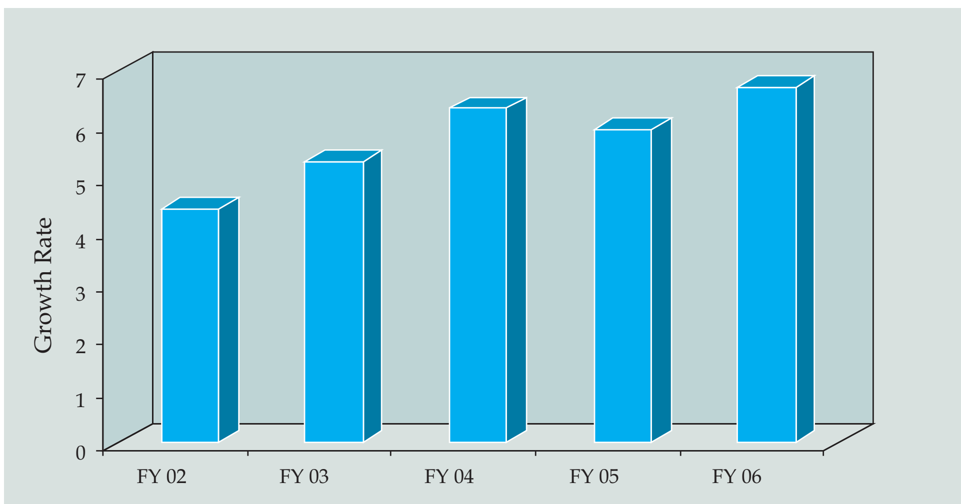
Chapter 2

Developments in Aggregate Demand

2.1 Domestic Demand [10]

Domestic demand is estimated to have grown by 6.09 percent in FY06 which is 0.25 percentage points higher than that of the previous year.[11] In FY05 Bangladesh realized a real GDP growth of 5.96 percent which had earlier been provisionally estimated to be 5.4 percent (as mentioned in the October 2005 Monetary Policy Review). Growth gained further momentum and is provisionally estimated to have been 6.7 percent in FY06.

Figure 2.1 : *Growth Rate of Real GDP*



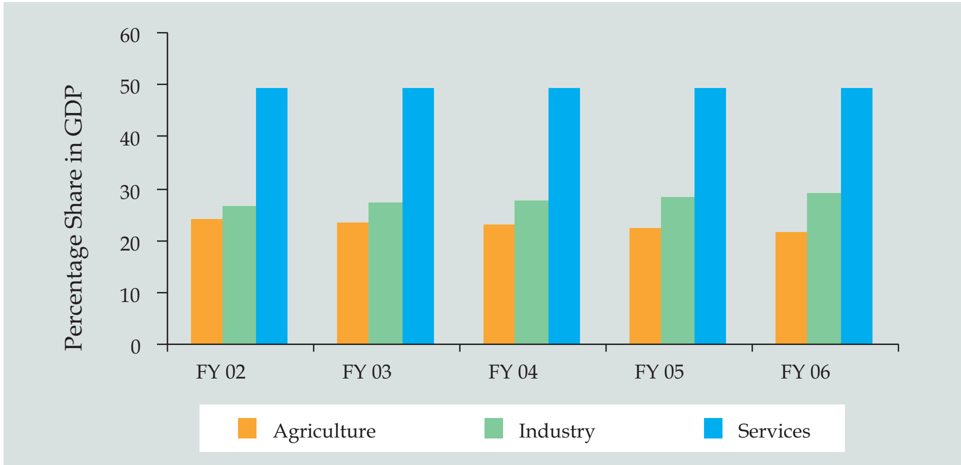
Source : Bangladesh Bureau of Statistics (2006)

Figure 2.2 shows that the share of industry in total GDP is estimated to have increased further in FY06 to 29.01 percent from 28.31 percent in FY05. The share of agriculture maintained its declining trend and decreased to 21.77 percent in FY06 from 22.27 percent in FY05. Share of service sector is essentially stable, though decreasing marginally from 49.42 percent in FY05 to 49.22 percent FY06.

The combined production of four major agricultural crops namely *Aus, Aman, Boro* and Wheat which had decreased by 4.7 percent from 27.4 million metric tons (MMT) in FY04 to 26.1 MMT in FY05, mainly due to flooding, increased to 27.3 MMT in FY06.

[10] Prepared by Mainul Islam Chowdhury, Research Economist, PAU.
[11] All FY06 figures are based on provisional estimates recently released by BBS.

Figure 2.2 : *Sectoral Share of GDP*



Source : Bangladesh Bureau of Statistics (2006)

Growth of animal farming and fisheries are estimated to have been 6.31 and 3.89 percent respectively in FY06 as against the realized growth of 7.23 and 3.65 percent respectively in FY05. On the whole, the agriculture sector is estimated to have grown by 4.49 percent in FY06 as against 2.21 percent in FY05.

Industrial output growth is estimated to be higher at 9.56 percent in FY06 as against 8.28 percent in FY05. Industrial output has been growing steadily since FY02 and the annual average growth during the last five years has been 7.84 percent. Growth in large and medium scale manufacturing industries is estimated to have risen by 11.04 percent and in small scale industries by 9.04 percent in FY06. Realized figures in FY05 were 8.30 and 7.93 percent respectively. According to the Quantum Index of Manufacturing Industries growth is expected to have occurred in all sub-sectors during FY06. Growth of RMG exports and its components, woven garments and knitwear products during the fourth quarter of FY06 over the corresponding period of FY05 is estimated to be 33.3, 47.5 and 21.42 percent respectively.

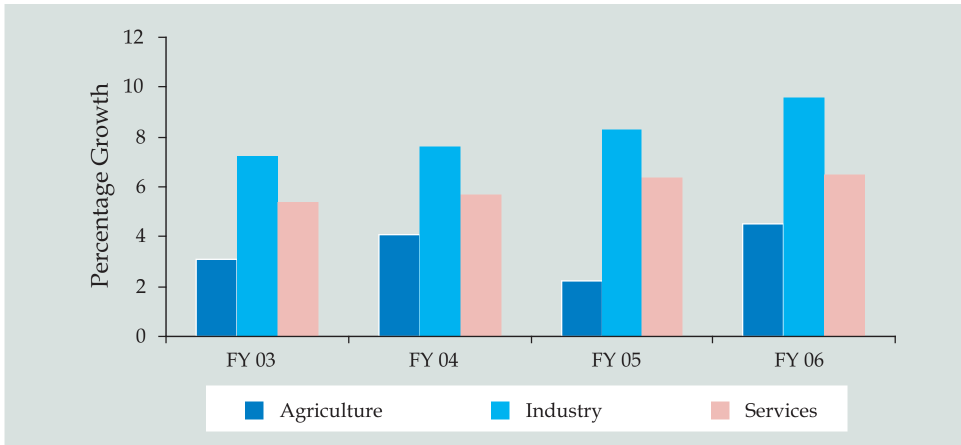
Table 2.1 : ***Sectoral share of GDP at Constant Prices***

	FY05	FY06 (p)
I. Agriculture	**22.27**	**21.77**
a) Crops and Horticulture	11.67	11.41
b) Animal Farmings	2.44	2.42
c) Fishing	4.35	4.06
II. Industry	**28.31**	**29.01**
a) Mining and Quarrying	1.14	1.14
b) Manufacturing	16.53	17.19
c) Construction	8.17	8.38
III. Service	**49.42**	**49.22**
a) Wholesale and Retail Trade	14.14	14.25
b) Transport, Storage and Communication	10.77	10.81
c) Financial Intermediation	1.67	1.64
d) Real Estate, Renting and Business Activities	8.36	8.04

Source : Bangladesh Bureau of Statistics (2006)

The service sector has been estimated to have grown by 6.47 percent in FY06. This sector is growing at an annual average rate of 5.86 percent over the last five years. Growth of financial and monetary intermediation also increased at 7.12 percent and 6.85 percent, respectively, in FY06 which are 1.8 and 2.26 percentage points lower than those of the previous year.

Figure 2.3 : *Growth of Broad Sectors of GDP*



Source : Bangladesh Bureau of Statistics (2006)

2.1.1 : Household Consumption

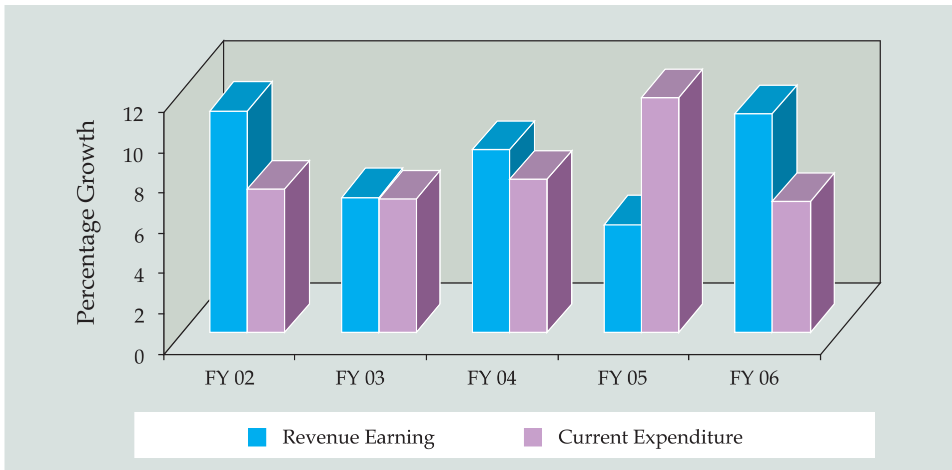
Household final consumption expenditure is estimated to have increased by 5.17 percent in FY06. Estimated private consumption growth for FY05 had been 4.41 percent but the realized figure was 3.87 percent, whereas the annual average growth during the last four years has been 3.93 percent. The higher private consumption is likely to have been caused by higher gross disposable national income, an increase of 7.23 percent in FY06. Overseas employment up to March 2006 also increased by 6.52 percent compared to March 2005 which not only induces additional consumption directly, but also increases the expectation about future income generation via acquisition of assets. A dampening effect on consumption spending, however, might have been induced by the recent increase in the 5-year NSD certificate rate to 12 percent and the subsequent increase in the deposit rates by commercial banks.

2.1.2 : Government Expenditure

Total government expenditure (in real terms) is provisionally seen to have increased by 13.5 percent in FY06. Government expenditure as a share of GDP is expected to be 15.5 percent in this fiscal whereas the share had been 14.6 percent on an average during the last five years. Government final consumption expenditure has grown by 7.92 percent in FY06 which is 0.11 percentage points higher than that in the previous year though it has generally been showing a decreasing trend since FY02. Current expenditure ("revenue expenditure") constitutes more than fifty percent of total government expenditure. Current expenditure and revenues have grown by 6.5 percent and 10.87 percent respectively in FY06 (as shown in Figure 2.4). Revenue-GDP ratio has been increasing steadily from 9.6 percent in FY01 and is estimated to have reached

10.99 percent in FY06. The ratio stood at 10.57 percent in FY05. Up to the third quarter of FY06 actual Annual Development Programme (ADP) expenditure stood at 50.9 percent of the revised allocation (of 215 billion taka), vis-à-vis 50.3 percent during the same period of FY05. During the last five years actual average ADP expenditure has been 89.6 percent of the revised allocation. Therefore a faster growth of ADP expenditure is expected during the last quarter of FY06 as experienced in the past.

Figure 2.4 : *Growth of Revenue Earning and Expenditure*

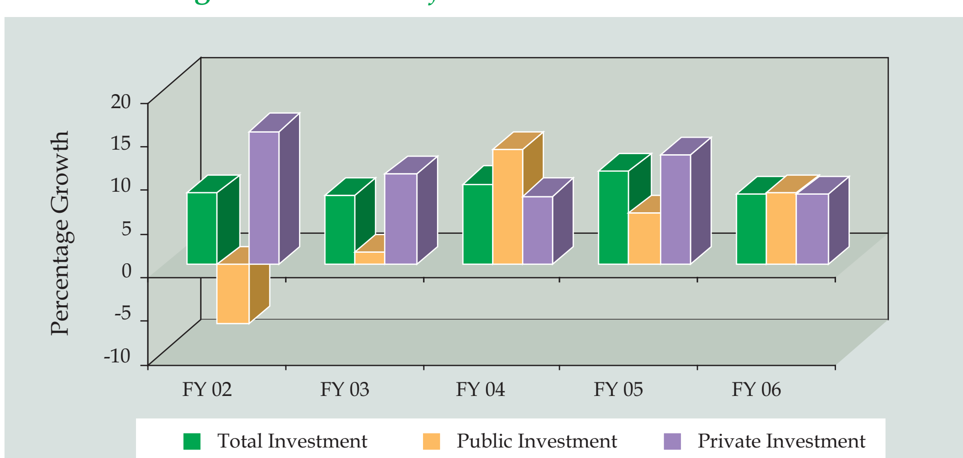


Source : MoF (2006)

2.1.3 : Investment

Real domestic investment is estimated to have grown by 8.05 percent in FY06, which is 2.7 percentage points lower than that of the previous year. Investment as a percentage of GDP has been increasing every year from 24.78 percent in FY02 and is estimated to have reached to 27.6 percent in FY06 resulting in an annual average ratio of 26.23 percent during the last five years. Though the projected government investment growth for FY05 had been 2.91 percent, actual growth

Figure 2.5 : *Growth of Public and Private Investment*



Source : Bangladesh Bureau of Statistics (2006) reached 5.85 percent. Public investment is estimated to have grown by 8.12 percent in FY06. Private investment, on the other hand, which constitutes about 75 percent of total domestic investment, is estimated to have grown by 8.02 percent in FY06 whereas growth was over 12 percent in FY05. The fall in the growth of private investment may possibly be an outcome of increased private consumption. Investment growth may also have been reduced due to skepticism about the MFA phase out. Figure 2.5 reveals that growth in private and public investment continue to have a negative relationship (i.e. private investment declines in the face of an increase in public investment) as mentioned in the October 2005 Monetary Policy Review. However, an examination of the private sector credit demand dispels any notion of crowding out.

2.1.4 : Conclusion

The sectoral share of GDP is changing in favour of the industrial sector since the last couple of years. The share of agriculture is decreasing, while the service sector is continuing to have the highest share of GDP. Household consumption in FY06 is estimated to have grown at a higher rate than the average of last five years, even in the face of the recent interest rate hike in the economy. While government expenditure is estimated to have increased by more than the last five year's average, growth of real domestic investment is estimated to be on a downward path. Given that the share of industrial sector in GDP is increasing, a continuing decline in the growth of domestic investment may have a dampening effect on the growth momentum of the economy.

2.2 Exports and External Demand [12]

This section deals with the prospect and challenges in sustaining the robust external demand of Bangladesh's exports with special reference to global economic progress during FY06.[13] In doing so an attempt is made to address the country's current overall export growth prospects in the context of the growth outlook obtaining in the major trading partners like USA and the Euro area countries.

2.2.1 : World Economic Outlook

The world output expansion, which has rebounded since the second quarter of calendar 2005 remained broadly on track and continued to increase moderately in the first half of 2006, with global output growth projected at 5.1 percent for the year 2006 as a whole. Following a temporary slow down in mid-2004, global GDP growth picked up through the first quarter of 2005 which has been continuing in to the second quarter of 2006, with robust service sector output more than offsetting slowing global growth in manufacturing and, lately, trade.[14] The outlook for global output growth in the year 2007 is somewhat lower and is estimated at 4.9 percent.[15]

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12 Prepared by Dr. Md. Akhtaruzzaman, Senior Research Economist, PAU and research assistances provided by Mohammad Mizanur Rahman, Assistant Director, PAU are duly acknowledged.

13 FY indicates fiscal year, July-June. Year mentioned in full digit form like 2004, 2005 indicates calendar year

14 The Economist poll GDP forecast has shown an annualized growth rate of about 2.0 to 4.0 percent for most of the OECD countries for the calendar 2006, though for 2007 GDP outlook the growth figures are somewhat less for US and Euro area countries (The Economist, September 30th 2006).

15 World Economic Outlook, September 2006, IMF

Growth performance for 2005 and 2006 in Euro area countries, however, has generally been modest with the continuing weakness of Italy and Germany. However, in the Euro area as a whole, recovery is underway and the growth outlook is projected at a higher rate of 1.7-2.5 percent in 2006 and 1.5-2.0 in 2007. The growth picture of United States, the main propeller of world GDP growth, has rebounded modestly in the first quarter of 2006, which continued to the second quarter of 2006 despite its long existing and indeed growing, imbalances in both her budget deficit and the deficit in the current account balance. The US annual output growth for 2006 is estimated to be 3.4 percent.

Among Bangladesh's major regional trade partners, India, Pakistan and Sri Lanka and to a lesser extent China, South Korea and Thailand are important. China and India's GDP growth rates for 2005 and 2006 remain robust and broadly on trend average. China's GDP growth shows an annualized figure of 11.3 percent for the second quarter of 2006 and thus a higher GDP growth outlook for 2007 can be expected. India recorded a growth rate of 7.5 and 8.1 percent during 2004 and 2005 respectively and for 2006 the growth rate is estimated to be even higher which is reflected in her 9.3 percent annualized growth figure for the first quarter of 2006. Pakistan also recorded a higher growth rate of 8.4 percent during 2005. However, projection for 2006 is a bit lower at about 6.5 percent. Other Asian growth nodes such as Sri Lanka, Hong Kong, Malaysia, Singapore, Taiwan, South Korea, Philippines and Thailand have also registered high growth rate in the fourth quarter of 2005. The near term outlook of the output growth in the Asian region as a whole is positive with significant industrial output growth in India (9.6 percent), Pakistan (11.6 percent), South Korea (4.4 percent) and Thailand (6.1 percent) during April-July 2006.

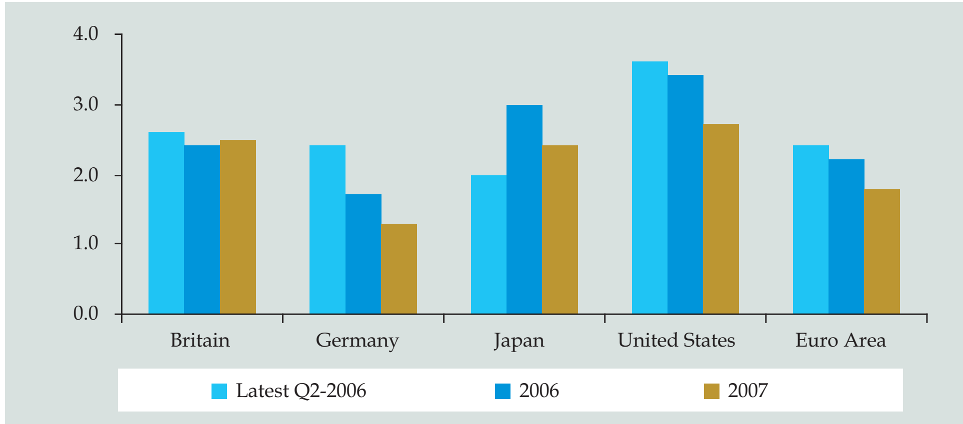
One of the positive developments in the world economy during FY05 and early FY06 is that there is a strong reversal in the once stagnated growth outlook of the Japanese economy. There were signs of upturn in Japanese economy which was becoming more firmly entrenched with real output rising by 2.7 percent in 2005 on top of the 2.6 percent in 2004. The growth figure for second quarter of 2006 shows signs of rebound at 2.5 percent. Thus the outlook for Japan's growth is expected to be hovering around 3.0 percent in 2006. Japan's growth outlook for 2007 is projected at 2.3 percent.

However, progress is yet to be made in removing some looming downside risks in the global perspective, notably those arising from the sustained high oil prices, and an absence of any significant pickup of growth projection for the Euro area in 2006, higher U.S. interest rates, and a continued substantial depreciation of Japanese yen during 2005-06.[16]

The year 2006 witnessed a general upward trend in both export and import growth in almost all the advanced countries. However, some euro area countries like Spain and France recorded an increase in exports growth, while Japan and Germany recorded a modest fall. The growth of US imports moderated and is projected at 5.9 percent in 2006 while US exports for 2006 has been estimated at 8.8 percent, which is somewhat higher than that of previous year. Japan's import

[16] Most recently (2nd quarter of 2006) Japan shows sign of some sparks and the yen appreciated briskly in trade weighted terms. The REER index shows a significant fall to 79.7 on September 30th 2006 from 85.7 a year ago (Source : The Economist, September 30th 2006)

Figure 2.6 : *Output Growth of selected OECD Countries*



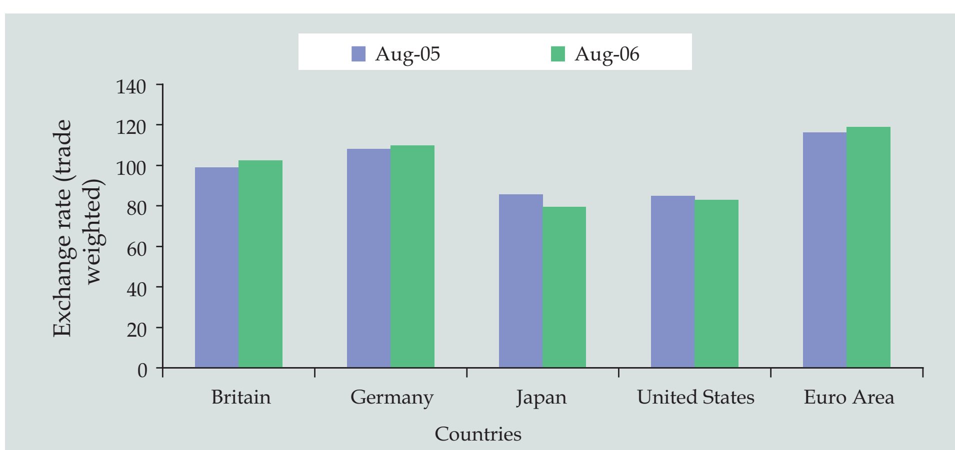
Source : The Economist, September 2nd 2006

growth is projected to grow at 6.6 percent in 2006. Global exports are projected to expand at 8.0 percent in 2006 before moderating to 6.0 percent in 2007. Growth in global imports is projected at 7.5 in 2006 and the outlook for 2007 is estimated at 6.0 percent. As a major indicator of consumer spending, the volume of retail sales shows sign of significant improvement in 2006 in many advanced countries especially in the Euro area while the US has gained the highest growth in retail sales (3.4 percent in June, 2006).

2.2.2 : Movement of Global Real Effective Exchange Rates

Current payment imbalances in many of the developed countries are potentially a threat to the progress of developing countries' external trade. These imbalances are contributing to volatility in the exchange rates of international currencies. The inflexibility of some Asian exchange rates also contribute to this process. The dependence on the USA as the primary driver of global output growth is itself a source of vulnerability. This is manifest in the fact that depreciation of the US dollar against the other major currencies during 2005 and 2006 has led to current

Figure 2.7 : *Real Exchange Rate for OECD countries*



Source : The Economist, September 30th 2006 account balance of all LDCs with a strong pressure on US imports.[17] As evident from the Figure 2.2 the US Dollar has continued to depreciate till June 2006. In contrast, the euro has gained modest appreciation during the said period. However, greater exchange rate flexibility in developing Asia including China and India would also facilitate the higher growth prospects in the Asian region as well as their American and European trade partners. Japanese yen depreciated 6.0 percent on year-on-year basis in trade-weighted terms by September 30th 2006. Inflationary pressures however remained subdued throughout most of the developed countries of the world.

2.2.3 : Domestic Output and External Demand

Bangladesh's historical GDP growth data shows a steady, albeit modest growth rate during the recent decade which is clustering around a fairly stable rate of 5 percent during the last few years. The growth record of the last two fiscal years (FY04 and FY05) were much above the long run trend value. Like FY04, the 6.0 percent growth record of Bangladesh economy in FY05 outperformed the provisional estimate of 5.5 percent of Bangladesh Bureau of Statistics (BBS) which was announced earlier. For FY06, BBS has estimated provisionally that output growth would come in as high as around 6.7 percent which would probably be achievable due to normal production environment in agriculture and in the service sector.

Bangladesh economy's openness has been showing upward trend and the value of her exports has risen to 17.7 percent of its nominal output in the last fiscal year, FY06 from only around 11.0-12.0 percent in the 1990s. Since global economic developments affect aggregate demand for both Bangladesh economy and its trading partners, Bangladesh's exports are directly affected by the import demand of foreigners. It can be mentioned here that only a handful of countries contribute a lion's share (about 80 percent) to our export demand. More particularly, in FY06 about 25 percent of Bangladesh's total exports were destined to USA and about 50 percent to the Euro area countries. In FY06, the share of US has risen to 30 percent whereas the share to the Euro area has declined to 48 percent.[18] Of the total exports, in recent years the major share (about 76 percent) has been contributed by RMG exports and about 95 percent of those are exported to US and the Euro area. Furthermore, among the export items; frozen foods, leather and leather products, jute goods and tea are the major items whose main destinations are again both USA and Euro area countries. Therefore, overall economic performance and the near term prospect of those principal trading partner economies would have a significant influence in determining the external demand of Bangladesh's products.

2.2.4 : Bangladesh Export Growth Performance

Despite decelerating growth of the woven portion of ready made garments (RMGs) exports, the principal component of the Bangladesh export basket,

[17] The depreciation of the US dollar between February 2002 and March 2005 amounted to 15 percent, according to the U.S. Federal Reserve Board's real effective broad index. Since the last quarter of 2005 till June 2006 the US dollar appreciated modestly but gradually in trade-weighted terms. (Source : The Economist, September 30th 2006)

[18] Of the Euro area countries about 17 percent is exported to Germany and about 11 percent, 7 percent, and 4 percent to UK, France and to three other European countries, Italy, Netherlands and Belgium respectively.

annual total exports of RMGs grew by 13.0 percent in FY05. Growth rate of export in FY06 is 21.6 percent (provisional), which is significantly higher than the growth figure for FY05 (13.8 percent).

It is notable that woven garments recorded a very low growth rate in FY05 due to global quota abolition effect but its growth rebounded since beginning of FY06 and end- FY06 at 13.5 percent. Despite challenges, RMG exports contributed the lion's share, around 75 percent, during the period FY90-FY05. Other major products are frozen foods, leather and leather products and tea whose combined share is currently around 15 percent. Item-wise, frozen foods, leather and leather products and also raw jute have registered strong positive growth in FY06.

Table 2.2 : *Period Average Growth Rate of Export and the RMG sector*

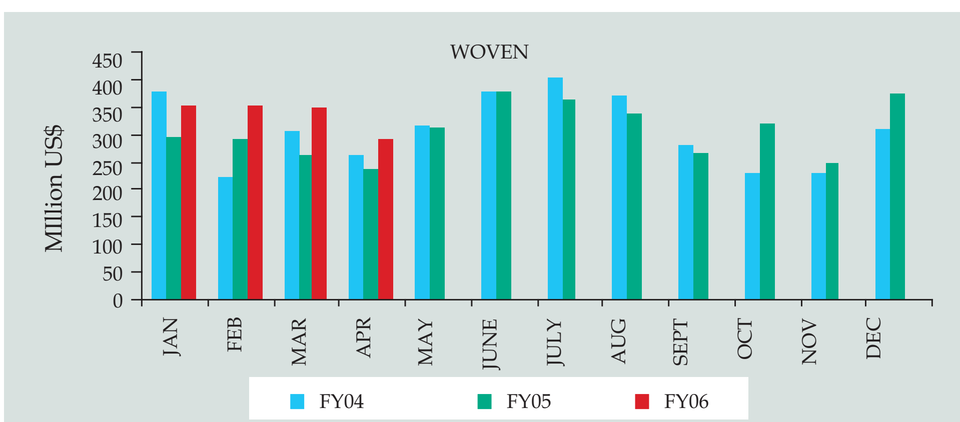
	FY90-FY04 (period average)	FY05 (year-on- year basis)	FY06 (year-on- year basis)
Total Export Growth Rate	12.91	13.83	21.63
RMG Export Growth Rate	18.83	12.90	23.11
Woven Export Growth Rate	13.24	1.70	13.50
Knit-wear Export Growth Rate	74.00	31.26	35.38

Source : Export Promotion Bureau of Bangladesh.

Bangladesh's export basket has remained rather narrow; only a few products comprise most of total exports. Though it was forecost that with the removal of quota on RMG, serious pressure would be created on the price competitiveness of Bangladesh's exports, it is seen that Bangladesh's market share has been maintained or even has gained in the US market, which is the largest market for Bangladesh's exports.

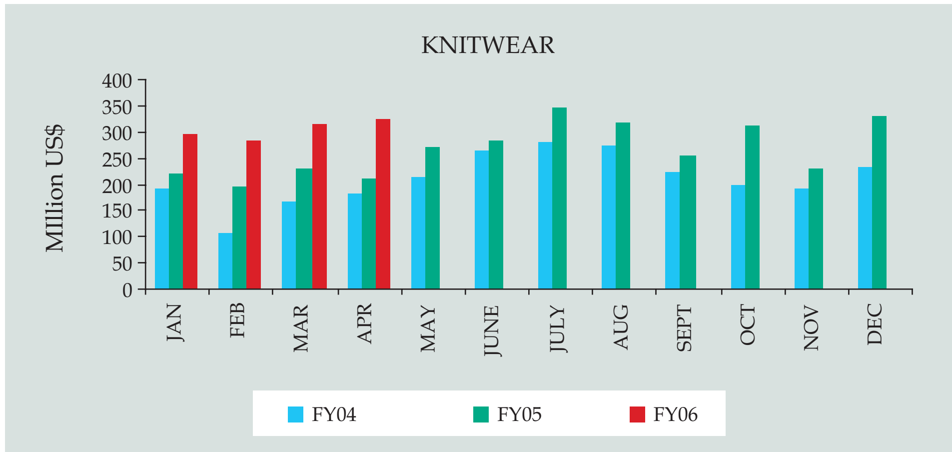
In the RMG category, the contribution of knitwear grew significantly on a year-on- year basis (more than 31 percent) in FY05. During FY06 knitwear's growth record exceeded 35 percent. The woven category also grew robustly during FY06 by over 13 percent as compared to only 1.7 percent growth in FY05.

Figure 2.8 : *Woven Export performance during FY04-FY06*



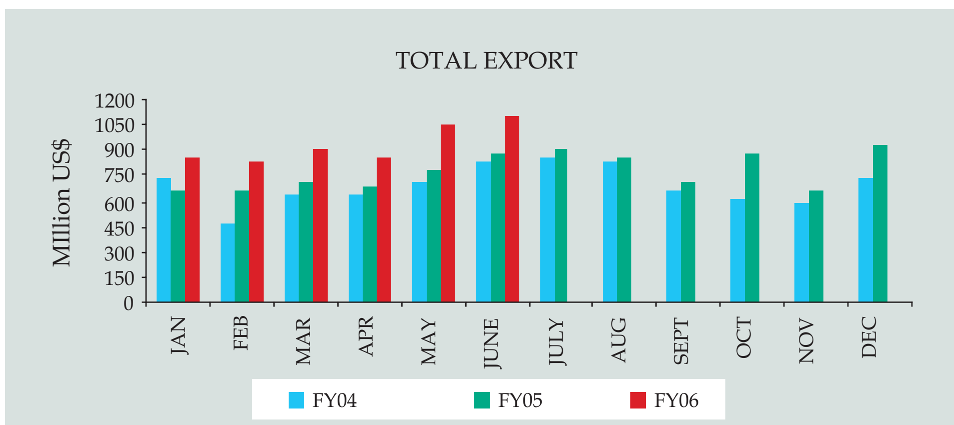
Source : Export Promotion Bureau of Bangladesh.

Figure 2.9 : *Knitwear Export performance during FY04-FY06*



Source : Export Promotion Bureau of Bangladesh.

Figure 2.10 : *Total Export performance during FY04-FY06*



Source : Export Promotion Bureau of Bangladesh

Due to the fact that Bangladesh's exports are significantly destined to USA and the Euro area (more than 70 percent), any positive growth outlook of both the USA and EU could enhance the demand. Statistics shows that the imports of US, Germany, France and UK have picked up briskly. Similarly, higher near term growth prospect together with recent rebound of employment growth in USA may divert low and middle income earners' spending toward inexpensive clothing from many developing countries including Bangladesh. Other positive factors such as the FY06 depreciation of BDT, against major currencies like US Dollar, the Pound Sterling and Euro, the slight improvement of Bangladesh's terms of trade against the major export destination countries could improve Bangladesh's export competitiveness in the international markets.[19] The enhanced GSP facility, effective since the middle of 2006, which Bangladesh traditionally found difficult to benefit from due to stringent rules of origin, may

[19] There was a sharp depreciation of the Bangladesh's taka against US Dollar during FY06 which is amounted to 8.5 percent. (Source : Bangladesh Bank Monthly Economic Trends, May 2006). However, early in FY07, some of the recent loss has been recouped by BDT.

now be exploited with the growing capacity of domestic value addition in boosting export growth. Therefore, in the backdrop of higher growth prospect for 2007 in both USA and the Euro area countries and also of growing competitive advantage of Bangladesh's knitwear products as well as woven products, Bangladesh's overall export growth in RMG is likely to remain robust in FY07.

2.2.5 : Conclusion

The share of export receipts in total output of Bangladesh has risen modestly to around 17 percent in FY06 from about 16 percent in FY05. The two major importing countries of Bangladesh's exports are the USA and the Euro area comprising about 75 percent of total export demand. Particularly, in FY06, about 30 percent of Bangladesh's total exports were destined to USA and about 48 percent to the Euro area countries. Bangladesh's export basket consists of mainly RMGs, frozen foods, leather and leather products, jute goods and tea, of which about 76 percent of the total export is contributed by the RMG sector alone. Near about 95 percent of total RMG products are exported to USA and Euro area countries.

Bangladesh's export growth rate in FY06 is 21.6 percent, which is significantly higher than FY05. Due to abolition of global quota on Bangladesh woven garments in FY05, it recorded a very low growth rate in FY05, but rebounded in FY06. In contrast, the contribution of knitwear grew significantly on a year-on-year basis which was 31 percent in FY05 and 35 percent during FY06. Faster growth rate of knitwear exports, which has a very high domestic value addition, is increasingly important for GDP growth in Bangladesh. However, the current year's moderately high growth outlook for USA, a soft and gradual recovery of EU economies in 2006 and other positive factors like depreciation of BDT against US dollar, the Pound Sterling and the Euro could improve Bangladesh's export competitiveness in the international market.

2.3 Imports [20]

After a robust growth of imports (about 21 percent) in FY05, it moderated to 12.06 percent in FY06. Though external pressure from rising oil prices in the international market continued throughout FY06, steady decline in some import items, particularly food grains and other food items, have contributed to the easing of the import situation of the country. Indeed, a rebound in cereal production, cautiously restrained monetary policy and depreciation of the domestic currency, among others, contributed to moderate import growth. The principal elements are reviewed below in additional depth.

2.3.1 : Composition of major import items

As in FY 05, the major import items in FY06 are textile, POL[21], capital machinery, construction[22], food grain, chemical, plastics, fertilizer and edible oil. Besides, import by EPZs, mostly textile related items was also significant. Considering

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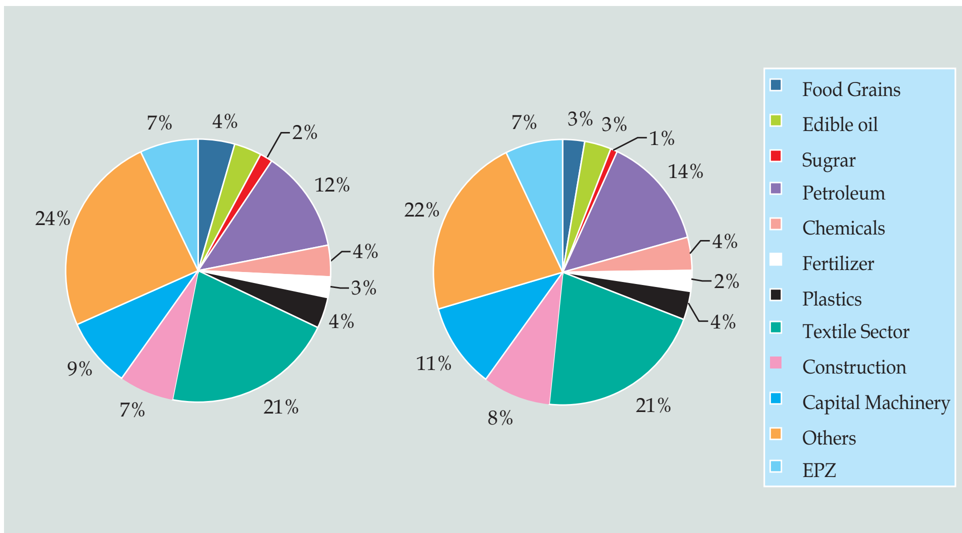
[20] Prepared by Md. Kabir Ahmed, Research Economist, PAU.
[21] POL refers to petroleum (crude & refined), oil and lubricants.
[22] Construction includes clinker, iron and steel etc.

EPZ items in the textile category, it is observed that four items such as petroleum (14 percent), textile (21 percent), capital machinery (11 percent) and construction material (8 percent) largely determined the total import structure of the country. These items accounted for 54 percent of total imports compared to 49 percent in the last fiscal year. This additional impetus was derived mainly from the rising share of petroleum, capital machinery and construction material. Among the remaining items, share of food grain, sugar and fertilizer declined while share of edible oil, chemical, plastics, textile and EPZ items remained the same. The compositions of the import portfolio for FY05 and FY06 have been shown in figure 2.11.

Figure 2.11 : *Share of Major Import Items*



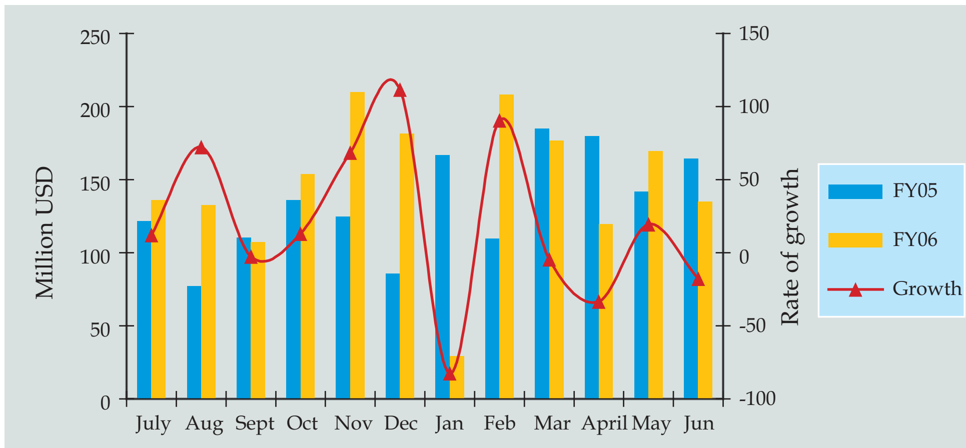
Source : Constructed based on data from Statistics Department, Bangladesh Bank

2.3.2 : Growth of major import items and the factors at work

POL: In value terms POL import increased by about 25 percent in the FY06 compared to 63 percent rise in the last fiscal year. It reached USD 2,004 million in FY06 compared to USD 1,603 million in the preceding fiscal year. International price significantly determines the import value of POL. For example, average price of crude petroleum per barrel in international market increased 44 percent in FY05 (from 31.4 USD in FY04 to 45.05 USD in FY05), which caused unprecedented growth of POL import in FY05, despite marked depreciation of the local currency. However, in spite of a large price change over FY06, POL imports grew more moderately in FY06. It can be noted that except textiles, it is the single major item that alone accounts for about 13.6 percent of total imports in FY06 which caused 25 percent of rise in total import this fiscal year. BPC, the SOE, is mainly responsible for oil imports (both crude and refined), further processing and distribution within the country. Though the international price went up dramatically in each of the last three fiscal years, administered domestic prices have failed to reflect the full cost of imports. The subsequent subsidization incured a substantial loss to BPC which in turn caused it to delay payments to the import financing banks, particularly the NCBs.

The government adjusted fuel price last June by increasing prices of petrol and octane by 33 percent and 29 percent respectively. [23] Prices of diesel and kerosene were adjusted up by 10 percent. These price increases are likely to generate revenue of about USD 210 million annually, reducing the implicit subsidy by one-fifth (ADB, 2006). Due to this adjustment, BPC is no longer incurring losses from Octane and Jet Fuel but its loss from diesel and kerosene continues. It is incurring losses of about BDT 16.88 and 15.93 per liter of diesel and kerosene respectively.

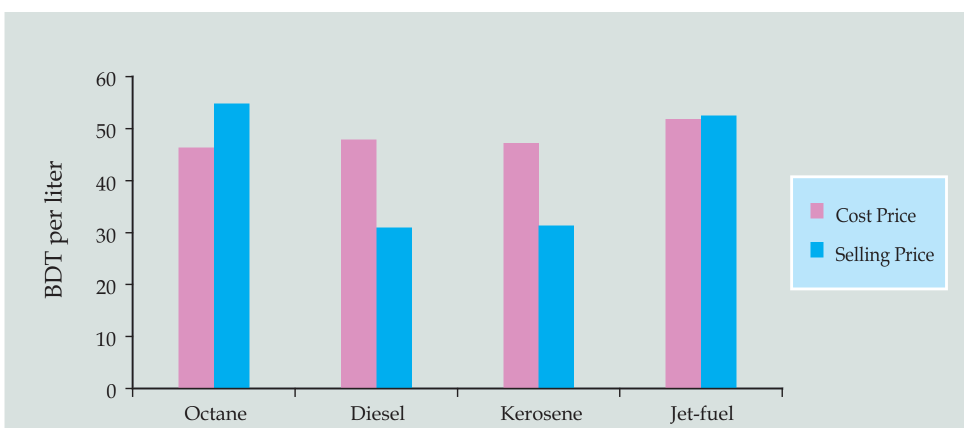
Figure 2.12 : *Changes in POL Imports: FY05 & FY06*



Source : Constructed based on data supplied by Statistics Department, Bangladesh Bank

Whether and how the government should further adjust the oil price is a debatable issue. Subsidisation of oil price has already caused financial distress for BPC. The implied financial stability of NCBs is another factor to contend with. Though the government has issued a BDT 10 billion bond in favor of Sonali Bank (the largest of the NCBs), this temporary remedy has in turn increased fiscal risk, because the ultimate burden of subsidized oil price will have to be borne by fiscal adjustment. Therefore, how long government's subsidization policy will be able

Figure 2.13 : *Margin of BPC's Petroleum Products as on 15 June 2006*

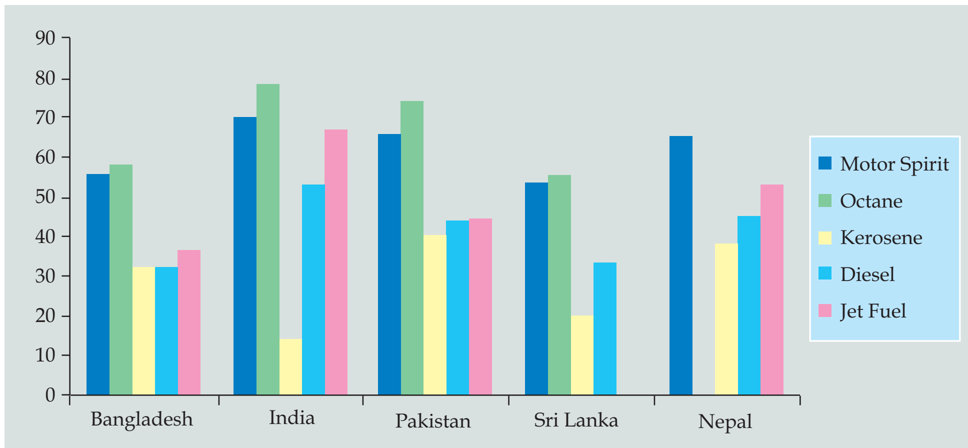


Source : ADB Quarterly Update, June 2006

[23] In Bangladesh, while the term "petrol" refers to leaded (or low-octane) gasoline, "octane" is meant to denote higher octane gasoline.

to cope with persistently high oil price in the international market is indeed a matter of debate. Looking at the retail fuel prices of the neighboring countries (see figure 2.14), it is observed that domestic prices of motor spirit (petrol), octane and diesel are higher both in India and Pakistan than in Bangladesh. Since Bangladesh has a large open border with India, lower domestic price may provide incentive for smuggling. Considering the above factors, a further orderly adjustment of octane, diesel and jet fuel deems to be reasonable.

Figure 2.14 : *End-User Prices of Petroleum Products in Sourth Asia, Tk/liter (June 2006)*



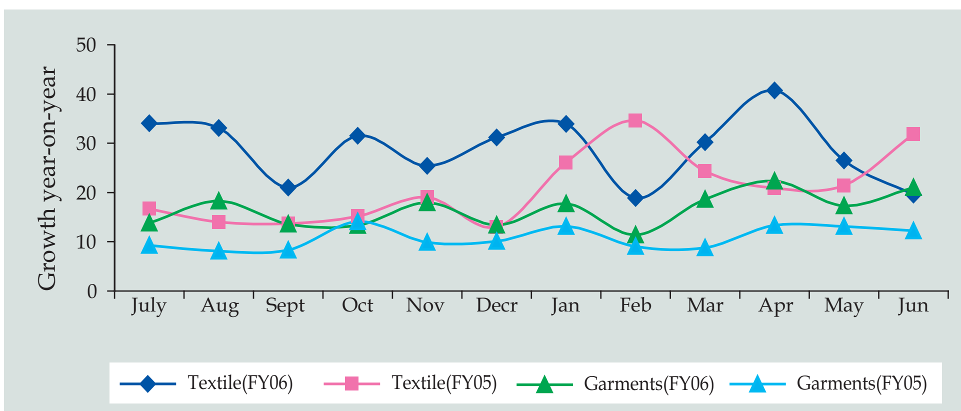
Source : ADB Quarterly Update, June 2006

Even if government decides to adjust fuel oil price further, finding an optimum one would be one of the most challenging tasks. Because the magnitude of adjustment effect on different stakeholders/sectors depends on exposure of those groups/sectors to oil price shock. Since kerosene is one of the principal household fuels in rural Bangladesh, further upward adjustment of kerosene price may hurt the poor. Higher price of diesel may increase transportation cost as well as cost of agricultural production. Further adjustment of both diesel and kerosene may hurt the poor both directly as well as via the risks of growth slow down, thus compromising the target of achieving the millennium development goals. In order to reduce any adverse effect on the poor due to further adjustment of fuel prices, the government is considering expanding and strengthening two social programs such as Food for Work Program and Primary Education Stipend. At the same time, ration cards for kerosene or a system of direct cash transfer to the poor might also be introduced. It may be mentioned that rationing system of kerosene in India did not bring fruitful result due to rent seeking and corruption of distribution networks and the translation of retailing to patronage (IIMA, 2006). Other alternatives deem to be examined. It can be argued that though kerosene is used by the poor-section of the population, it is taxed like other petroleum products such as octane, diesel and jet fuel. Taxes per liter of octane, diesel, kerosene and jet fuel are the same, i.e., BDT 7.346. Maintaining BPC's present selling price and allowing exemption of tax for kerosene may reduce about 46 percent of its loss due to the under-pricing of kerosene. Similarly, tax on diesel may be rationalized by lowering the current tax rate. Government may moderately adjust the price of octane and jet fuel further. The additional revenue from this source may partly compensate the losses in other two items. However, the importance of swiftly dealing with the situation can hardly be overemphasized, especially when it appears that political uncertainty and hence the high world oil price are unlikely to wither away soon. Given the large share of POL in total import and its increasing domestic demand, POL imports may continue to create significant pressure on the current account balance (CAB) in FY07.

***Capital machinery*:** Import of capital machinery continued to rise in FY06. It reached USD 1539 million compared to USD 1114 million in FY05. The growth rate in FY06 is a healthy 38.15 percent, though 14.66 percentage points lower than in the preceding period. Like the preceding fiscal year, import of textile and garments related machinery grew faster than other heavy machinery. Growth rates of textile and garments machinery in FY06 were about 38 and 53 percent respectively against 50.20 and 31.92 percent in the preceding fiscal year. Growth of other heavy capital machinery was about 24 percent. Month-to-month import behaviour shows that upsurge in the import of textile machinery continues since January of the last fiscal year which reflects the industry's persistent efforts to adapt to post-MFA challenges.

Looking at monthly figures for FY05 and 06, it is seen that machinery imports have kept on growing in a more consistent fashion. It also shows RMG sector's continuous efforts to improve competitiveness by updating and strengthening its capacity. It appears that RMG sector is enjoying a momentum after the MFA-phase out period. It may be expected that high growth rate in imports of textile and garments machinery would have a positive influence on exports of readymade-garments in FY07. However, recent labour unrest may tarnish the international image of the industry and may affect productivity. In order to avoid further repercussion, a strategic plan and pragmatic approach by the government, workers and entrepreneurs is required.

Figure 2.15 : *Import of Textile and Garments Machinery*

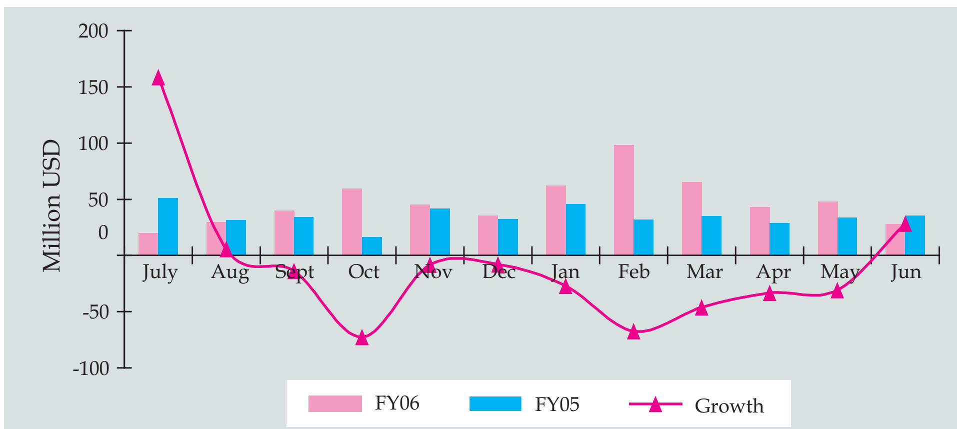


Source : Constructed based on data from Statistics Department, Bangladesh

Food grains and other food items: Import of food grains declined by about 27 percent, i.e., from USD 574 million in FY05 to USD 418 million in FY06 due to strong recovery in cereal production. Favorable climate, sufficient supply of high yielding seed varieties and minor flooding, among others, contributed to the buoyant growth of agriculture (see section … for details). It can be noted that significant growth (33.18 percent) of food grain import in FY05 was mainly driven by supply-side shock, i.e., crop failure due to the floods in 2004.

In FY06, import of spices milk and cream, among the other food items, declined by 24 and 15 percent respectively. On the other hand, import of oil seeds, edible oil and pulses increased marginally, i.e., by 3.4, 7.2 and 3.1 percent respectively. After experiencing significant growth in sugar import in the last five years (average annual growth of sugar import from FY01 to FY05 was almost 92.26 percent), the economy experienced a decline in sugar import in FY06. It declined by about 43.64 percent in the last fiscal year. This trend can be attributed to, among others, continual rising price in international market which makes domestic production viable. Besides depreciation of local currency also made the import price higher to end-use consumers, which contributed to a moderating of demand. Average price per pound of sugar in FY06 was 14.14 US cents compared to 8.7 US cents in the preceding fiscal year. As the government has already relaxed custom duty on sugar import in FY07, growth in sugar import may be expected to resume next year.

Figure 2.16 : *Import of Food Grains*



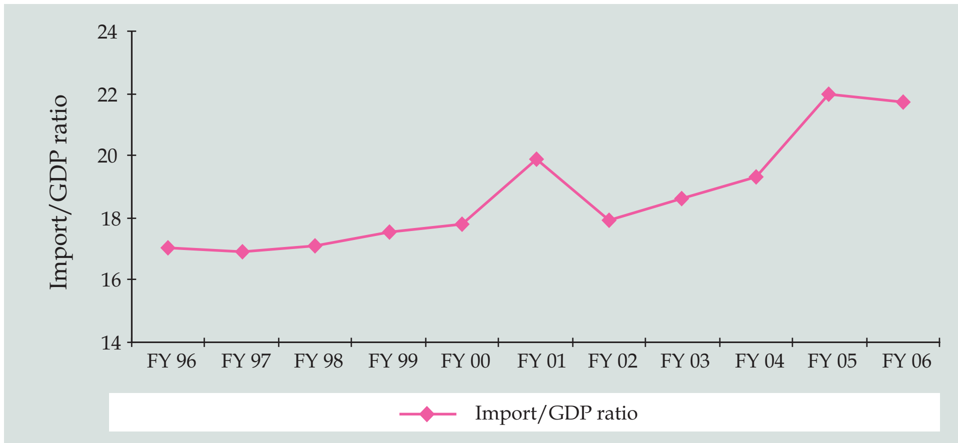
Source : Constructed based on data from Statistics Department, Bangladesh Bank

Intermediate goods: Moderate to high import growth of textile and garments related inputs such as raw cotton (11.58 per cent), yarn (27.81 percent), textile and related articles (9.99 percent) during FY06, compared to FY05, supported the continuing robust export performance of the RMG sector. Import of chemicals registered a significant growth, i.e., about 13.95 percent higher in FY06 than in FY05. Import of iron and steel experienced unprecedented growth (about 44.33 percent), surpassing FY05's growth (37.54 percent). Strong domestic demand due to rapid urbanization and infrastructure development and rising price in the international market due to China and India's impressive growth, among others, contributed to this phenomenon. Construction sector has been continually growing fast and its share in GDP growth has also been rising which created the strong domestic demand for iron and steel. Over and above, global pressures, growth of domestic spending via the Annual Development Program (ADP), which increased by over 50 percent (in nominal terms) from the previous fiscal year may continue to influence high growth of imports for construction materials in FY07.

2.3.3 : Trend of Import/GDP ratio

Compared to GDP growth, Bangladesh experienced a significant growth in imports during the last three fiscal years, as reflected in continuous upward movement in import/GDP ratio. However, the situation was reversed in FY06; import as a percent of GDP in FY05 was 21.95 which decreased marginally to 21.70 in FY06. While the nominal value of private sector credit expanded by 18.3 percent, the share allocated for the finance of imports grew far slower in USD terms due to currency depreciation. The latter phenomenon, among other, may have contributed to this development.

Figure 2.17 : *Import/GDP Ratio Trend*

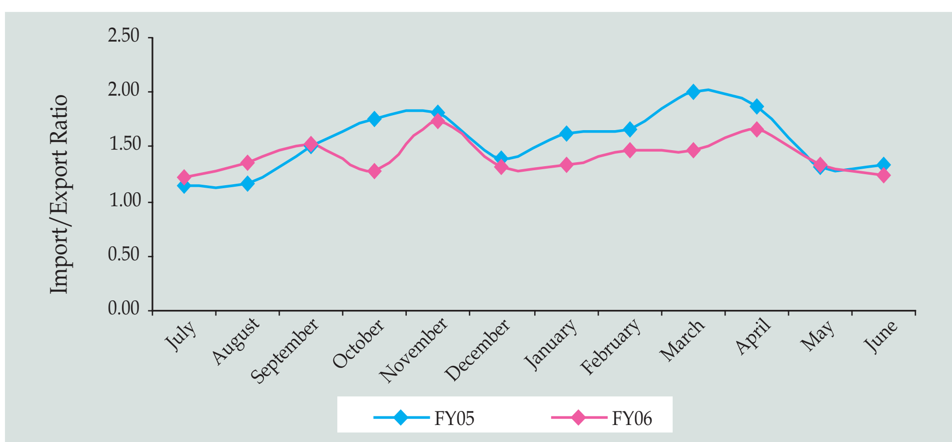


Source : Constructed based on data from National Accounts Statistics, BBS.

2.3.4 : Import/Export Trend [24]

Compared to imports, exports have increased more significantly during FY06 causing a moderate improvement in the trade balance. Import/export ratio declined to 1.40 in FY06 in contrast to 1.53 in FY05 (see figure 2.18). Moderate growth of import accompanied by high export growth helped lead to this outcome. Since the economy experienced strong import growth of export related capital machinery this may further improve the trade balance in FY07.

Figure 2.18 : *Import/Export trends*

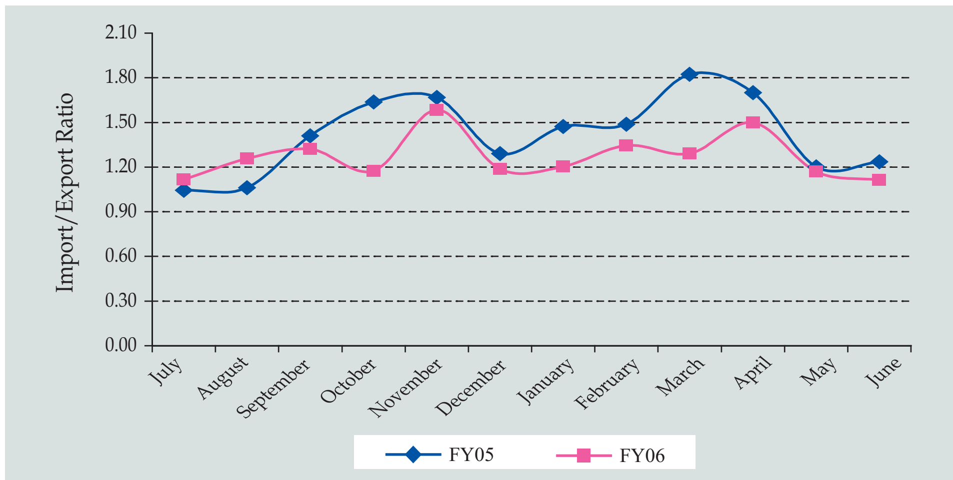


Source : Constructed based on data from Statistics Department, Bangladesh Bank

[24] Import data includes c.i.f. figures, while export data includes f.o.b. figures.

Since import of capita machinery increases productive capacity of the economy and have a positive effect on trade balance through import substitution effect and export-led growth effect, import of capital machinery can be momentarily disregarded in order to sharpen the understanding of the "core" import/export trend. It is observed that core import/export ratio further improved, i.e., reached about 1.26 in FY 06, compared to 1.41 in previous fiscal year. (see figure 2.19)

Figure 2.19 : *Import/Export trends excluding the imports of capital machinery*



Source : Constructed based on data from Statistics Department, Bangladesh Bank

2.3.5 : Conclusion

Petroleum, textile, capital machinery and construction material largely determine the total import structure of the country. Though price of petroleum and construction material continued to rise in the international market, a rebound in cereal production, cautiously restrained monetary policy, and depreciation of the domestic currency, among others, contributed to moderate growth of imports. Continuation of the policy to subsidize oil prices to end consumers has exacerbated financial distress of BPC, and the consequent insolvency of the lenders (NCBs). A proper budgetary adjustment to relieve NCBs of losses incurred on account of BPC loans and a further round of orderly oil price adjustment would be necessary soon. On the other hand, improvement of both import/GDP ratio and "core" import/export ratio indicate positive developments on the front in FY06, which is likely to continue in FY07.

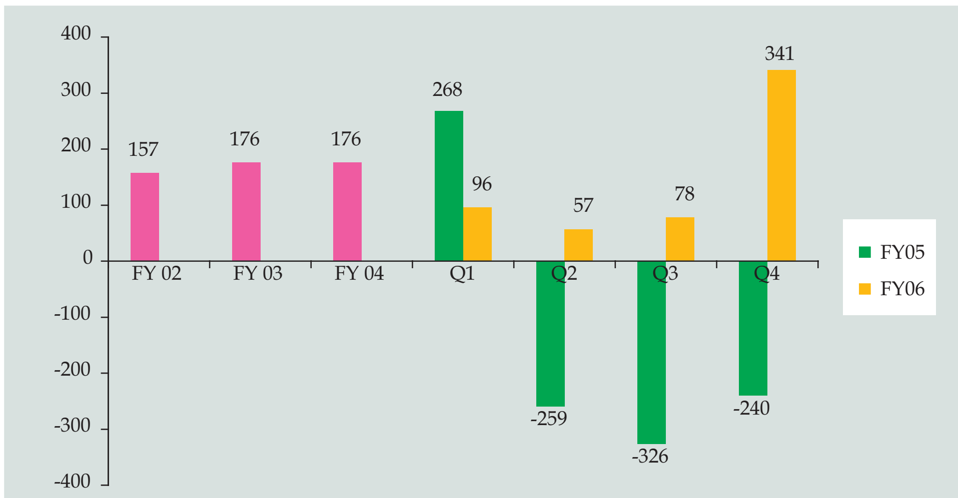
2.4 Current Account Balance[25]

Despite sustained high oil price in the international market, the Current Account Balance (CAB) in FY06 rebounded to a surplus (USD 572 million) following a sizeable deficit in the last fiscal year. In fact, the economy witnessed surpluses in each of the four quarters of FY06 compared to a surplus only in the first quarter of the last fiscal year. Knight and Scacciavillani (2004) argue that the behavior of the current account balance provides useful insights about shifts in the stance of

[25] Prepared by Md. Kabir Ahmed, Research Economist, PAU.

the macroeconomic policy and other autonomous shocks. Thus it can be said that economic and financial policies initiated by both the Government and the Bangladesh Bank have contributed to achieving substantial amount of surplus balance in FY06. Indeed, burgeoning growth of exports, modest growth of imports due to strong domestic supply of food grains and other food items, restrained monetary policy accompanied by depreciation of domestic currency and significant growth of remittances, among others, have contributed to the surplus in CAB.

Figure 2.20 : *Trends in Current Account Balance*



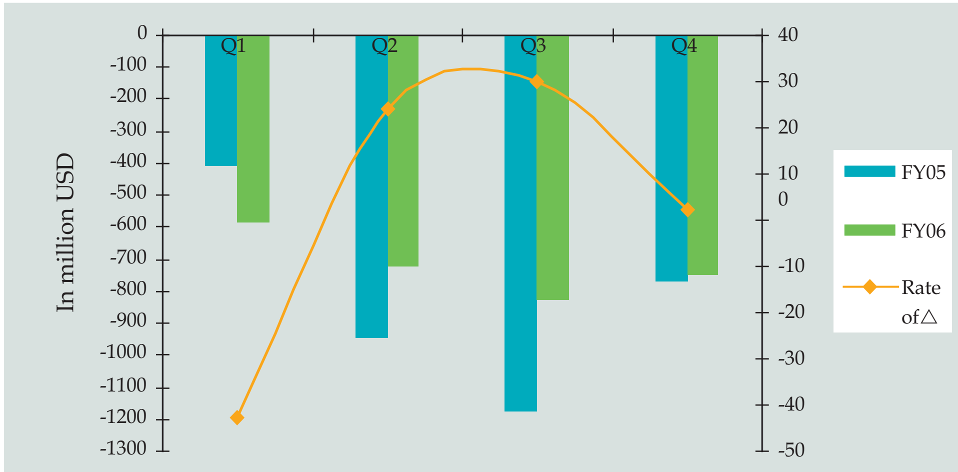
Source : Constructed based on data from Statistics Department, Bangladesh Bank

The main components of CAB are trade balance, services, income and current transfers. The notable feature of CAB in FY06 is that both trade balance and current transfers have improved. On the other hand, both services and income accounts have further deteriorated. The details are discussed below.

2.4.1 : Trade Balance

Trade deficit improved by USD 418 million in FY06. It reached USD (-)2879 million in FY06, i.e., about 12.68 percent higher than it was in the preceding period. Burgeoning effect of exports (about 21.57 percent) and modest growth of import (12.06 percent) contributed to this achievement. Since the quota facility given to RMG sector has been withdrawn since the last fiscal year, there was a widespread fear that this sector may be affected due to uncertainty and strong competition in the international market. However, exports from this sector increased rather significantly, i.e., about 21.63 percent higher in FY06 over that in FY05 indicating the sector's external competitiveness and further prospects in the global market. Robust growth (about 35.30 percent) in the US market substantially contributed to this result. By contrast, RMG exports to the European countries declined by about 4.6 percent in FY06. Europe, however, continues to reflect the largest share (about 50 percent) of RMG exports. In terms of geographic concentration, export portfolio of RMG sector was more diversified in FY06 than in FY05. For example, exports of RMG to 'other countries' increased from USD 328.8 million in FY05 to USD 1308.8 million in FY06, i.e., about 3 times higher than the preceding fiscal year.

Figure 2.21 : *Changes in Trade Balance*



Source : Constructed based on data from Statistics Department, Bangladesh Bank

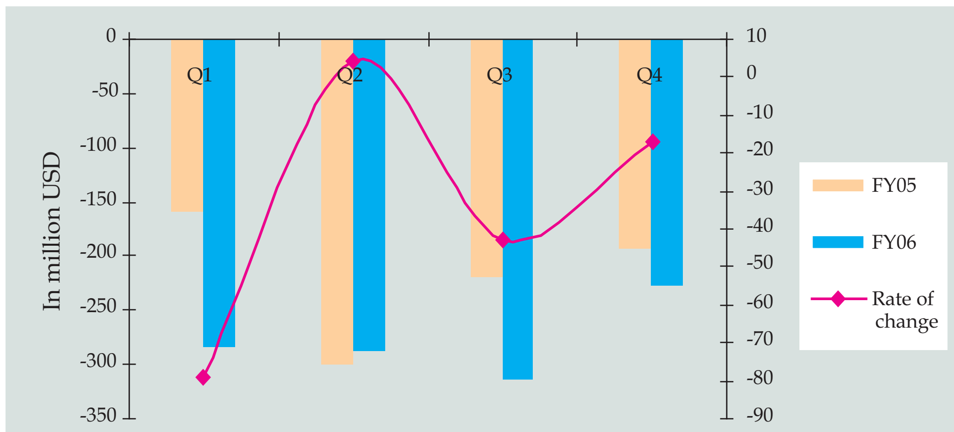
China continues to be the United States' largest supplier of textile and apparel, accounting for one-third of total imports in 2005 (about 16.8 billion USD). Since MFA phase out, import of Chinese textile and apparel in the US grew by 43.7 percent in 2005. This exceptionally high growth led US administration to impose 'safeguard quotas' on China for three categories of clothing such as textile, apparel and undergarments during 2006 to 2008. Such a restriction can allow RMG sector in Bangladesh a temporary advantage in the US. market. But the industry must overcome labour disgruntlement in order to ensure further growth in the near future.

In FY06 the economy experienced significant growth (about 25 percent) of oil imports (in usher term) due to sustained high prices and also witnessed strong import growth of capital machinery (38.15 percent) and construction material (about 40.16) emanated from high domestic demand. However, good harvest, a restrained monetary policy and depreciation of domestic currency, as noted above kept the overall growth of imports at a moderate level. While import of capital machinery and construction material may benefitted the economy in the medium to long term by increasing productive capacity and providing infrastructure facility, the persistently high oil prices may continue to put pressure on CAB in FY07.

2.4.2 : Services

The main components of services account are transportation, travel and others. The net balance of this account in FY06 stood at USD (–)1110 million, compared to USD (-)870 million in FY05, causing a further deterioration by USD (-)240 million. The major sources of this deterioration were rising costs of transportation and insurance services. In fact, transportation costs for freight increased by about 18 percent while cost of insurance services increased by about 24 percent. Higher price of petroleum in the international market was clearly one of the major reasons behind higher transportation costs. Increased export volume may augment this component. The figure 2.22 shows that deficit in services account significantly increased in the first and third quarters of FY06. Price of crude petroleum increased in these periods. For example, average price of crude petroleum per barrel reached USD 59.9 and USD 59.7 in the said quarters from USD 40.6 and USD 46.1 in the corresponding periods of the preceding fiscal. However, the deficit in the net balance of services was partly compensated by favorable improvement in construction as well as computer and information services which increased by about 494 percent and 129 percent respectively. The increase in net receipts of computer and information services indicates that the economy is gaining momentum in software exports. However, the upward trend in transportation costs may persist in future due to sustaining of rising oil price in the international market and thereby the deficit in the net balance of services account is unlikely to improve in FY07.

Figure 2.22 : *Changes in Services*

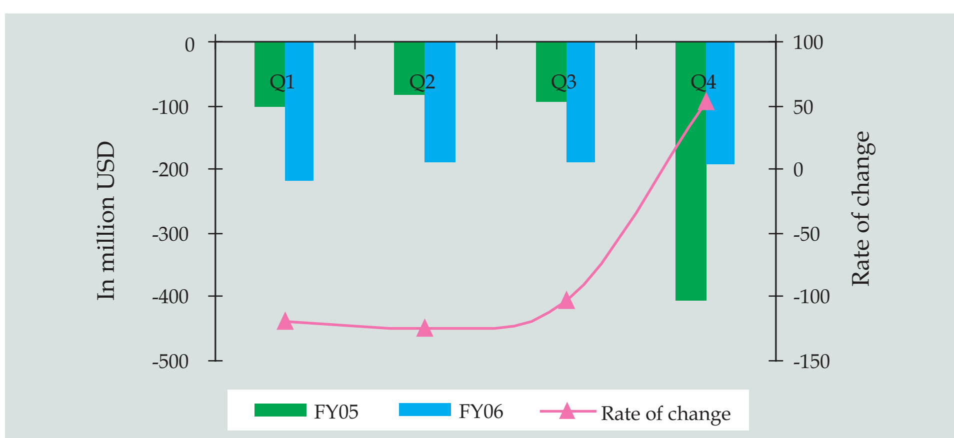


Source : Constructed based on data from Statistics Department, Bangladesh Bank

2.4.3 : Income Account

Net outflow on the income account in FY06 was about USD 786 million compared to USD 641 million in the preceding fiscal year showing a deterioration of USD 145 million, i.e., a decline of about 22.62 percent. Among the three major accounts

Figure 2.23 : *Changes in Income Account*



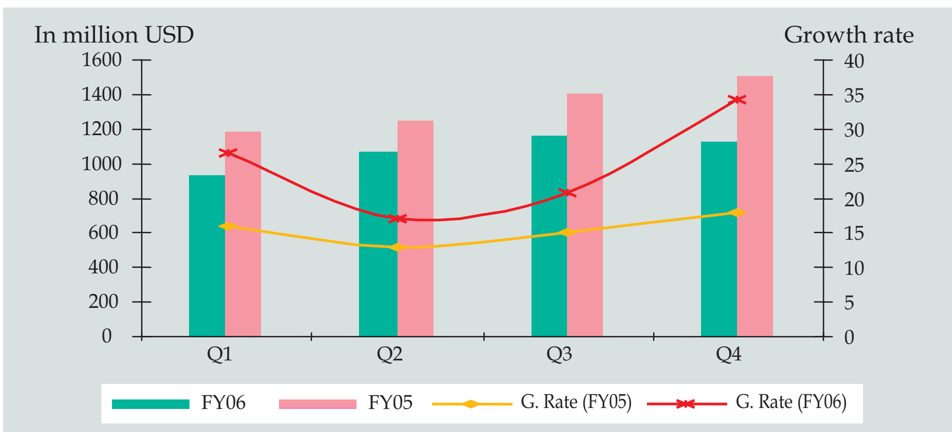
Source : Constructed based on data from Statistics Department, Bangladesh Bank namely, direct investment, portfolio investment and other investment account, major outflow occurred in the direct investment account, i.e., about 88 percent of net outflow. A further analysis shows that earnings of oil, gas and power companies were the major source of outflow of investment income. However, if the existing rate of outflow on the investment account persistently increases, the CAB may well remain under pressure.

2.4.4 : Current Transfers

Current transfers (CT) mainly include unilateral transfers from the external economy. Since there is no outflow on this account, the balance of this account compensates and generally outweighs the deficit in other three accounts. For instance, except for a shortfall in FY05, CT alone outweighed the total deficits in trade, service and income accounts in the previous four fiscal years, causing a surplus in CAB. However, this account registered a resilient growth, i.e., about 24.64 percent in FY06 covering about 111.98 percent of total deficit in other three accounts. Consequently, CAB achieved a surplus of USD 572 million in FY06.

It can be noted that workers' remittance accounts for more than 90 percent of "Current transfers" in FY06. Workers' remittances reached USD 4,802 million in FY06 compared to USD 3,848 million in FY05, reflecting a robust growth of about 25 percent. While balance in the CT Account increased by USD 1,057 million in FY06, workers' remittances increased by USD 954 million contributing 90 percent of the total increase in the CT compared to 87 percent in the preceding fiscal year.

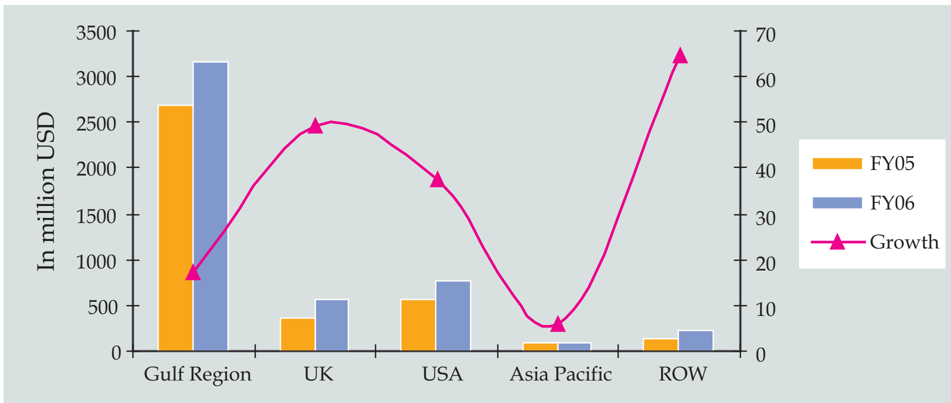
Figure 2.24 : *Changes in Current Transfers*



Source : Constructed based on data from Statistics Department, Bangladesh Bank

Given the reduction of wages (Siddiqui and Abrar, 2003) in the labor importing countries, the rising trend in remittances may be questioned. Three factors may have contributed to this cause. In FY06, more than 286,381 Bangladeshi nationals left for foreign employment which was about 13.78 percent higher than that in FY05. Another notable factor is that inflow of remittances substantially increased from the western countries, particularly from USA and UK. USA alone contributed 21.69 percent of the total increase while UK contributed about 19.23 percent. Finally, remittances grew significantly (about 64.75 percent) from the rest of the world (ROW) as well. It is argued that international efforts to crack down on money laundering and terrorism financing have affected remittances through the informal networks, and workers are looking for formal banking channels through which to remit funds. BB has undertaken measures to make it easier via the banking and other legitimate channels. This may be one of the reasons behind the increased remittance flow from the western countries. The downside risk that has emerged in FY06 is that remittance increase from the Asia Pacific region remains stagnant. Except Singapore, growth of remittances from Malaysia and Japan was negative.

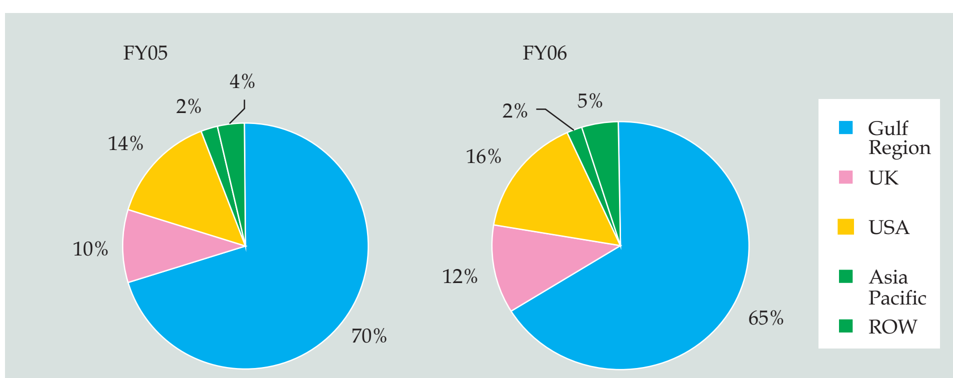
Figure 2.25 : *Region-wise inflow and growth of worker remittance*



Source : Constructed based on data from Statistics Department, Bangladesh Bank

Indeed, significant growth of remittance from the USA, UK and the rest of the world has reshaped the source-based share of workers' remittance. Though inflow of remittances from the Gulf countries has been playing a pivotal role in determining overall growth, their share in aggregate inflow declined to about 65 percent in FY06 from about 70 percent in the last fiscal year. Conversely, share of the USA, UK and ROW have increased to 16, 12 and 5 percent respectively in FY06 from 14, 10 and 4 percent in FY05. These changes indicate that remittance portfolio has been more diversified and has strengthened the capacity to absorb external shock. It is expected that government's recent efforts to enhance employment of Bangladeshi workers in Kuwait, UAE, Malaysia and other countries may further boost remittance inflow in FY07.

Figure 2.26 : *Share of workers' remittances*



Source : Constructed based on data from Statistics Department, Bangladesh Bank

Box 2.1

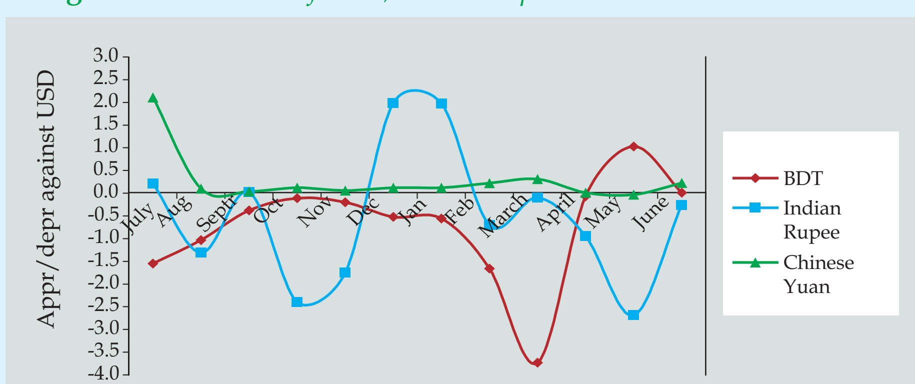
Impact of depreciation on CAB

BDT depreciated against US dollar by 8.50 percent in FY06 compared to 4.23 percent in FY05. The question is whether it had been beneficial to the economy. Economic theory suggests that when an economy runs a deficit in current account balance (CAB), depreciation of domestic currency is essential to restore external balance in the CAB. The argument is that depreciation of local currency makes foreign goods costlier in the domestic market, and helps to curb import. Conversely, it enables exportables more competitive in the international market and thus boosts exports. The unpleasant consequence of depreciation is that foreign investors (except in export-oriented industries) may be affected during conversion of domestic currency into foreign currency, and government debt burden may increase for the same reason. Consumer welfare may suffer due to higher prices of imported goods. Overall evaluation of the net outcome is indeed a difficult task.

When the economy experienced a deficit in CAB in the second quarter of FY05, Bangladesh Bank did not intervene in the foreign exchange market, which allowed BDT to suffer a mild depreciation, i.e., 1.91 percent against USD. When a sizable depreciation (4.43 percent) occurred in the third quarter, BB immediately intervened in the market by selling USD 74 million. As a result, BDT remained almost steady at the fourth quarter, though only a mild depreciation (0.46) occurred. In fact, BB sold USD 389.4 million in FY05 and 336 million in FY06. BB also extended overdraft facilities to commercial banks (NCBs as well as PCBs) facing temporary shortfall in liquidity. During the July-February period of FY06, BB extended 199 million USD through overdraft facilities. Significant growth of export, moderate growth of import, remarkable growth of foreign remittance in FY06 may be partly the outcome of depreciation of BDT in FY05.

It can be noted that after China, India is the main competitor of RMG exports to the US and the EU countries. Revaluation of the Chinese currency in FY05 might have provided Bangladesh with a more advantageous position. But marked depreciation of the Indian rupee against USD indicates that depreciation of BDT was essential to retain competitiveness of RMG exports in the international market. Thus BDT's movement in the same direction might have, to some extent, contributed to improving the overall balance of the current account in FY06.

Figure : *Movement of BDT, Indian Rupee and Chinese RMB in FY 06*



Source : Constructed based on data from Economic Trends, BB

It is argued that remittances are stable even during downturn of the business cycle in the recipient countries than private capital flows, and thus play a vital role in their ability to import capital goods. However, the Economist (26 November, 2005), quoting a World Bank report, mentioned that 50 percent of remittances in the developing countries are sent through informal channels. Bangladesh is not an exception to this observation. The principal informal mode is the *hundi* system, where *hundi* operators take the foreign currency from the wage earner abroad while his relatives or agents in Bangladesh receives an equivalent amount of money in local currency. Since the foreign currency is likely to remain outside the economy, the country is unable to exploit the desired benefit. On the contrary, presence of informal channel indicates formal channels' inefficiency in remitting money to the recipients. Indeed, relatives of the rural migrant workers in the Middle East typically do not have bank accounts and even if they do, they find difficulties with official paper work. Therefore, one of the major challenges confronting traditional financial institutions and other financial service providers is to integrate the remitters and recipients into the financial system (The World Bank, 2004). Though private commercial banks are more efficient in delivering financial services, they have a limited branch network in rural Bangladesh. They (private banks) can remit money to rural areas through the licensed MFIs. They can also use post-offices and pay special attention to those areas where inflows of remittance from immigrant workers are concentrated. Further harmonizing regulatory and compliance requirements of financial institutions between source and destination countries may speed up the activities and shorten the tenure to reach remittance to the ultimate recipients.

2.4.5 : Conclusion

Burgeoning growth (about 21.57 percent) of exports, modest growth (12.06 percent) of import due to strong domestic supply of food grains and other food items, restrained monetary policy accompanied by depreciation of domestic currency and significant growth of remittances, among other, have contributed to the surplus in CAB. Except current transfer account, other three accounts such as trade deficit, services and income account remained in deficit in FY06. Robust growth of RMG exports and relatively lower growth of POL in FY06, among other, moderated the trade deficit in FY06. 'Safeguard quotas' by the US on China for three categories of clothing such as textile, apparel and undergarments during 2006 to 2008 would indeed allow RMG sector a temporary advantage in the US market. However, the industry must overcome labour disgruntlement in order to ensure further growth in the near future. The net balance of services account saw further deterioration by USD (-) 240 million mainly due to rising cost of transportation and insurance services. Higher price of petroleum in the international market must clearly be one of the major reasons behind higher transportation costs. Nevertheless, the upward trend in transportation costs may persist in future due to the high oil price in the international market and thereby the deficit in the net balance of services account is unlikely to improve in FY07. Net outflow on the income account in FY06 showed a deterioration of USD 145 million mainly due to outflow of earnings of oil, gas and power companies. Current transfers (CT), where workers' remittance accounts for more than 90 percent, registered a resilient growth, i.e., about 24.64 percent in FY06 covering about 111.98 percent of total deficit in the other three accounts. Three factors such as higher number of wage earners, rising inflow of remittance from western countries as well as from rest of the world appear to have contributed to this cause. The downside risk that has emerged in FY06 is that remittance increase from the Asia Pacific region remains stagnant. These changes indicate that remittance portfolio has become more diversified and has strengthened the capacity to absorb external shocks. It is expected that government's recent efforts to enhance employment of Bangladeshi workers in Kuwait, UAE, Malaysia and other countries may further boost remittance inflow in FY07. Integrating the remitters and recipients into the financial system and further harmonization of regulatory and compliance requirements of financial institutions between source and destination countries may speed up the activities and shorten the tenure for the remittance to reach ultimate recipients.

2.5 Fiscal Developments [26]

The developing countries have the potential to achieve high economic growth through physical and human capital accumulation, technological progress and structural change. Availability of domestic resources is vital for accelerating the rate of physical and human capital accumulation in a developing country. In analyzing the limits and potential for domestic resource mobilization, UNCTAD (2006: 105) rightly points out that limited domestic resources availability is one of the three reasons why the rate of physical and human capital accumulation is inadequate in most of the LDCs. Higher level of domestic resource mobilization can deliver more government expenditure both in consumption and the productive capacity in the public sectors. There is no denying that the domestic resource component in the budget deficit has been increasing during the last one and half decades in Bangladesh.

2.5.1 : Revenue Management

The level of government expenditure in the developing countries is often limited because of their low level of taxation arising from narrow access to resource rents. In general, government revenues are very low in most LDCs due to the structural constraint facing these economies. During the 1990s, the Bangladesh economy has suffered a serious structural constraint in the domestic resources mobilization efforts. Though the share of revenue (tax, non-tax and grants together) in GDP increased from 10.3 percent in FY91 to 11.2 percent in FY06, one can observe that the revenue/GDP ratio remained virtually stagnant between FY93 and FY97 as depicted in Figure 1.[27] Then the revenue/GDP ratio started to decrease until FY00 and recovered considerably after that. However, Bangladesh's revenue/GDP ratio is one of the lowest in the developing world due to tax evasion especially in the agricultural and the growing informal sector. Even, the revenue receipts as a share of GDP is lower compared to its South Asian neighbours. For example, the average revenue/GDP ratio during 1991-2005 in Bangladesh was 11.1 percent, which is lower in comparison to that of India (12.1 percent), Pakistan (16.1 percent) and Sri Lanka (18.5 percent).

The tax revenue/GDP ratio is even lower in Bangladesh compared with other developing countries and developed countries. A recent calculation of tax revenue as a share of GDP indicates that it is 18 percent on average in developing

[26] Prepared by M. Golam Mortaza, Research Economist, PAU.

[27] The budgetary data is somewhat tricky to analyze. Conventionally, at the time of announcing the budget, say, of FY07 towards the end of FY06, alongwith new figures for the next fiscal year, the original allocation for FY06 are "revised" typically downward in view of both anticipated revenue shortfall (both domestic and foreign sourced) and limited administrative capacity to spend, especially on development projects. The realized figures for a given fiscal year become available after a few months of the conclusion of the year, and are typically called "provisional" estimates.

countries and 38 percent in developed countries (McKinley, 2005). Although on average annual tax collection in the South Asian Region is quite low compared to other developing regions, the scenario is even worse in Bangladesh compared to its neighbours.[28] The average tax revenue-GDP ratio in Bangladesh during 1991-2005 was recorded at 7.5 percent, whereas the average ratio for India, Pakistan and Sri Lanka was 9.1 percent, 12.2 percent, 16.2 percent respectively.

Total budgetary revenue in Bangladesh is mainly divided into three major parts, namely tax revenue, non tax revenue and grants from abroad. Historically, in Bangladesh, taxes contribute around 80 percent of total revenue collection in a given year. Major portions of the tax revenue are collected by National Board of Revenue (NBR), about 95 percent, and the rest is non-NBR portion.[29] Three major items, namely VAT, customs duty and income tax dominate the tax revenue. According to the latest available data for the period of July-June FY06, NBR registered a significant 13.7 percent growth over the corresponding period of FY05, where income tax registered 28.3 percent growth. Among other major components of NBR tax revenue, VAT registered a considerable 19.1 percent growth during this period, whereas a marginal negative growth ((-) 1.1 percent) of import duties has been observed during the same period. On the other hand, according to the Budget FY07, non-NBR tax revenue registered a growth of 15.7 percent during the July-June FY06, while non-tax revenue posted a significant growth of 16.6 percent during the same period.

(a) VAT

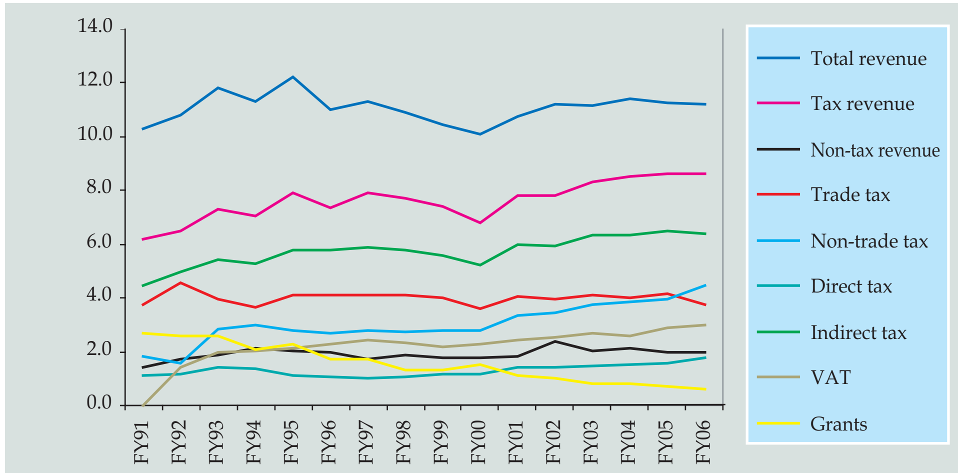
The success of the early 1990s in revenue growth was triggered by the introduction of Value Added Tax (VAT), expanding the tax base and increasing of the tax rates. VAT provided a bigger source of revenue compared to the taxes it replaced, mainly in respect of taxation of domestic production. Currently VAT contributes one-third of total tax revenue collection of the country and the share of VAT in GDP increased from 1.4 percent in FY92 to 3.0 percent in FY06, as depicted in Figure 2.28 The fall of VAT collection in the second half of 1990s was largely predicated by the devastating floods of 1998. Some recovery was, however, observed in FY01, when the total revenue collection recorded 10.7 per cent of GDP and reached its peak during the last one and half decades in FY04, when total revenue was 11.4 percent as a percent of GDP. This was possible due to some progress in meeting the revenue collection targets facilitated by on-going reforms initiated by NBR.

(b) Tax and non-tax revenues

It is observed that tax revenue as a percentage of GDP increased considerably from 6.2 percent in FY91 to 8.6 percent in FY06, whereas non-tax revenue as a percentage of GDP increased from 1.4 percent in FY91 to 2.1 percent in FY06. Although both the components of total revenue receipts increased in terms of a percentage of GDP, their relative share in the total revenue receipts remained virtually the same, even declining a little, during the last one and half decades. However, on average, the share of non-tax revenue in total revenue receipts increased slightly from 19.4 percent during 1991-95 to 20.1 percent during 2001-06.

[28] For instance, see, Ahmed (2005).
[29] Non-NBR portion of tax revenue contains narcotics duty, motor vehicles tax, land tax and non-judicial stamp tax.

Figure 2.28 : *Revenues as percent of GDP*



Source : Author's construction based on MoF (2002-2006), BB (1997-2006)

(c) Trade and non-trade taxes

Tax revenue, the share of trade tax revenue in GDP remained stagnant at around 4 percent during FY91-FY06, whereas the non-trade taxes increased significantly from 1.84 percent in FY91 to 4.46 percent in FY06. This suggests that the non-trade tax revenue increased its share from one third of total tax revenues to almost half of that just within one and half decades, mainly due to considerable success in VAT collection.

(d) Direct and indirect taxes [30]

Although the share of both the direct tax and indirect tax revenue as a percent of GDP increased, their share in the total tax revenue remained stagnant, around 20 percent and 80 percent respectively, since the beginning of 1990s.

(e) Grants

Grants contributed significantly in reducing budget deficit during the first half of 1990s, when on average, grants recorded 2.5 percent share of GDP. However, a declining trend in grants/GDP ratio has been observed since FY96, and the share of grants in GDP remained below 2 percent during the later half of 1990s. The decline in disbursement of grants continued during the first 6 years of the new decade, when the share of grants was 0.8 percent of GDP.

2.5.2 : Public Expenditures

In general, government final consumption expenditure in developing countries is equivalent to about 15 to 16 percent of GDP. At around 14 percent of GDP, public expenditure in Bangladesh is among the lowest in the developing countries and even in the world (Glinskaya et. al., 2005). Public expenditures as a share of GDP experienced a rise in the early 1990s from the benchmark level of 13.6 percent in FY91 and hovered above 14 percent during the mid-1990s. The said share once

[30] Direct taxes mainly consist of income tax, other taxes and non-NBR portion of tax revenue, where the rest of the tax revenue is defined as indirect taxes.

again started to increase in the second half of the 1990s, recording its peak in FY06 (15.0 percent). It is important to note that in comparison to its neighbours, public expenditure-GDP ratio in Bangladesh remains quite low. For example, in Sri Lanka and Pakistan central government expenditures as a share of GDP (2005) were about 23.5 percent and 18.2 percent respectively, whereas the ratio was 12.3 percent in India. However, in terms of the quality of public expenditure allocation, Bangladesh performed much better compared to these countries.[31] For example, both interest payments and defence spending as percent of GDP in Bangladesh are lower when compared with India, Pakistan and Sri Lanka, while social expenditures increased over the years in the country (Glinskaya et. al., 2005).

(a) Current Expenditures

Traditionally, current expenditures in Bangladesh are around 6-8 percent of GDP, one of the lowest even in the South Asian region. Current expenditures as a share of GDP experienced a sluggish rise throughout the 1990s. However, it is observed that the average growth of current expenditure was lower during the first half of the 1990s compared to the second half. For instance, current expenditures as a percent of GDP were, on average, 6.7 percent during the FY91-FY95 period; whereas the comparable figure for the next period (FY96-FY00) was 7.2 percent. The said ratio increased to 8.5 percent on average during the first five years of the new decade (FY01-FY05).

The latest available data from budget FY07 for the period of July-June FY06 shows that actual current spending was 10.1 percent higher than the corresponding figure of the previous fiscal year. Actual spending up to June FY06 was 97.3 percent of the total FY06 target, which was 101.4 percent during the same period in FY05. A detailed sector-wise share of revenue expenditure suggests that interest payments have the largest share (21.7 percent), followed by Education (18.6 percent), General Public Services (13.7 percent) and Defence (12.7 percent).

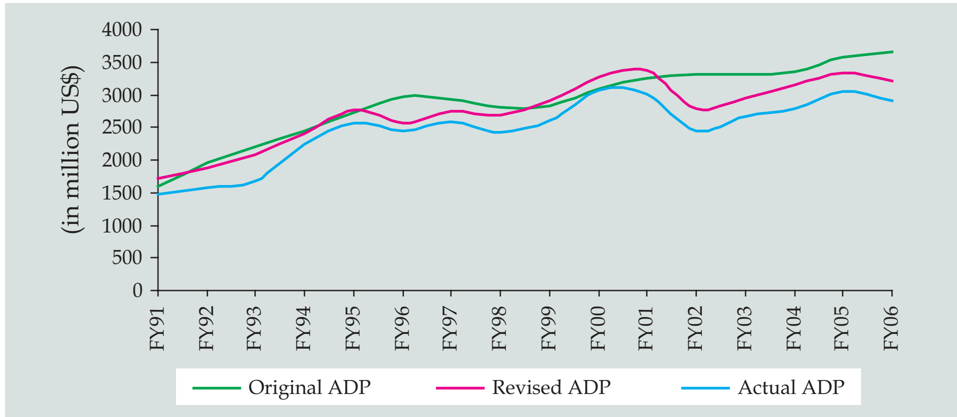
(b) Annual Development Programme (ADP)

During the 1990s, the records of the Annual Development Programme (ADP) do not show any consistency between original, revised and actual outlays. In the first half of the 1990s revised allocations of ADP plunged below the originally budgeted amount except for FY91 and FY95; this trend continued in the first three years of the second half of 1990s as depicted in Figure 2. A tradition of increasing the size of the ADP during its revision has been observed for the three consecutive years since FY99. However, original ADP has been above the revised ADP during the FY02-FY06.

Actual ADP fell short of the original as well as the revised targets during the last one and half decades (see, Figure 2.29) showing weak project implementation. The actual ADP size has risen steadily during the 1990s with local peaks in year-over-year growth recorded in FY94 (34.2 percent), followed by FY00 (18.2 percent). The annual performance (in US$ terms) took a sharp negative turn in FY02, and reached to the end-millennium level by FY06. However, as a share of

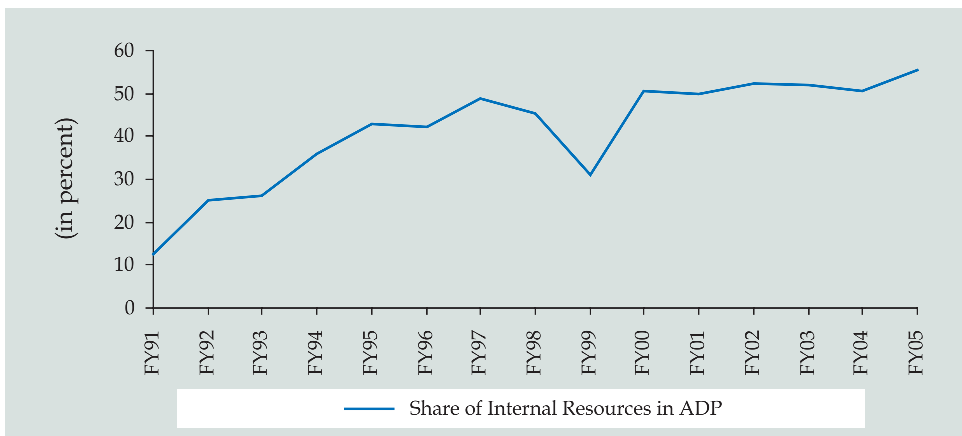
[31] Here, the broad categories of public expenditures allocations include interest payment, education, health, agriculture, transport, public order and safety and defence spending.

Figure 2.29 : *Original, Revised and Actual ADP (in million US$)*



Source : Author's construction based on MoF (2002-2006).

Figure 2.30 : *Share of Internal Resources in Actual ADP (FY91-FY05)*



Source : Author's construction based on MoF (2002-2006).

GDP, a downward trend was observed in the actual ADP-GDP ratio since the end of 1990s. On average, the figure stood at 5.4 percent for FY91-95 and 5.9 percent for FY96-FY00. During the first six years of the new decade (FY01-FY06) the said ratio continued to decrease and stood at 5.7 percent.

One of the key constructive trends in public expenditure management of Bangladesh throughout the 1990s has been the decrease in the dependence on foreign aid for financing the ADP. The realized share of the domestic contribution in ADP financing increased from about 13 percent in FY91 to more than 50 percent at the end of the decade - with the exception of the flood year FY99 as depicted in Figure 2.30. It needs to be pointed out that the incremental share of domestic financing of the ADP was underwritten only in part by domestic revenue, and by government borrowing from the banking and the non-bank public sources.

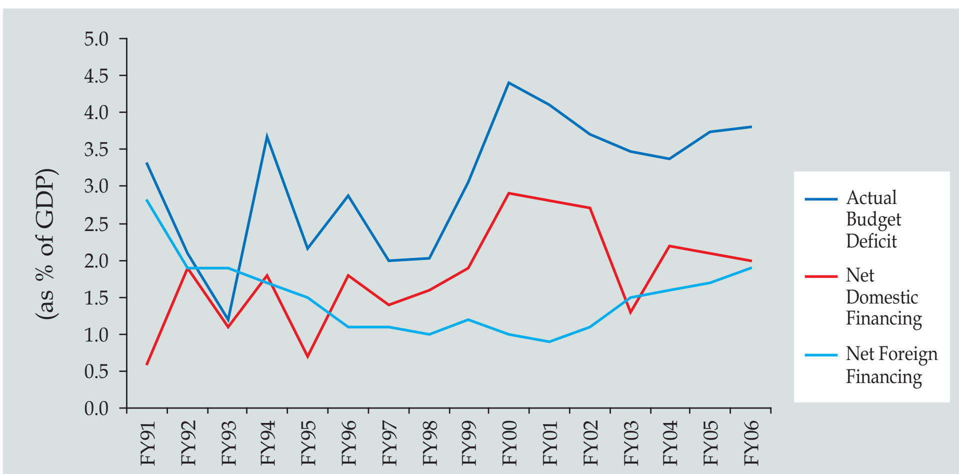
Recent data for the period of July-June FY06 indicates that 90.57 percent of the revised ADP allocation was spent, implying some underutilization of the development expenditure. Nevertheless, the actual expenditure during July-June

FY06 is 4.0 percentage points higher than the amount spent during the comparable period of FY05 and it constitutes about 5.9 percent of GDP in FY06. Despite the ADP underutilization in FY06, the size of ADP for FY07 has been set at BDT 260 billion which is 33.5 percent higher than the actual ADP of FY06.

2.5.3 : Fiscal Deficits and its Management

Traditionally, Bangladesh, as a developing country, has a tendency to experience income-induced fiscal deficits (Hossain, 1995).[32] While implications of this trend are supportive of the overall growth process of the country, fiscal management became difficult especially since the 1990s. Although a higher level of the budget deficit as percentage of GDP was observed in the early period of the 1990s, the share had decreased to 2.2 percent in FY95, from 3.3 percent in FY91 (see Appendix 1). The share remained below 3 percent for the first couple of years in the second half of 1990s. However, in the presence of increased demand on expenditures and lower-than-forecast revenue collection, largely because of flood- related expenditures, the overall budget deficit shot up to 4.4 percent of GDP in FY00. However, a gradual decrease in the relative size of the fiscal deficit was observed since FY00 and the deficit was restrained at less than 4.0 percent over the period FY01-FY05.

Figure 2.31 : *Budget Deficit and its Financing*



Source : Author's construction based on MoF (2002-2006).

In the early 1990s budget deficit were largely financed by foreign resources. However, the share of foreign resources in the total deficit financing decreased steadily since the second half of the 1990s, as depicted in Figure 2.31. For example, net foreign financing of budget deficit was 2.8 percent of GDP in FY91 which decreased to 1.7 percent in FY05. The incremental share of the budget deficit was mostly financed by the domestic sources and net foreign financing sequentially fell during the second half of the 1990s. In FY06, the share of domestic and foreign financing was 2.0 percent and 1.9 percent of GDP, respectively.

[32] This means that the income elasticity of government expenditure exceeds the income elasticity of government revenue in the long- run.

Among domestic sources, the trend in government borrowing suggests that non-banking sources dominate the overall domestic financing. Over time, government borrowing from non-banking sources has been increasing, while an irregular trend has been observed in the borrowing from scheduled banks and the Central Bank (BB, 2006: 23-29).

The budget FY07 suggests that overall budget deficit during July-June, FY06 was 0.54 percent lower than the corresponding period of FY05. While net foreign financing showed a negative growth of (-) 9.9 percent, the share of domestic financing in the total increased from 55.1 percent in June FY05 to 59.4 percent in June FY06. Since the net domestic financing has increased significantly, borrowing from the banking sector stood at BDT 46.2 billion during July-June of FY06 which is 25.9 percent higher than the corresponding period of FY05.

2.5.4 : Conclusion

One of the major challenges of the government is to manage its budget through raising revenue in order to reduce the pressure on borrowing. The challenges in regard to raising revenue come from the low tax base of the country. It is going to be increasingly difficult to collect revenue from a very limited set of tax handles. However, inefficiency and lack of proper planning by various government departments have kept a significant fraction of planned expenditures (especially ADP) from being implemented. Consequently, the deficit has been contained at a more moderate level than otherwise would have been the case. As a result, dependency on foreign resources to manage country's budget deficit has fallen during the last one and half decades.

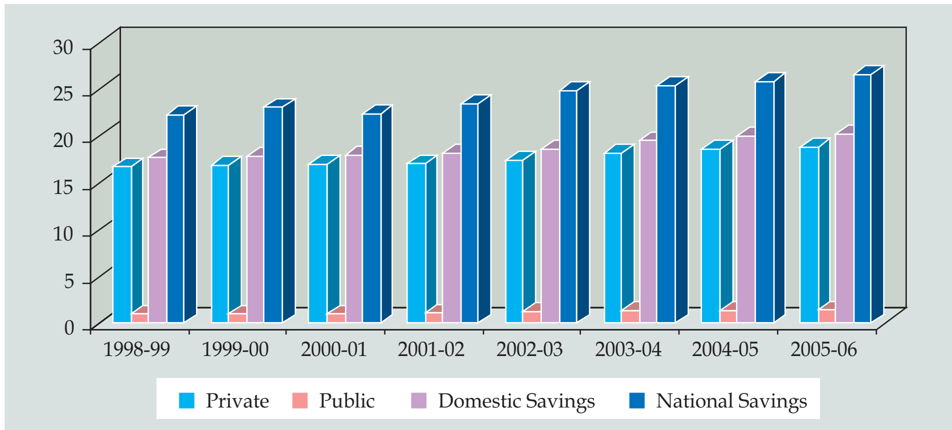
Although NBR has undertaken efforts to raise revenue and modernize tax administration, it also needs to think about a broad-based reform of the tax system in order to strengthen tax collection. The NBR, as an organization, needs to improve its efficiency in collecting taxes by improving the tax structure. Moreover, income tax coverage will need to be expanded to change the current tax structure of the country. Since a significant number of the urban retailers remain outside the VAT umbrella, revenue mobilization will increase through a more and effective implementation of VAT in the urban area. It is also necessary to take steps to provide income tax related information easily to the potential tax payers, both in rural and urban areas, so that tax compliance process seems easy to them.

2.6 Savings [33]

In Bangladesh, domestic savings GDP ratio has been growing over time. Although the level of savings GDP ratio in the country had been fairly moderate in the last decade viewed in the perspective of higher economic growth target, the recent trend is positive. The ratio rose from 17.71 percent in FY99 to 20.26 percent in FY06 (Figure 2.32). Besides, national and gross domestic savings maintained an average growth of about 12.50 and 13 percent respectively for the period between FY00 and FY06 (Figure 2.33). The major share of domestic savings, which is the private sector component, shows a steady upward trend, reflecting rising private sector dominance in overall economic activities in recent years. In particular, the share of private savings in GDP has increased to 18.85

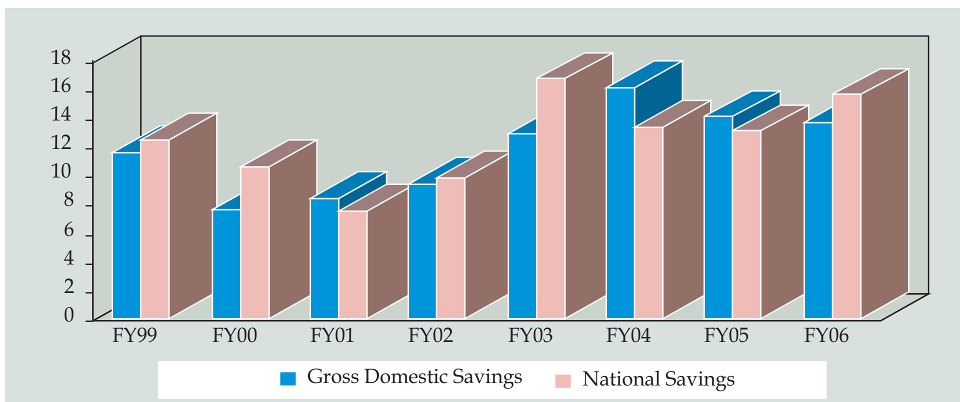
[33] Prepared by Md. Ezazul Islam and Shamim Ahmed, Research Economists, PAU.

Figure 2.32 : *Savings as percent of GDP in Bangladesh*



Source : BBS (2001, 2005, 2006)

Figure 2.33 : *Savings Growth Rates in Bangladesh*



Source : BBS (2001, 2005, 2006).

percent in FY06 from 16.72 percent in FY99. On the other hand, the public sector savings grew to 1.41 percent from 1-percent during the same period, inspite of continuous losses incurred by the SOEs.

National savings, depending mainly on net factor income and net current transfer (Box: 2.6.1), show a remarkable movement in recent years due to strong inflow of current transfers, especially remittances. Available data indicate that the share of national savings in GDP has moved to 26.61 percent in FY06 from 22.31 percent in FY99. According to BBS, net factor incomes (NFI) and net official and private transfers grew by 7.8 percent and 26.4 percent in FY05 respectively.[34]

If the share of savings in GDP in the country is compared with that of India, Pakistan, and Sri Lanka, an interesting picture emerges (Figure 2.6.3). It is seen that savings share in GDP is higher than that of Pakistan and Sri Lanka while lower than that of India (e.g., in FY04, savings share in GDP was 28.1 percent in India, 16.5 percent in Pakistan, and 16 percent in Sri Lanka).

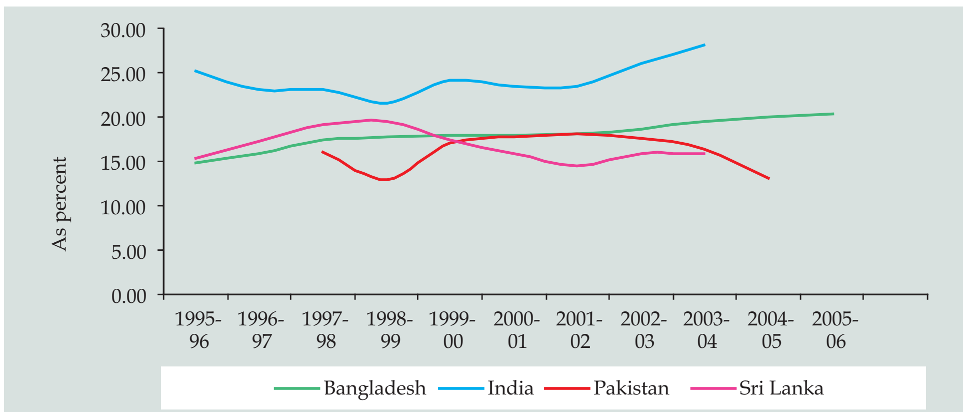
[34] BBS definition of NFI includes workers remittances from overseas.

Box 2.2 : *National Income Identity: Saving*

GDP	= C + I + (X-M)
or, GDP-C (private & government consumption)	= I + (X-M)
or, S_D (gross domestic saving)	= I + (X-M)
Again, GDP	= C + I + (X-M)
or, GDP + NFI (net factor income from abroad)	= C + I + (X-M) +NFI
or, GNI (gross national income)	= C + I + (X-M) + NFI
or, GNI + NCT (net current transfer)	= C + I+ (X-M) + NFI + NCT
or, GNDI (gross national disposable income)	= C + I + (X-M) + NFI + NCT
or, GDNI - C	= I + (X-M) + NFI + NCT
i.e., S_G (gross national saving)	= I + CAB
where CAB = (X-M) + NFI + NCT	
CAB = Current account balance obtained from the balance of payments (BOP)	

Source : BBS (2005).

Figure 2.34 : *Savings as percent of GDP in Selected South Asian Countries*



Sources: 1. BBS (2001, 2005, 2006), 2. Reserve Bank of India (www.rbi.org.in), State Bank of Pakistan (www.sbp.org.pk), and the Central Bank of Sri Lanka (www.cbs.org).

In Bangladesh, although the growth of savings share in GDP and national savings have been impressive during recent years, it is still quite moderate for attaining and sustaining economic growth of 8 to 9 percent per annum as would be consistent with the goals of poverty reduction.[35] While private savings is growing faster, public sector contribution to savings is quite low and there is a good scope of increasing public savings by reducing losses incurred by SOEs. The later may be effectual by a judicious plan of divestment and privatization. Therefore, the major challenge for Bangladesh is to mobilize and raise savings to provide enough funds for investment spending to about 30 percent of GDP.[36] Although this might appear as a reasonable proposition, it could be difficult to materialize in the absence of an enhanced level of FDI and the political economy of steering public sector losses.

[35] According to the Poverty Reduction Strategy Paper (PRSP), an enhanced economic growth rate of 8 to 9 percent per annum is required to achieve the poverty reduction targets set by the Millennium Development Goals (MDGs) in Bangladesh (GOB, 2005).

[36] This figure follows from authors' own estimation by the well known capital-output ratio in the Harrod-Domar framework. This framework has been used extensively in developing countries to examine the relationship between economic growth and capital requirement, i.e., investment spending (Perkins et al., 2001).

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Appendix 2.1 : *Bangladesh Central Government Operations, FY91-FY06 (as % of GDP)**

	FY91	FY92	FY93	FY94	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06(p)
1. Total revenue	**10.3**	**10.8**	**11.8**	**11.3**	**12.2**	**11.0**	**11.3**	**10.9**	**10.5**	**10.1**	**10.7**	**11.2**	**11.2**	**11.4**	**11.3**	**11.2**
a) Tax revenue	6.2	6.5	7.3	7.1	7.9	7.4	7.9	7.7	7.4	6.8	7.8	7.8	8.3	8.5	8.6	8.6
i) VAT	0.0	1.4	2.0	2.0	2.1	2.3	2.5	2.3	2.2	2.3	2.4	2.5	2.7	2.6	2.9	3.0
ii) Customs duty	2.1	2.4	2.3	2.3	2.4	2.3	2.4	2.2	2.2	1.9	1.9	2.0	2.0	2.2	2.2	1.9
iii) Income tax	1.0	1.1	1.4	1.3	1.0	1.0	1.0	1.0	1.1	1.3	1.4	1.5	1.6	1.6	1.6	1.7
iv) Others	3.1	1.6	1.7	1.5	2.3	1.8	2.1	2.1	2.0	1.4	2.1	1.8	2.1	2.1	2.0	2.0
b) Non-tax revenue	1.4	1.7	1.9	2.1	2.0	2.0	1.7	1.9	1.8	1.8	1.8	2.4	2.1	2.1	2.0	2.0
c) Grant	2.7	2.6	2.6	2.1	2.3	1.7	1.7	1.3	1.3	1.5	1.1	1.0	0.8	0.8	0.7	0.6
2. Total expenditure	**13.6**	**12.9**	**13.0**	**15.0**	**14.4**	**13.9**	**13.3**	**12.9**	**13.5**	**14.5**	**14.8**	**14.9**	**14.6**	**14.8**	**15.0**	**15.0**
a) Current expenditure	6.7	6.6	6.8	6.7	6.7	7.0	6.8	7.1	7.5	7.7	8.1	8.3	8.4	8.6	9.0	8.5
b) Annual development Program (ADP)	4.4	4.7	5.0	6.5	6.6	5.9	6.0	5.4	5.6	6.4	6.3	5.5	5.6	5.7	5.5	5.9
c) Others**	2.5	1.6	1.2	1.8	1.1	1.0	0.5	0.4	0.4	0.4	0.4	1.1	0.6	0.6	0.5	0.6
Overall budget deficit (excluding grants)	**-6.0**	**-4.7**	**-3.8**	**-5.8**	**-4.5**	**-4.6**	**-3.7**	**-3.3**	**-4.3**	**-5.9**	**-5.2**	**-4.7**	**-4.3**	**-4.2**	**-4.5**	**-4.4**
Overall budget deficit (including grants)	**-3.3**	**-2.1**	**-1.2**	**-3.7**	**-2.2**	**-2.9**	**-2.0**	**-2.0**	**-3.0**	**-4.4**	**-4.1**	**-3.7**	**-3.5**	**-3.4**	**-3.7**	**-3.8**
Financing	**3.4**	**3.8**	**3.0**	**3.5**	**2.2**	**2.9**	**2.5**	**2.6**	**3.1**	**3.9**	**3.7**	**3.8**	**2.8**	**3.8**	**3.8**	**3.9**
a) Domestic financing	0.6	1.9	1.1	1.8	0.7	1.8	1.4	1.6	1.9	2.9	2.8	2.7	1.3	2.2	2.1	2.0
i) Bank Financing	0.2	1.2	0.2	0.6	0.0	1.0	0.9	0.6	0.9	1.5	1.1	0.9	-0.3	0.8	1.0	0.9
ii) Non-bank financing	0.4	0.7	0.9	1.2	0.7	0.8	0.5	1.0	1.0	1.4	1.7	1.8	1.6	1.4	1.1	1.1
b) Foreign financing	2.8	1.9	1.9	1.7	1.5	1.1	1.1	1.0	1.2	1.0	0.9	1.1	1.5	1.6	1.7	1.9
Current GDP (BDT in billion)	1105.18	1195.42	1253.70	1354.12	1525.18	1663.24	1807.01	2001.77	2196.97	2370.86	2535.46	2732.01	3005.79	3329.73	3684.76	4161.60

*Prepared by Md. Golam Mortaza, Research Economist, PAU.

** i) Others include net outlay for food account operation, loans and advances, structural adjustment expenditure, and items in the development expenditure such as programs financed from non-development budget, non-ADP employment generation programs and non-ADP Food For Work (FFW) and transfers, ii) p = Provisional

Sources: Bangladesh Economic Review 2002-2006, Finance Division, Ministry of Finance.