8.0% by FY2014. Moving to the higher growth trajectory will require raising the country's investment-to-GDP ratio by at least six to eight percentage points, from 24.0% to 30.0%–32.0% of GDP. To attain the higher growth targets, private, public, and foreign direct investment (FDI) need to increase. The country's investment climate will require significant improvement. The financial sector has to cater for higher investment demand. Development of the domestic bond market is important as a source of long-term funds (e.g., pension and insurance funds) for

[4] The sign of a gradual pickup in investment is evidenced by the 37.4% rise in opening of import L/Cs for capital machinery and 14.1% rise in L/C opening for machinery and miscellaneous industry only during July–December 2010. In addition, industrial term loans have increased by 9.1% during July–September 2010.

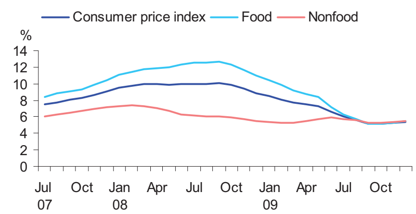
investment in infrastructure. The size and quality of the ADP needs to be significantly raised. The government has yet to operationalize public–private partnerships; this will require major institutional capacity building. Higher inflow of FDI is needed to expand the production base to cater to both domestic and external markets, upgrade technology, introduce efficient work and management practices, and develop entrepreneurship. FDI inflow has played a greater role in countries like Cambodia, Lao People's Democratic Republic, Sri Lanka and Viet Nam. Bangladesh should seize the opportunity of the ongoing relocation of industries from east Asian countries to countries with lower labor costs, and capable of providing required infrastructure facilities and a sound business environment.

Figure 7. Inflation, point-to-point



17. To spur investment and growth, the government should continue to maintain macroeconomic stability and fiscal prudence. Limiting inflation is vital for ensuring pro-poor growth. The government needs to raise the revenue–GDP ratio to increase public investment, especially for financing infrastructure projects, and avoid inflationary financing of public investment through larger domestic borrowing, which would also crowd out private investment. Raising foreign aid absorption capacity is vital for overcoming resource constraints and maintaining macroeconomic balance.

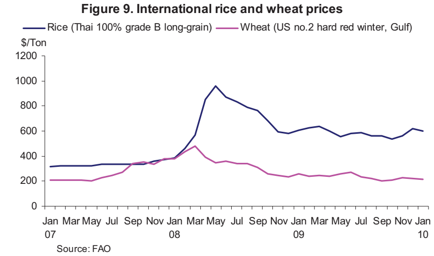
Figure 8. Inflation, 12-month moving average



Inflation

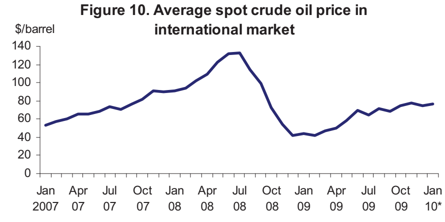
18. Inflation rose steadily from 2.3% year-on-year in June 2009 (90-month low) to 4.6% in September, and then to 8.5% in December 2009 (Figures 7 and 8). Both food and nonfood inflation contributed to the recent price hike. While food inflation edged up to 9.5% in December 2009 from 0.3% in June, nonfood inflation rose to 7.0% from 5.9%. Inflation is more pronounced in urban areas (9.1% in December 2009) than rural areas (8.3%). The effects on crop production of unfavorable weather and the rising trends in prices of rice (Figure 9) and other commodities, including oil (Figure 10), in the international market contributed to the recent price escalation.

Figure 9. International rice and wheat prices



19. Inflation in the coming months will depend on several underlying factors. The rising commodity prices in the international market will be a key factor. However, the renewed attention of the government to boosting agricultural production and measures taken to enhance the availability of farm inputs (e.g., the cut in fertilizer prices announced in November 2009) will help to stabilize food prices. The excess liquidity in the banking system and

Figure 10. Average spot crude oil price in international market



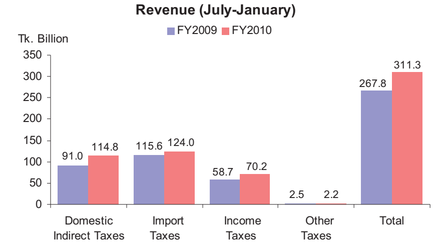
higher than targeted broad money growth may create further inflationary pressures.

20. The government took several measures to keep inflation in check. In early December 2009, the government imposed a ban on rice exports to stabilize rice prices and ensure availability of the staple in the domestic market. Also, focusing on the objectives of food price stability and ensuring food security, the government issued “Krishi Cards” (agricultural cards) to 18.2 million farmers for fertilizers, agricultural loans, and subsidies for diesel and other inputs. In January 2010, the government started open market sales of rice in Dhaka, the capital city, and adjoining districts to stabilize rice prices. The government also introduced fair price cards in February for 2.5 million ultra-poor families across the country, under which families with no permanent income or land and not enlisted for any social safety net programs would receive 20 kilograms of rice per month at Tk22.0 a kilogram for 3 months.

Fiscal Management

21. Raising the revenue–GDP ratio is a major fiscal challenge. Bangladesh's tax–GDP ratio (9.0% of GDP in FY2009) is 3.5 percentage points lower than the average (12.5%) in developing Asian countries, and the lowest among its South Asian neighbors. To reduce dependence on foreign aid, increase public investment, and enhance debt sustainability, the government intends to scale up revenue earning by 0.7 percentage points annually over the medium term. The FY2010 budget targets 11.6% growth in revenue receipts over revenue earning in FY2009. The government is implementing a number of reform measures focusing on enhancing efficiency of the National Board of Revenue (NBR). The latest NBR data show that tax revenue rose by 16.2% during the first seven months of FY2010 over the corresponding period of FY2009 (Figure 11).

Figure 11. Revenue collection by National Board of Revenue (July-January)



22. The FY2010 budget envisages a slight rise in nontax revenue earning from 2.2% of GDP in FY2009 to 2.3% in FY2010. During July–December 2009, nontax revenue rose by 8.7% over the corresponding period of 2008. The Bangladesh Telecommunications Regulatory Commission (BTRC) is a major source of nontax revenue. The provision to transfer the surplus revenue of BTRC to the government exchequer in the following year, along with lower profit received from Bangladesh Bank, has affected revenue from nontax sources. The government is in the process of revising the relevant laws to require transfer of

the surplus on 3—4 months basis, which is expected to compensate for the fall in profit from Bangladesh Bank.

23. Import-based taxes during the first seven months of FY2010 rose by 7.2%, with customs duties growing by only 1.1%, value-added tax (VAT) by 7.7%, and supplementary duties by 30.3%. The growth of import-based taxes improved, compared with the first quarter (July–September) of FY2010, because of growing import payments, especially with the rise in volume of imports and prices of oil and foodgrains in international markets. Responding to recent policy and procedural reforms and streamlining of administration, domestic indirect taxes recorded robust growth of 26.2% during the first seven months of FY2010. Domestic VAT grew by 28.4%, while supplementary duties rose by 22.5%. Income tax collections continued brisk growth (19.7%) during the first seven months of FY2010. The 10.7% decline in other taxes will have a negligible impact on overall collections due to their small share in total taxes.

24. The government has initiated a number of institutional measures to raise the tax-to-GDP ratio. These include reducing tax and duty exemptions, widening tax coverage by outsourcing tax identification and monitoring in upazilas, completing ongoing reforms to amend income tax and VAT laws within the current fiscal year, expediting efforts to raise taxes from domestic sources to compensate for lower customs duties due to trade liberalization, establishing a dedicated tribunal for resolving revenue disputes and promoting alternative dispute resolution, and continuing work to automate tax management.

25. Revenue from non-NBR sources is targeted at Tk29.6 billion in FY2010. During July–December 2009, Tk12.3 billion was earned, up by 2.8% over the same period of FY2009. Preannouncement of land registration at lower value decreased the collection of land registration fees during July–September of the current fiscal year, which affected earning from non-NBR sources. However, it will have limited impact on overall revenue growth due to its minor share (0.4% of GDP) of total revenue receipts.

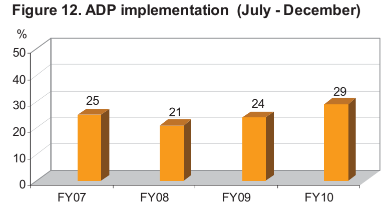
26. In the FY2010 budget, total fiscal spending is targeted to increase to 16.6% of GDP from 15.3% in FY2009. During the first half of FY2010, 34.8% of planned spending was implemented. In the FY2010 budget, current spending is targeted at 10.3% of GDP compared with 10.4% of GDP in FY2009. During the first half of FY2010, 36.9% of total current spending was implemented, up by 12.2% over the same period of the previous year.

27. During the first half of FY2010, the government spent less on agriculture subsidies, employment generation programs, interest payments, and food procurement accounts compared with the first half of FY2009. It did not receive any demand for subsidy from Bangladesh Petroleum Corporation during the first 6 months of FY2010. Further, during the first half of FY2010 no spending was made beyond the initial allocation for implementing the new pay scale for public servants.

28. The spending on social safety net programs is targeted to rise from 2.3% of GDP in FY2009 to 2.5% of GDP in FY2010. Implementation of these programs faces capacity constraints for field monitoring in line ministries. In addition, the government departments lack capacity to indentify real beneficiaries and prevent multiple entries of beneficiaries under various programs. To ensure that the benefits reach the needy and the vulnerable, institutional reforms will be necessary along with capacity building for the ministries.

29. Strengthening ADP implementation has direct implications for increasing the country's growth potential. Chronic underutilization of the ADP is a major weakness in the country's fiscal management. With a target to increase the size of the ADP to 6.0% of GDP over the medium term, the FY2010 budget announced the scaling up of the ADP from Tk230.0 billion in FY2009 to Tk305.0 billion in the current year. During the first half of FY2010, Tk88.1 billion (29.0% of total allocation) was spent, an improvement over (24.0%) over the same period of FY2009 (Figure 12).

Figure 12. ADP implementation (July - December)

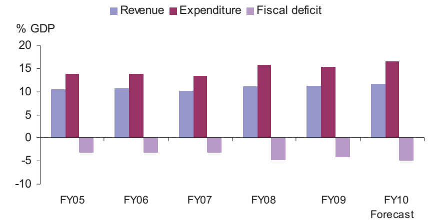


30. To increase ADP utilization, the government is implementing a number of institutional measures. These include ensuring discipline in planning; undertaking projects on the basis of implementation capacity of line ministries and divisions; setting priorities among projects; undertaking advanced procurement planning for ensuring smooth project implementation; ensuring matching funds for foreign-aided projects and intensively monitoring implementation progress; introducing a management information system; rationalizing the number of projects and expanding implementation capacity of large ministries such as education, communication, and local government; and establishing separate budget wings in ministries and divisions by reorganizing existing structures.

31. Implementation of the public spending program largely depends on performance of the top 10 ministries, which account for 41.5% of the total budget outlay and 76.0% of the total ADP. During the first half of FY2010, the

top 10 ministries spent 35.3% of the total allocation. Their utilization rates are education 40.8%, primary and mass education 38.7%, health and family welfare 28.6%, water resources 17.7%, housing and public works 3.9%, agriculture 37.5%, energy and mineral resources 74.0%, local government 39.5%, roads and railways 16.2%, and power 21.6%.

Figure 13. Fiscal deficit



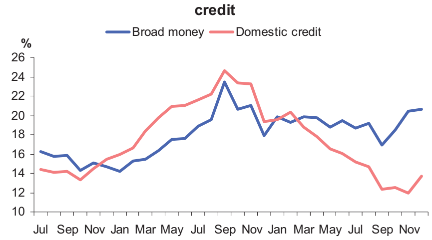
32. Because of the government's expansionary fiscal stance, the FY2010 budget is targeted to increase the fiscal deficit from 4.1% of GDP in FY2009 to 5.0% (Figure 13). During the first 6 months of FY2010, the fiscal deficit amounted to Tk40.0 billion, which is Tk46.7 billion less than the fiscal deficit during the same period of FY2009. This major decline in the fiscal deficit is attributed to higher growth in revenue compared with public spending.

33. To finance the deficit, the budget targets increasing external financing from 1.8% of GDP in FY2009 to 2.0% in the current year. The budget also targets increasing domestic financing from 2.3% of GDP in FY2009 to 3.0% in FY2010, of which financing from banking sources is targeted at 2.4% of GDP and from nonbanking sources at 0.6%. During July–December 2009, although domestic financing through banking system decreased by Tk72.5 billion over the same period in the previous year, financing from nonbanking sources, mainly through national saving certificates was higher at Tk51.8 billion compared with the whole year target of Tk38.0 billion. Higher interest rates on national saving certificates compared with that on bank deposits induced more investment on this account. This will raise the government's interest payment burden. To control the rising trend in interest payments, the government should improve its aid absorption capacity, reduce the interest burden by rationalizing interest rates on saving certificates, and promote competition in government bond and treasury-bills (T-bills) markets.

Monetary and Financial Developments

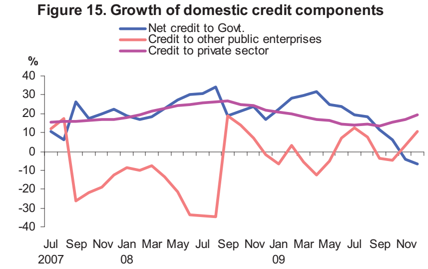
34. Broad money growth was 20.7% year-on-year in December 2009 (Figure 14), up from 17.9% in December 2008 and also significantly higher than the target growth of 15.5% in FY2010. This was caused by high growth in net foreign assets (78.7%) resulting from the large purchase of foreign exchange by Bangladesh Bank from the interbank market. Growth in domestic credit moderated to 13.7% from 19.3% in December 2008, well below the annual target of 15.6%. The fall in domestic credit was driven by the sharp drop in credit to the public sector. Although private sector credit growth was lower at 19.2% in

Figure 14. Growth of broad money and domestic credit



December 2009, down from 21.8% in December 2008, it was higher than in the earlier months of FY2010 as well as annual target of 16.7%. Net credit to government declined by 6.7% in December 2009, down from 16.7% growth in December 2008 (Figure 15).

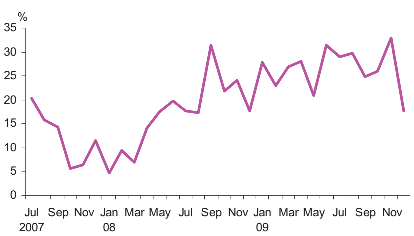
Figure 15. Growth of domestic credit components



35. Reserve money rose by 17.7% year-on-year in December 2009 (Figure 16) because of the rise in net foreign assets of Bangladesh Bank (82.3%), although net domestic assets declined sharply (55.7%). The reserve money multiplier rose to 4.7 at the end of December 2009 from 4.5 a year earlier. Excess liquidity of the scheduled banks reached Tk343.6 billion at the end of November 2009, up from Tk200.9 billion in November 2008, showing a significant lack of investment demand. Excess liquidity (measured as a percentage of deposits) rose from 8.6% in November 2008 to 12.4% in November 2009.

36. Bangladesh Bank conducted regular auctions of its 91-day, 182-day, and 364-day T-bills with their yields rising marginally to limit growth of liquidity in the banking system. For the same purpose, the central bank resumed auction of 30- and 90-day Bangladesh Bank bills alongside the regular auctions of reverse repos, although both the policy rates—repo and reverse repo—have remained unchanged at 4.5% and 2.5%, respectively.

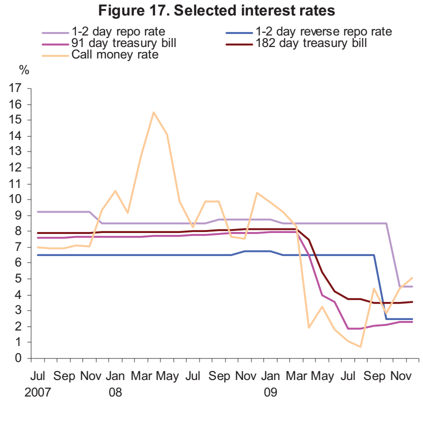
Figure 16. Growth of reserve money



37. The weighted average yield on 91-day T-bills rose to 2.3% in December 2009 from 2.1% in September 2009 and on 364-day bills to 4.6% from 4.3%, although yields on 182-day bills remained unchanged at 3.5%. While the interbank call money rate dropped to less than 1.0% in the beginning of the fiscal year due to the large excess liquidity in the banking system, it gradually rose to 5.1% by December 2009 as Bangladesh Bank attempted to withdraw excess money from the banking system (Figure 17). Credit demand also picked up, indicated by high growth of L/C opening for capital machinery imports.

38. The weighted average lending rate declined to 11.6% in September 2009 from 12.3% a year earlier and the deposit rate declined to 6.6% from 7.2%. The prevailing real deposit rates could turn negative if inflation accelerates. The interest rate spread narrowed to 5.0 percentage points in September 2009 from 5.2 percentage points in September 2008.

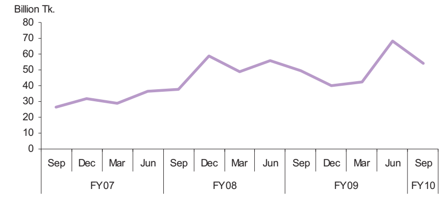
Figure 17. Selected interest rates



39. Industrial term lending and agricultural credit have recently started to increase following Bangladesh Bank's direction. The disbursement of industrial term lending stood at Tk54.0 billion during July–September 2009,

growth of 9.1% over the same period of 2008 (Figure 18). Of the Tk115.1 billion targeted for disbursement as fresh agricultural credit in FY2010, Tk56.0 billion (48.6%) was disbursed during the first half of FY2010, representing growth of 32.4% over the corresponding period of FY2009. Under its refinancing program, Bangladesh Bank disbursed Tk1.8 billion in the small- and medium-sized enterprise (SME) sector, Tk1.5 billion for the export sector, and Tk0.3 billion for women's entrepreneurship development during July–December 2009, although no refinancing took place in the agriculture sector.

Figure 18. Disbursement of term loans by banks and non-bank financial institutions



40. The commercial banks continue to prioritize loans to SMEs following Bangladesh Bank's policy directives. The outstanding loans to SMEs reached Tk424.9 billion in September 2009, 4.4% higher than in September 2008, although the ratio of SME loans to total loans in the banking system declined to 17.8% in September 2009 from 19.1% in September 2008. While the share of SME loans in total loans of private banks rose by 13.9%, that of state-owned commercial banks declined by 17.8%.

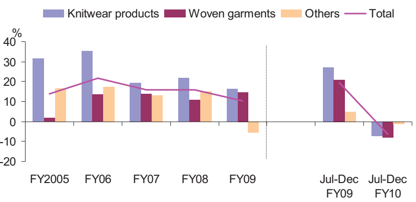
41. The high nonperforming loan (NPL) ratio remains a matter of concern despite progress in reducing it. In September 2009, the gross NPLs of the banking system accounted for 10.4% of outstanding loans compared with 12.3% in September 2008. Although the NPL ratio of state-owned commercial banks remained high at 23.6% in September 2009 (down from 29.3% in September 2008), their financial performance and operating efficiency through the major recovery of default loans improved significantly, thanks to the central bank's close supervision and monitoring. The central bank, in its efforts to implement the BASEL-II capital adequacy requirement for banks and nonbank financial institutions, is encouraging systematic evaluation of material risks to their capital base.

42. With the economic growth and inflation outlook for FY2010 unchanged, as reported in the July–December 2009 monetary policy statement (MPS) of Bangladesh Bank, the MPS for January–June 2010 seeks to continue the accommodative monetary policy stance to help exports recover and to encourage investment activities. Broadening financial inclusion through higher lending to sectors such as agriculture, SMEs, effluent and waste disposal, and renewable energy will receive priority under the latest MPS. The MPS also expects that the boost to production from improved credit availability will help contain FY2010 inflation within the target range of 6.5%.

Balance of Payments

43. Export earnings declined by 6.2% during July–December 2009 (Figure 19), raising concerns about the prospects of attaining the annual export target of $17.6 billion (12.8% growth over FY2009). The decline in exports was broad-based, led by the fall in RMG, with the exception of raw jute, jute goods, engineering products, petroleum products, and handicrafts.

Figure 19. Growth in exports and components



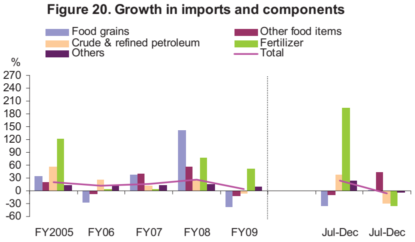
44. Among the export items, woven garments declined by 8.0% and knitwear by 7.2%, due to reduced demand in developed countries. Other major exportable items experiencing a decline are frozen food (17.9%), chemical products (42.0%), and leather (6.9%). Products experiencing robust growth during the period include raw jute (28.2%), jute goods (39.6%), and engineering products (37.6%), as these benefitted from the lower base due to the decline in exports in the previous year.

45. Primary product exports declined by 6.0%, while exports of manufactured products declined by 6.2%. Downward pressures on prices of exportables continued as the price index for primary products declined by 20.2% and manufacturing products by 1.6%. Although the volume index of primary products rose by 14.1%, that of manufacturing products declined by 4.6%.

46. The government allocated Tk18.0 billion in FY2010 as cash subsidy to boost the export sector, and has released half of that amount. Seventy percent of the export cash subsidy is provided instantly without examination. As a part of the export stimulus package, benefits such as loan rescheduling, reduction of interest rates for export loans, and cash subsidy are being provided. The government also took steps to promote export diversification to reduce the overwhelming dependence on RMG and reduce the susceptibility of the country's balance of payments to external shocks. For new export items and destinations (other than Canada, the European Union [EU] and the United States), a 5.0% subsidy is provided on export earnings in the first year, followed by 4.0% in the second year, and 2.0% in the third year.

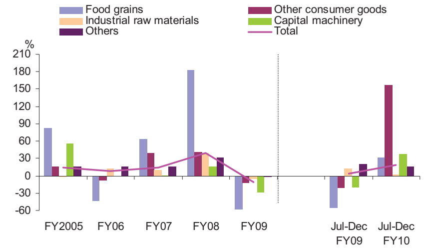
47. Import payments have followed a declining trend since the beginning of FY2010 due to the fall in imports of rice and other commodities, and also the decline in commodity prices in the international market. During July–December 2009, imports declined by 5.7% over the same period of 2008 (Figure 20). Among the major items, rice imports experienced a sharp fall (96.3%), followed by

Figure 20. Growth in imports and components



crude petroleum (36.4%), fertilizer (35.9%), refined petroleum (26.9%), and yarn (19.9%). Capital goods imports declined by 0.8%, indicating slower investment activity in the near future. Imports of wheat rose by 100.3%, edible oil by 29.6%, and sugar by 44.8%.

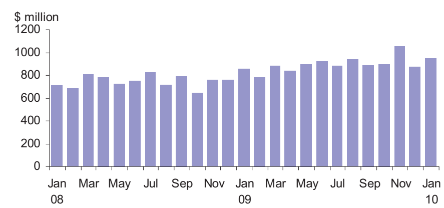
Figure 21. Growth in opening of import letters of credit



48. The total value of L/Cs opened during the first half of FY2010 grew significantly at 18.1% (Figure 21). This is in part caused by the recent rise in commodity prices in the international market and improved business confidence. L/Cs increased by 31.4% for the import of food grains, 37.4% for capital machinery, and 156.5% for other consumer goods; and declined by 4.6% for intermediate goods.

49. Despite the decline in out-of-country jobs, the growth in total remittances was significant during the first seven months of FY2010. Out-of-country workers remitted a total of $6.5 billion during the first seven months of FY2010, an increase of 20.9% over the same period of FY2009 (Figure 22). A series of measures taken by Bangladesh Bank to encourage expatriate Bangladeshis to send money through legal channels helped the growth of remittance inflows. It approved the establishment of 295 exchange houses and set up 840 drawing arrangements abroad, along with issuing clearance to local banks to establish contacts with international exchange houses through drawing arrangements.

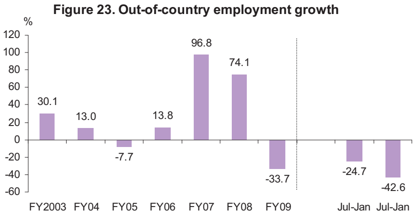
Figure 22. Workers' remittances



50. Compared with the record number of 875,055 out-of-country jobs in 2008, only 475,278 Bangladeshi workers obtained such jobs in 2009, reflecting the effects of the global economic recession (Figure 23). About 72,000 jobless Bangladeshi workers returned home in 2009, a 33.0% rise from 2008. In 2009, about 23,000 Bangladeshi workers returned from Saudi Arabia alone, the largest market for Bangladeshi workers.

51. Net FDI in Bangladesh during July–December 2009 was $197.0 million, a 67.3% decline from the same period of 2008. Foreign assistance (net of repayments) stood at $157.7 million during July–October 2009, compared with $419.7 million during the same period of 2008.

Figure 23. Out-of-country employment growth

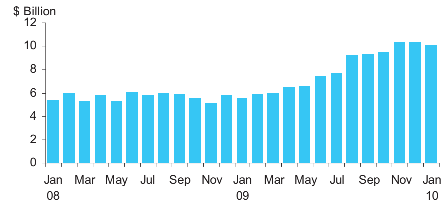


52. The trade deficit narrowed to $2.8 billion during July–December 2009 from $2.9 billion during the year earlier period, as the decline in imports more than offset the decline in exports. With the lower deficit in trade and services, and the still healthy rise in remittances (22.8%), the current account surplus rose to $1.7 billion during the first half of FY2010, from a deficit of $128.0 million in the

same period of the previous year. As a result, the surplus in the overall balance rose to $2.1 billion, up from $489.0 million during the first half of FY2009.

53. After crossing the $10.0 billion mark in early November 2009, the country's foreign exchange reserves continue to rise. Gross foreign exchange reserves of Bangladesh Bank reached $10.1 billion (over 5 months of imports) at the end of January 2010, up from $5.6 billion a year earlier (Figure 24). The continued healthy growth of remittance receipts and lower import demand contributed to the high growth of foreign reserves. In addition, Bangladesh Bank purchased a significant amount of foreign exchange from the interbank market to augment its foreign reserves.

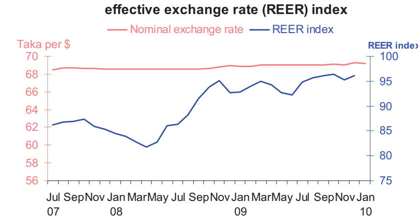
Figure 24. Gross foreign exchange reserves



Exchange Rate

54. The weighted average nominal (taka–dollar) exchange rate remained stable, from Tk69.0:$1 to Tk69.3:$1 during the first seven months of FY2010 (Figure 25). Bangladesh Bank's intervention in the foreign exchange market continues to keep the exchange rate stable as its net purchase from the interbank market stood at $1.6 billion until mid-January 2010. The real effective exchange rate continues to appreciate because of relatively higher domestic inflation, implying some erosion of export competitiveness.

Figure 25: Nominal exchange rate (taka-dollar) and real effective exchange rate (REER) index



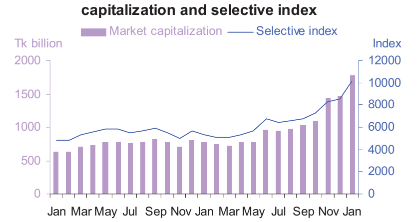
Capital Markets

55. The major stock market indicators showed an upward trend during the first seven months of FY2010, after exhibiting considerable volatility during FY2009. The index reached 5,367.1 points at the end of January 2010, a rise of 102.6% over January 2009 because of the listing of GrameenPhone (the country's largest mobile phone company) on the stock exchange and significant involvement of institutional participants in daily transactions. During the same period, market capitalization of the Dhaka Stock Exchange rose by 112.0%, from Tk1,024.3 billion (16.7% of GDP) in January 2009 to Tk2,171.4 billion (31.5% of GDP) by the end of January 2010, reflecting the listing of a large number of companies (a total of 16 companies listed in 2009) (Figure 26).

Figure 26. Dhaka Stock Exchange: Market capitalization and general index

56. The Chittagong Stock Exchange (CSE) selective categories index mostly followed the trend of the Dhaka Stock Exchange index. The CSE index rose to 10,150.2 points by the end of January 2010, a rise of 92.2% over January 2009. CSE market capitalization rose by 129.3% in the year to January 2010 (Figure 27).

Figure 27. Chittagong Stock Exchange: Market capitalization and selective index



57. The rapid rise in transactions in the stock market remains a concern for investors and companies. Due to the lower supply of shares compared with demand, along with the higher flows of liquidity in the absence of productive investment, prices are rising rapidly. To stabilize the market, the regulatory authority more frequently intervenes through precautionary administrative measures such as allowing a lower margin–loan ratio. Recently, the government enlisted five government-owned companies in the stock market. The process of offloading the shares of 39 government-owned companies is under way. The authorities need to reduce the cost of listing and address inefficient pricing mechanisms to encourage greater trading activity, which would help improve stability in the capital market.

EXPORT DIVERSIFICATION IN BANGLADESH: KEY ISSUES

Context

58. The RMG industry,[5] which accounts for close to 80% of the country's export earnings, has played a key role in Bangladesh's impressive economic growth over the past decade. The large number of jobs created in the RMG sector and in linked industries contributed immensely to maintaining social stability and reducing poverty. The sector has also promoted empowerment and self-reliance for women, as they comprise the majority of workers in this sector. The substantial foreign exchange earned through RMG exports support the import of machinery, raw materials, food grains, and other essential commodities. The rapid growth of RMG has also helped to develop a new class of entrepreneurs equipped with the knowledge and skills to undertake international business ventures with confidence. However, overwhelming dependence on RMG exports as a source of growth makes the country's economic performance excessively dependent on one particular sector. A major slippage in the dominant position that RMG currently enjoys could trigger significant instability in the balance of payments and upset the country's growth momentum. Bangladesh thus needs to diversify its export base to exploit the opportunities of higher growth and accelerated poverty reduction by utilizing the potential in other promising sectors, which would also help to maintain a more stable external position.

59. The benefits of export diversification are well documented in the trade literature. Export diversification can positively contribute to overcoming export instability, terms of trade shocks, and macroeconomic instability.[6] It is also associated with higher income growth rates and a number of spillover benefits (production, management, marketing, and informational), which serve to foster higher economic development. Using Chilean data, Herzer and Nowak-Lehmann found robust evidence that both horizontal (raising the number of export sectors) and vertical (movement from primary to manufacturing) export diversification benefit economic growth.[7] They proposed that horizontal diversification generates positive externalities as firms learn about foreign markets and improve their competitiveness. In addition, they suggest that primary industries including agriculture generally have low spillovers (and are vulnerable to declining terms of trade). Thus, any vertical diversification into secondary industries would result in stronger potential for learning and spillovers.[8] Lederman and Maloney find empirical support that export concentration results in lower overall economic growth.[9] They propose that the negative effects, including terms of trade volatility, associated with export concentration may outweigh the potentially positive effects such as scale economies. Most studies have suggested that export diversification may have direct economic benefits in the form of increasing economic

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5 Includes both woven and knitwear garments.

6 H. Hesse. 2008. Export Diversification and Economic Growth. Working Paper, the Commission on Growth and Development.

7 D. Herzer and F. Nowak-Lehmann. 2006. What Does Export Diversification Do for Growth? An Econometric Analysis. *Applied Economics* 38: 1825–38.

8 Al-Marhubi also tested the thesis that diversification could potentially lead to stronger economic growth through both knowledge spillover and less export volatility induced through shocks to primary commodity prices. He examined 91 countries between 1961 and 1988 and found a positive relationship between the level of export diversification and the rate of economic growth. F. Al-Marhubi. 2000. Export Diversification and Growth: An Empirical Investigation. *Applied Economics Letters,* 7(9). pp. 559–562.

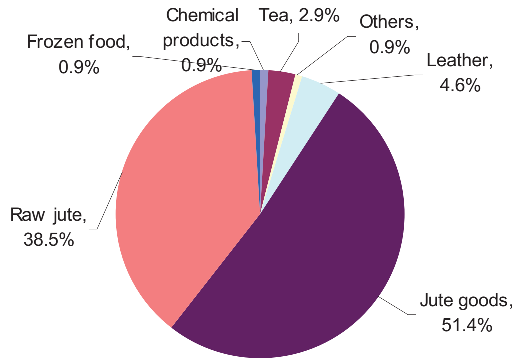
9 D. Lederman, and W. Maloney. 2007. Trade Structure and Growth. In *Natural Resources: Neither Curse Nor Destiny*. Palo Alto: Stanford University Press.

growth and positive industry spillovers.[10] It may also play a vital role in driving overall export growth,[11] which contributes to economic growth.

Trends in Export Concentration

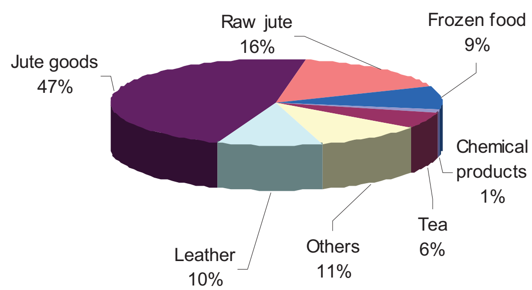
60. In the initial years after independence, Bangladesh's exports were dependent on primary commodities, such as raw jute and jute goods (Figure 28). Since the beginning of the 1980s, the contribution of these items to the country's total export earnings declined, due to their falling prices in the international market (Figure 29). As leather, frozen foods, and shrimp emerged as important export items, total earnings export continued to rise with a lower overall concentration in the export base.

Figure 28. Composition of Bangladesh's export, 1972/73 (% of total exports)



Source: Export Promotion Bureau.

Figure 29. Composition of Bangladesh's exports, 1982/83 (% of total exports)



Source: Export Promotion Bureau.

61. Starting from a narrow base in the mid 1980s, the spectacular growth of RMG during the 1990s and subsequent years has resulted in two major changes in the country's export structure. First, the country's export sector experienced a structural transformation in switching from a primary commodity-based structure to one that is manufacturing-based (Figure 30). Second, as the value of jute and tea exports fell in absolute terms, and other commodities such as leather, frozen foods, and shrimp did not grow as strongly as RMG, the country's export structure came to be dominated by RMG (Figure 31). Although, the number of export items rose from 25 in FY1973 to 673 in FY2007, except for RMG, none of the products exhibited any consistent pattern of growth to cause effective diversification of the export base.

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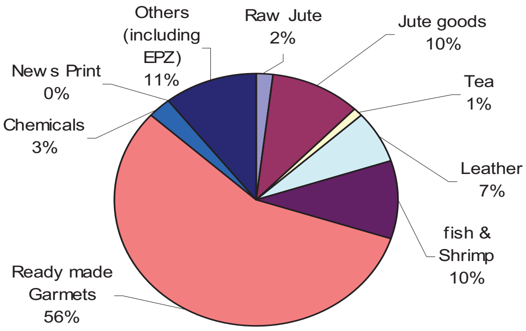
[10] S. Raihan and A. K. Adhikari (eds.). 2007. *Export Diversification for Human Development in Post-ATC Era: Perspectives from LDCs*. New York : United Nations Development Programme.

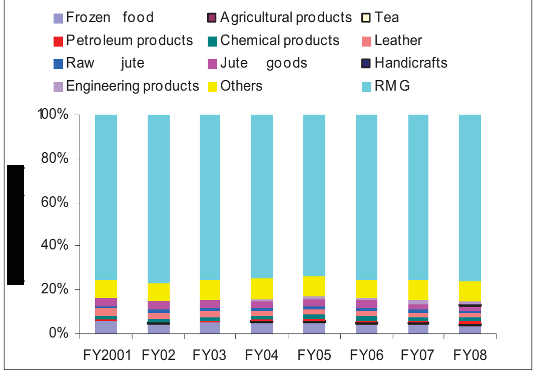
[11] Brenton and Newfarmer found that export diversification accounted for 57% of the total export growth in some African nations. P. Brenton and R. Newfarmer. 2007. Watching More Than the Discovery Channel: Export Cycles and Diversification in Development. *World Bank Policy Research Working Paper No. 4302.* Washington, DC: World Bank.

Figure 30. Composition of Bangladesh's export, 1994/95 (% of total exports)



Source: Export Promotion Bureau.

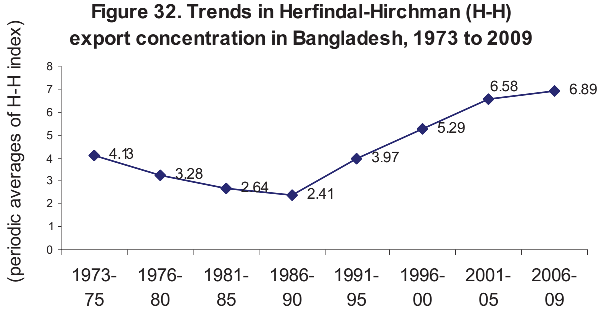
Figure 31. Composition of Bangladesh's export, FY2001 to FY2008



Source: Export Promotion Bureau.

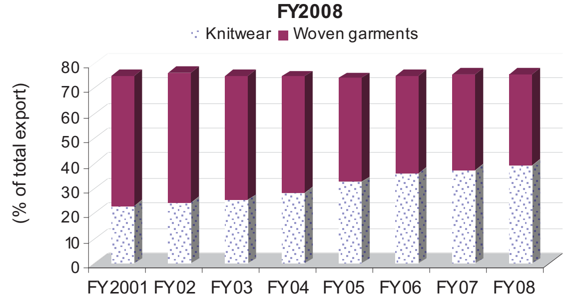
62. Bangladesh's export concentration is evidenced by the high value of the share of the top 10 products (all belonging to the RMG industry) in the total export basket. A well-known measure of commodity concentration is the Herfindahl-Hirschman index (H-HI).[12] The value of the H-HI ranges from zero to unity, with a higher value implying a higher concentration of export structure. A number of studies found higher value of HH-I for Bangladesh's export structure.[13] All studies report that the value of H-HI for Bangladesh is still rising, implying growing concentration of the country's export base. This finding is confirmed by the growing share of RMG in the total export basket. The H-HI calculated for 1973–2009 (Figure 32) shows that starting from a higher level, the HH-I declined until the mid-1980s because of the falling share of jute and jute goods, and the rising share of frozen foods, shrimp, and leather products. Since the late 1980s, the HH-I is growing because of RMG's rising share in the export basket.

Figure 32. Trends in Herfindal-Hirchman (H-H) export concentration in Bangladesh, 1973 to 2009



Source: Asian Development Bank estimates.

Figure 33. Composition of RMG export, FY2001 to FY2008



Source: Export Promotion Bureau.

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[12] The Herfindahl-Hirschman index can be expressed as

$$HH_i = \sum_{i=1}^{n} (S_{it})^{2}, \text{ Where, } s_{it} = \frac{X_{it}}{\sum_{i=1}^{n} X_{it}}$$

s_{it} is the share of commodity *i* in the country's total export at time t. Value of the HH_i ranges between 0 to 1. The higher the value of HH_i, the greater is the degree of concentration.

[13] International Monetary Fund. 2008. Bangladesh: Selected Issues, *IMF Country Report No. 08/335*. A. Razzaque and Selim Raihan. 2008. *Venturing into a Quota-Free World: The Ready Made Garment Industry of Bangladesh*. Pathak Somabesh Dhaka. O. H. Chowdhury and William van der Geest (eds.) 2004. *Economic Reform in South Asia*. Dhaka: University Press Limited.

63. Since the mid-1990s, exports of knitwear have risen at the expense of woven garments (Figure 33). In FY2001, knitwear exports made up 23.1% of total exports, while woven garments represented 52%. In FY2008, knitwear exports increased to 39.2% of total exports, and the share of woven garments to 36.6%. The sustained growth of RMG provided impetus to develop backward linkage industries, which contributed to some diversification of the domestic manufacturing base.

64. Despite fluctuating trends, several items have demonstrated good export potential. Items such as pharmaceuticals, leather goods, frozen foods, shipbuilding, and information technology enabled services (ITES) can emerge as significant export items from their current narrow product space. For this to happen, the country's investment climate must be improved.

65. Bangladesh’s pharmaceutical industry is among the largest in the least-developed countries (LDCs), catering to nearly 96% of domestic demand and exporting ($43 million in FY2008) to more than 50 countries (mainly other LDCs). Similarly, leather and leather products have bright prospects to contribute to export diversification. In FY2008, Bangladesh exported leather products valued at $463 million. Prospects for leather exports have been hampered by infrastructure and financing constraints, and lack of environment-compliant treatment plants and raw material supplies. Frozen food (mostly shrimp and other fish) exports were $534 million in FY2008, although the sector was badly hit by the 2007 cyclone. Warm tropical weather with vast areas of inland water and 480 kilometers of coastline offer a huge reserve of freshwater fish, shrimp, and seafood; and provide ideal conditions for aquaculture.

66. Another potential export item is the ITES. In 2007, Bangladesh exported $300 million worth of data processing, software, and other ITES services. In 2007, the global marketplace for ITES was estimated at more than $1 trillion, growing at a staggering rate of 30%. Shipbuilding has also emerged as a promising export industry. In 2007, local shipbuilders received more than $500 million of foreign contracts. Ship export has tremendous potential with a global market size of $400 billion. To cater to this market, Bangladesh has to meet daunting investment needs in shipbuilding infrastructure and human resource development. With cheap and easily trained labor and demonstrated ability of learning by doing, Bangladesh is favorably positioned to diversify exports into these sectors. The fact that entrepreneurs in these sectors have remained engaged through challenging circumstances is a testament to their confidence in these sectors' ability to become profitable sources of exports.

67. A notable aspect of the country's export concentration is that its exports are confined to a few external markets. While as noted, about 80% of the country's exports are concentrated in textile, over 90% of those exports are destined fro US and EU markets[14]. During the 1990s, Bangladesh made modest progress in diversifying export markets by increasing its export share to EU countries. Despite high potential, Bangladesh could not seize the opportunity of duty-free market access to Canada, Japan and the EU because of its narrow export base and failure to comply with the minimum threshold of domestic value-added content. In addition, trade similarity among the member countries coupled with institutional bottlenecks prevented Bangladesh from benefiting from preferential trading arrangements within the SAFTA (South Asia Free Trade Agreement) framework.

[14] Computing Finger-Krenin market concentration indices and Polarzation Index, Chowdhury and Geest found that Bangladesh's export markets became narrower from 1889/90 to 1999/00. O. H. Chowdhury and William van der Geest (eds.) 2004. *Economic Reform in South Asia*. Dhaka: University Press Limited.

Government Policy for Export Diversification

68. Export diversification remains a key element of the government's development strategy. The Export Policy, 2006–2009 contained the broader strategies for export diversification currently being implemented.[15] In addition, the National Strategy for Accelerated Poverty Reduction II (NSAPR II) outlines the government's medium-term strategies to accelerate export diversification. The Ministry of Commerce created a number of sector- and product-specific business promotion councils for diversifying exports, improving and ensuring product quality, acquiring appropriate technology, and maintaining compliance requirements and product marketing.

Export Policy 2006–2009

69. Through the export policy, the government took various sector- and product-specific steps for export diversification. It identified product sectors as "highest priority sectors" and "special development sectors." Under the highest priority sectors, the product sectors with special export potential are agroproducts and agroprocessing products, light engineering products (including automobile parts and bicycles), footwear and leather products, pharmaceutical products, software and information communication and technology products; and home textiles. Product sectors included in the special development sectors are finished leather, frozen fish production and processing, handicraft products, electronic products, fresh flower and foliage, jute products, handwoven textiles from the hill areas, uncut diamonds, and herbal medicine and medicinal plants.

70. In the highest priority sectors, the policy covers sectors with special export potential, but where such potential could not be fully utilized due to specific constraints. Therefore, adequate support is needed to help these sectors flourish. In the special development sectors, product sectors with export potential but where production, supply, and the export base are not well organized were included. The new export policy (to be announced) for 2010–2013 is expected to outline measures to boost export diversification.

National Strategy for Accelerated Poverty Reduction II

71. In the NSAPR II, FY2009–2011, the government targets increasing the export share to non-US and non-Euro markets to 35.0% from the existing 28.5% as part of diversifying export destinations. On the other hand, to diversify export items, the government targets increasing the nongarment export share to 35.0% from the present 21.0% within the NSAPR II period.

72. To diversify export commodities, the government is enhancing cash incentives for products such as handicrafts, agroprocessing, vegetables and vegetable-processing, pharmaceuticals, and light engineering; it is providing both cash and credit incentives for products from SMEs and nontraditional items. The government plans to enhance fiscal, monetary, and other incentives to broaden the export base, and undertake market studies in several countries to identify demand and problems with marketing existing products. The government also plans to establish small special economic zones in different parts of the country for cluster development of products and facilities.

73. To diversify export destinations, the government has taken measures to explore markets, especially in east European countries. The Bangladesh Garments Manufacturers and

[15] The government has drafted the Export Policy for 2010–2013, which will be announced soon.

Exporters' Association has employed a lobbyist to obtain duty-free access for RMG to the US. Bangladesh already has quota and duty-free access to the Australia, Canada, EU, Norway, and New Zealand. The government plans to continue initiatives to diversify exports by increasing participation in international fairs and exhibitions and strengthening the Bangladesh Standards and Testing Institute and Bangladesh Accreditation Board to control quality of exports and to provide certification and accreditation.

Policy Issues

74. **Maintaining macroeconomic stability**: Macroeconomic stability is essential for promoting private sector led export diversification, especially for attracting new investment in potential export sectors. Inflation and the tax regime have direct linkages with external sector performance. Tax policy should ensure neutrality in terms of incentives so that sectors having comparative advantage can develop. Bangladesh should build on its success in maintaining a competitive exchange rate regime to enhance external competitiveness.

75. **Competitive trade regime:** The significant anti-export bias in Bangladesh's trade regime needs to be addressed. Import duties should shift from revenue generation to more of a trade facilitating role. The export sector, which is very import intensive, should be able to procure inputs at world prices. The Duty Exemption and Drawback Office should be modernized to make it more service-oriented. In addition, trade facilitation measures should be expedited through modernizing the customs establishment and improving trade logistics.

76. **Conducive investment climate.** The investment climate needs to be improved to reduce the cost of doing business and make entry and exit easier. Special attention particularly needs to be given to SMEs, where full potential cannot be utilized without a supportive investment climate.

77. **Removal of infrastructure bottlenecks.** Infrastructure needs to be improved to lower business costs and promote new investment, and raise the productivity and competitiveness of firms. The problem of finding suitable land for setting up new industries is a serious one and needs to be carefully addressed. Infrastructure facilities, such as roads, transport, electricity, gas, ports, and telecommunication services need to be expanded. In particular, lack of power and energy is a key constraint to new investment, which is reflected in the very poor *perception index* for quality of infrastructure in Bangladesh compared with other South Asian neighbors[16]. Public investment in infrastructure is inadequate, and it is severely affected by lower ADP utilization, while foreign investment is meager due to structural and institutional bottlenecks. The government lacks experience and institutional capacity to quickly operationalize its new public private partnership framework to encourage infrastructure investments. Infrastructure bottlenecks have seriously hampered industrialization in the country's north, northwest and southwest regions. Developing the Dhaka-Chittagong Economic Corridor and setting up special economic zones[17] could be given consideration for promoting export diversification.

78. **Financing.** The efficiency of the financial sector needs to be improved through reducing NPLs and cutting operational costs to lower the cost of borrowing. Access to financing needs to be increased for entrepreneurs keen on setting up new firms, and also for those seeking to invest in technology and product quality improvements.

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[16] World Economic Forum. 2008. *Global Competitiveness Index.*

[17] Japan International Cooperation Agency designed a detailed road map for developing special economic zones in 2006.

79. **Identification of new products.** To diversify the export base, it is essential to identify and develop new products. The capacity of enterprises for product and process innovation, and access to competitive supply need to be enhanced. The transition to specialized and differentiated products or to niche products, and vertical diversification could allow enterprises to strengthen their positions in the commodity chain. The challenge is to identify opportunities, recognize requirements, and ensure timely response to market opportunities. With comparative advantage changing over time, diversification opportunities must be continuously sought, even away from areas that seem successful, into other high-value products. In addition to an across-the-board conducive incentive regime, the government should design a sector-specific action plan under its new export policy order to promote export diversification.[18]

80. **Standardization and quality improvement.** Improving quality of exports is vital for enhancing competitiveness in the international market and for successful diversification of the country's export base. Training and dissemination of information need to be strengthened to enhance understanding and meeting internationally accepted standards.

81. **Development of skills and productivity.** To increase the productivity of firms, a supply of skilled labor, particularly for mid-management, needs to be ensured and access to modern technology enhanced. Scope for on-the-job training for operational staff needs to be created. Links between private enterprises and national research institutes should be established to support the diffusion of technology.

82. **Promoting regional and subregional cooperation.** Regional/subregional cooperation can act as an effective tool for promoting export diversification. Through tapping the regional/subregional complementarities, the country's export structure can become more dynamic and diversified. An integrated regional/subregional market will enhance economies of scale, and foster other dynamic catalysts to export diversification. Developing regional institutions can contribute to product differentiation, and raise quality and standardization. Bangladesh should utilize its geographical advantage as the gateway to central Asia and east and southeast Asia through greater connectivity and integration with the neighboring countries, particularly India and Myanmar. Higher connectivity in the South Asia region will increase both intra and inter regional trade and investment. In particular, Bangladesh can address its power and energy shortages through regional/subregional cooperation, which are essential for facilitating industrialization, including export diversification.

Concluding Observations

83. Cross country evidence suggests that export diversification not only reduces potential shocks to a country's balance of payments and economic growth prospects, it also enhances a country's trade and investment flows and supports a more balanced economic development. Bangladesh's trade regime needs to be reviewed and reoriented to support a more diversified export base. For diversification of Bangladesh's export base, efficiency in production needs to be raised and competitiveness of potential export items enhanced to create opportunities in global markets. The areas of the country's comparative advantage need to be identified and exploited. The business environment also needs to be improved to encourage larger inflows of FDI in export-oriented manufacturing.

[18] Japan International Cooperation Agency (2009) recently prepared a detailed road map for 12 potential export sectors in Bangladesh.

Table 1: Benefits and Facilities for Respective Sectors

Highest Priority Sectors	Special Development Sectors
1. Project loans with reduced interest rates 2. Income tax exemptions 3. Subsidies compatible with WTO Agreement on Agriculture, and WTO Agreement on Subsidies and Countervailing Measures 4. Financial benefits or subsidies for utility services such as electricity, water, and gas, provided these are compatible with WTO Agreement on Agriculture, and WTO Agreement on Subsidies and Countervailing Measures 5. Export loans with soft terms and lower interest rates 6. Reduced air travel fares 7. Duty draw-back and bond facilities 8. Privileges for establishing backward linkage industries including infrastructure development to reduce production cost 9. Expansion of institutional and technical facilities to improve and control product quality 10. Assistance in production and marketing 11. Assistance in foreign market search 12. Initiatives to attract foreign investment	1. Project loans on a priority basis 2. Export loans with soft terms and lower interest rates 3. Subsidies compatible with WTO Agreement on Agriculture, and WTO Agreement on Subsidies and Countervailing Measures 4. Reduced air fare for shipment of products 5. Duty draw-back and bond facilities 6. Privileges for establishing backward linkage industries including infrastructure development to reduce production cost 7. Expansion of technical facilities to improve product quality 8. Assistance in product marketing 9. Assistance in foreign market search 10. Financial benefits for utility services such as electricity, water, and gas 11. Initiatives to attract foreign investment

WTO = World Trade Organization. .
Source: Export Policy 2006-2009, Ministry of Commerce, December 2007. .

Table 2: Exports by SITC (Standard International Trade Classification) Sections

SITC	2007 ($ million)	Average Growth Rate (%) 2003–2007	Average Growth Rate (%) 2006–2007	2007 Share (%)
Total	**13,143.00**	**19.70**	**12.40**	**100.00**
0+1	856.10	23.40	23.70	6.50
2+4	452.60	64.00	104.50	3.40
3	213.30	79.20	139.50	1.60
5	176.40	19.20	22.00	1.30
6	1,406.80	23.00	(23.10)	10.70
7	335.40	51.20	72.50	2.60
8	9,698.70	17.00	13.80	73.80
9	3.70	38.10	3,368.30	0.00

Source: International Trade Centre, 2008.

Table 3: Top 10 Export Commodities 2005 to 2007

HS Code	All Commodities	Value ($ million)			% share		
		2005	2006	2007	2005	2006	2007
6203	Men's or boys' suits, ensembles, jackets, blazers, trousers	1,399.1	1,923.5	21,83.8	15.0	16.4	16.6
6109	T-shirts, singlets and other vests, knitted or crocheted	1474.9	1,886.6	2,087.1	15.8	16.1	15.9
6110	Jersey, pullovers, cardigans, waist-coats and similar articles, knitted or crocheted	995.0	1,209.4	1,300.0	10.7	10.3	9.9
6204	Women's or girls' suits, ensembles, jackets, blazers, dresses, skirts	807.7	935.3	1,033.6	8.7	8.0	7.9
6205	Men's or boys' shirts	821.4	849.1	841.3	8.8	7.3	6.4
0306	Crustaceans, whether in shell or not	354.9	482.6	612.6	3.8	4.1	4.7
6105	Men's or boys' shirts, knitted or crocheted	286.3	307.9	359.6	3.1	2.6	2.7
5209	Woven fabrics of cotton, containing 85% or more cotton by weight	12.7	692.1	12.3	0.1	5.9	0.1
6108	Women's or girls' slips, petticoats, briefs, panties, nightdresses	107.3	140.8	389.6	1.1	1.2	3.0
6302	Bed linen, table linen, toilet linen, and kitchen linen	148.3	201.5	247.1	1.6	1.7	1.9
	Total	**9,331.6**	**11,696.7**	**13,143.0**			

HS = Harmonized System. .
Source: International Trade Centre.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two thrids of the world's poor. Around 903 million people in the region live on $1.25 or less a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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