Chapter 5

Macroeconomic Outlook for FY 07[97]

5.1 Growth Outlook

5.1.1 : Assessment of Growth Prospect in FY07

Official Estimate (BBS) of the real GDP growth (provisional) for FY06 has been put at 6.7 percent, which is significantly higher than 6.0 percent recorded in FY05. The higher growth is mainly attributed to the significant advances in agriculture & forestry and manufacturing industry sectors which grew at 4.7 percent and 10.5 percent respectively (against a positive growth of 1.8 and 8.2 percent in the previous fiscal year).[98] While precise estimates are not available, it is plausible that the sustained high international price of oil in FY06 has adversely affected potential output in all sectors, even though the former has not been fully passed on to the domestic level.

A principal task of this chapter is to provide an assessment of the growth prospects for FY07. Several figures have already been suggested in different studies. Government's latest revised target for output growth for FY07 is 6.8 percent as discussed in the "Medium Term Macroeconomic Framework (MTMF)" which was prepared within the context of the National Strategy for Accelerated Poverty Reduction, NSAPR (GOB, 2005). The Asian Development Bank's Update (ADB, June 2006) forecasts growth rate of 6.0 percent in FY07. The *Monetary Policy Statement* of Bangladesh Bank (July, 2006) forecasts the real GDP growth in the range of 6.5 percent to 6.8 percent in FY07. The above cited documents generally hold that the growth momentum is expected to sustain or strengthen in industry and services, while agricultural sector growth may moderate towards its trend level. We re-evaluate these positions in light of analysis based on more recent information.

5.1.2 : Aggregate Spending: Demand-Side Outlook

Gross disposable income has been estimated by BBS to have grown by 7.2 percent in FY06 as opposed to a rate of 5.9 percent over the preceding two years (FY04 and 05). Since *tax revenue* (as a share of GDP) has remained constant at 8.5 percent over the past two fiscal years (FY05 and 06), the higher growth of disposable income is mainly due to net factor income from abroad. Real wage growth data (1969-70 base), which covers only a fraction of the employed work force, shows stable growth (on average) at six percent over the past three years, a little behind the real GDP growth of 6.3 percent.

[97] While parts of this chapter were initially drafted by Dr. Md. Akhtaruzzaman, Md. Shahiduzzaman, Md. Habibour Rahman, Md. Sakhawat Hossain, and Md. Nehal Ahmed, it has been extensively debated within BB, and the final version has been edited by the Resident Economic Advisor.

[98] Note that "agriculture & forestry and manufacturing industry" occupied 16.91 and 17.05 percent share of GDP in FY06.

Household (i.e., private) real consumption spending is however estimated to have grown at 5.2 percent in FY06. While this figure indicates faster growth than experienced over the past several years, the pace is still behind that of real GDP, which may be due to the slower relative growth of wage income. Given the fast growth of disposable income in FY06, continuing growth in remittance flows, the ongoing property boom and the second phase of public sector salary adjustment currently being implemented all point to higher growth of consumer spending in FY07. Inflow of remittances, which recorded a significant growth of 24.9 percent during FY06, is expected to remain robust in FY07. Manpower exports are likely to pick up in countries such as Malaysia, which had some form of embargo in effect until recently. Indeed, during the first quarter of FY07 remittances have grown by 24 percent (over the corresponding period of FY06).

Investment demand, especially for capital machinery, power generation, infrastructure development in railway, road transportation, gas, telecommunication and health care delivery, appears to remain strong in FY07. Growing private sector credit, FDI and donor commitment to fund infrastructure and energy development projects are likely to provide the funding in FY07 to support the required investment. FY06 gross domestic investment (inclusive of public investment) has been estimated at 25.0 percent, which, as discussed elsewhere in the *Review*, has to grow to the 30-percent range in order to deliver sustained faster growth required in view of the goals of poverty reduction. It is unlikely that such a level of investment can be met from domestic sources alone, and under a suitable enabling environment, there is a significant scope of FDI in the sectors cited above. Indeed, Board of Investment (BOI) has received several tentative proposals of interest.

Since the Annual Development Program (ADP) budget is a major source (typically 60 percent or above) of public investment, it would be appropriate to review its likely outcome in FY07. Provisional estimates of FY06 ADP expenditure reached 5.0 percent of GDP from 3.7 percent in FY05. The targeted ADP of 5.6 percent of GDP proposed in the FY07 budget would appear overly ambitious. Domestic financing of ADP, which of late has dominated foreign financing, is likely to be restrained by limited growth in revenue collection and concern over macroeconomic stability on account of undue reliance on bank borrowing (especially central bank) by the government.[99] Current expenditure of the government, a good part of which constitutes "public consumption", on the other hand, has been targeted to reach 8.0 percent of GDP, which is close to the average for the last five years, and would thus appear realizable.

Government revenue collection during FY06 recorded a modest growth of 13.6 percent (in nominal terms), which is slightly off the previous year's record of 14.0 percent. As a share of GDP it crawled up to 10.5 percent of GDP (vs. 10.4 in FY05), well below the original budgetary target of 11.0 percent. Lacking significant reforms, the target revenue collection of 11.3 percent of GDP for FY07 would appear overly optimistic. Indeed, the first quarter growth in tax revenue collected by NBR rose by a meagre 8.9 percent (vis-à-vis 16.0 percent growth in the first quarter of the last fiscal). Unless reversed in subsequent quarters, the

[99] In FY06, foreign financing contributed 24.5 percent of total ADP outlays as against 36.7 percent in FY05, while the share of "bank financing" in FY06 rose to 27.5 percent of ADP from 22.9 percent in FY05 (Table III.1, p60, BB, 2006b).

latter development may imply an excessive reliance on domestic borrowing in FY07 (both bank and non-bank) thereby compromising the budgetary discipline of the government.

5.1.3 : Outlook for Net Trade

Export Potential: In FY06, Bangladesh crossed a threshold of 10 billion USD of exports for the first time, actually reaching USD 10.53 billion, which implied a growth of 21.63 percent over the previous fiscal. The growth of export earnings contributed to reducing the trade deficit by about 12 percent compared to the previous year. Bangladesh's export basket is narrow; only a few products contribute major share of total exports. RMG alone contributes more than 75 percent of the total export earnings. The recent surge in knitwear, where clearly Bangladesh has a comparative advantage among its competitors, and the renewed strength of the woven category early in FY07 is expected to continue in the immediate future partly due to the imposition of 'safeguard quotas' by the US administration up to 2008 on China, which is the largest supplier of textile and apparel products to USA.[100] This advantage, along with other factors like price competitiveness, enhanced GSP facility, better adjustment to the rules of origin criteria, and market diversification will each help the country to continue the growth momentum of export earnings in the apparel sector. In FY06, exports to new destinations (other than US or EU) grew by nearly 300 percent (Table 5.1).[101] This is a welcome development and augers well for the future. Export data for the first two months of FY07, which shows 31.3 percent growth, has been encouraging.

In FY06, earnings from RMG exports totalled USD 7.9 billion with 23.1 percent growth over FY05. Knitwear products continued to maintain a robust growth, posting a 35.38 percent rise. Export of woven garments also maintained a moderate growth of 13.50 percent during the year. Significant flow of import of textile and garments related machinery reveals the sector's continuous efforts to improve competitiveness by updating and strengthening its capacity. However, the recent labour unrest for wage hike may have tarnished the image of the industry. Although government, entrepreneurs and labour unions have worked out an agreement on the structure of wages, tension still prevails between the employer and the employee. In response to the wage hike, the entrepreneurs are planning to increase the product price, which, according to BGMEA, is unlikely to affect the competitiveness of the RMG products as most exports are competitive vis-à-vis India, Pakistan and Vietnam. It is anticipated that such a price rationalization will fetch about an additional USD 1 billion in exports income in FY07.

Apart from RMG, the other promising areas like leather (16.45 percent), petroleum by-products (152.08 percent), textile fabrics (117.45 percent), raw jute (54.14 percent), pharmaceuticals (29.16 percent), and frozen food (9.12 percent) performed well in FY06. This trend is expected to continue in the FY07 because of the diverse interest for the above mentioned products. Earnings from tea, handicrafts and ceramic products have declined and recorded a negative growth during this period.

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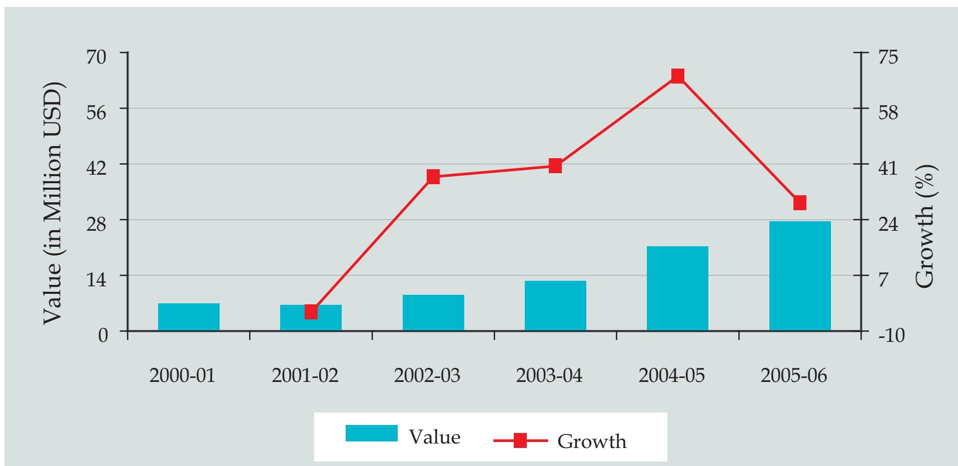
[100] Restrictions are also in force against Chinese imports to EU.

[101] While the figure is impressive, the quantitative significance is still rather limited.

Frozen foods, mainly shrimps, the second in the country's export basket, registered a record earning of USD 459 million with a growth of 9.12 percent in the last fiscal year. Having immense potential, the sector is suffering from poor management in shrimp processing, for example in quality control, hygienic issues etc, which pose serious obstacle for further expansion. Necessary steps should be taken in order to implement corrective measures, which, according to some estimates, may help to increase the sectoral export earnings by three folds by 2010.

Pharmaceuticals is one of the fastest growing industries in the country having a market size of USD 500 million in 2005. After fulfilling 96 percent of domestic demand, the industry contributed about 30 percent of annual export growth. The quality of pharmaceutical products provides an opportunity for market expansion both locally and internationally. At present products are being supplied to various countries including Myanmar, Sri Lanka, Pakistan, Kenya, Singapore and African Countries.

Figure 5.1 : *Growth of Pharmaceutical Exports*



Source: Export Promotion Bureau (EPB)

According to the World Trade Organization's Doha Declaration on Trade-Related Aspects of Intellectual Property Rights (TRIPs), all LDCs, including Bangladesh (except China and India), were given an exemption from pharmaceutical patent protection until 2016. This exemption creates possibilities for significant growth in the home market as well as exports. Entrepreneurs and policy makers should create an environment that allows the industry to siege the opportunities created by this trade provision.

Import Outlook: FY06 growth in import payment (12.16 percent) turned to a more sustainable figure than the previous year's growth of about 21 percent. Even then in FY06 significant growth occurred in the import of capital machinery, petroleum products and construction material. Although the textile sector observed a moderate growth compared to other sectors, its share in total import was the highest. The latter phenomenon can be explained by persistent efforts by the industry to establish strong backward linkage by setting up composite mills with adequate capacity to meet the growing demand. Of course strong negative growth of foodstuff helped to limit the overall growth of imports (Table 5.2).

Given the recent trend in industrial (both large and medium scale) and construction sub-sector growth, imports related to these activities are expected to continue at about the pace of the current fiscal year. In spite of the recent price moderation, global tensions leave the oil market rather volatile. While volume of petroleum demand may not increase, the enhanced oil price may still result in a large import bill. Growth rates of textile and garments related machinery in FY06 were about 47 and 52 percent respectively against 50 and 32 percent in FY05, and strong growth of capital machinery import in these sectors is expected to continue in FY07 in order to expand capacity and competitiveness.

The first two months of FY07 saw imports rise by 17.1 percent over the corresponding period of FY06. The first two-month growth of import in FY06 was a shade higher at 18.1 percent. Given seasonality in the flow of imports, the early indication is that FY07 import growth would remain stable. One has to contend with the possibility that the recent currency appreciation would make imports somewhat attractive, especially for raw material and intermediate goods for the expanding industrial sector. It is anticipated that the Bangladesh Bank's monetary policy stance would help in maintaining import growth at the currently sustainable range of 10 to 15 percent.

A Sum Up: Export oriented enterprises have been growing for the last few years, which caused significant improvement in export earnings during the last fiscal year, and is expected to remain healthy in FY07. Government has set a target of USD 12.33 billion exports for the current fiscal year (i.e., a projected growth of 17 percent). Among the export items, RMG is expected to experience robust growth and the projected earnings from this sector is about USD 9.3 billion, implying an 18 percent growth. Despite the moderate growth in imports and record growth in exports, the trade deficit is still high at about 4.64 percent of GDP in FY06 (vis-à-vis 5.46 percent in FY05). Since this *Review* expects that exports will continue its current level of growth and import growth remain moderate, the trade deficit is expected to narrow further in FY07, though the volatile cost of petroleum products remains a source of disquiet in this prediction.

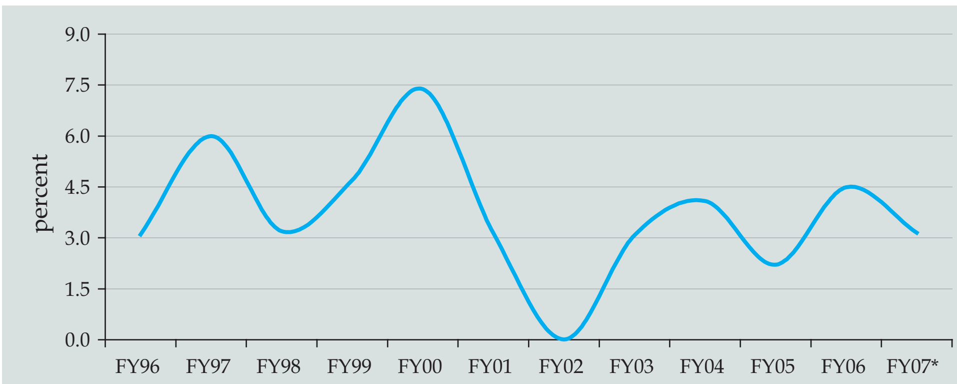
5.1.4 : Sectoral Output Growth: Supply-Side Outlook

Agriculture: As part of the intensive crop production program, initiatives have been taken by the Ministry of Agriculture (MOA) of the Government of Bangladesh (GOB) to increase production in FY07. The recent projection of the Directorate of Agricultural Extension indicates strong production in FY07 following a rebound in FY06. MOA expects agriculture growth to be led by expected bumper production of cereal products (8.05 percent). However, as the agriculture production in Bangladesh is largely dependent on nature, adverse climatic conditions may result in a slower growth in FY07; *aman* production is already found suffering from unexpected drought, especially in northern districts. Also, higher prices of fuel oils and shortage in the supply of electricity are putting additional difficulties to farmers to meet their cultivation target. While the disbursement of agricultural credit over July-August '06 has actually declined marginally vis-à-vis the level reached in the comparable period of FY06, the targeted level of disbursement over FY07 has been set at 9.1 percent higher than last year's, which appears to be adequate.[102]

[102] FY06 disbursement actually exceeded the target by 4.5 percent. Note may also be taken of the recent government directive to sanction agricultural credit for selected crops at the special subsidized rate of two percent to be administered by Bangladesh Bank.

In view of the analyzed trend during the period FY97-06, this *Review* projects the agricultural sector to grow in a range of 2.8-3.4 percent in FY07 (Table 4.1 of chapter 4). This projection is lower than the actual growth of agriculture in FY06, but higher than that in FY05. It is uncertain whether the export impetus may succeed in driving the eventual agricultural output over the trend rate. While a part of the July-August exports may originate from output recorded in FY06 GDP, a year-over-year comparison indicates that exports of 'frozen food' has been growing strongly (by 13.6 percent) followed by 10.5 percent growth of 'raw jute and jute products' during the first two months of FY07 over the corresponding period of FY06.[103] *Based on a detailed analysis of sub-sectoral growth rates, Chapter 4 of this Review projects the overall growth for the agricultural sector to be in the 2.8- 3.4 percent range in FY07.*

Figure 5.2 : *Growth Rate of Agriculture Sector*



* PAU *Projection.*

Industry: Overall industrial output growth is estimated to have been 9.6 percent in FY06 which is 1.3 percentage points higher than that of FY05. The higher growth is partly due to robust manufacturing activities during FY06. Figures show that the large and medium-sized manufacturing firms have been the principal drivers of industrial growth in FY06, growing at 11.0 percent. Evidently, industrial growth is intimately connected with the export potential, where woven and knitwear products make up nearly 80 percent of total exports. Data on export earnings during FY06 suggest a robust growth, in value (USD fob) terms, of 21.6 percent. One positive sign is that the export growth has been broad based, of course, with the knitwear products providing the bulk of the growth spurt (35.4 percent). In spite of the recent industry unrest, it appears that apparel exports have been gaining further momentum early in FY07. *In the first two months of fiscal year, growth has been 35.8 and 30.3 percent for the two principal categories, namely knitwear and woven products.* While the knitwear growth is consistent with recent experience, the 30 percent growth in the mature woven sector is indeed remarkably high especially when seen in the context of post-MFA era.

The construction sector growth gained momentum, reaching (8.4 percent) in FY06 as seen from BBS's provisional estimates. Fast growth in the import value of "clinker" and "iron, steel and other base metals" in FY06, by 24 and 44 percent,

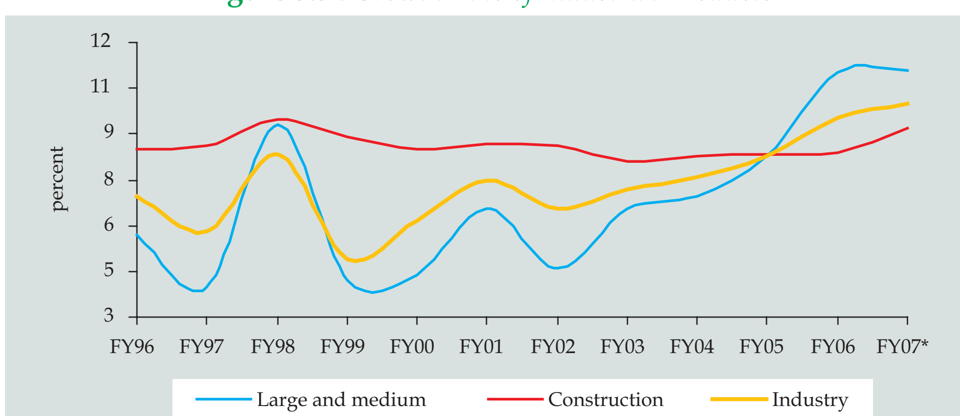
[103] All FY07 export figures reported in this section are based on records of the Export Promotion Bureau (EPB).

respectively, which are intermediate inputs in this sector, is indicative of continuing growth momentum. Again the first two month's L/C opening data shows that some of the inputs of the construction sector, namely, "iron and steel scrap" and "cement" have grown by 207 and 49 percent respectively over the corresponding period of FY06. The construction sector is expected to gain from the sustained buoyant outlook for remittance flows in FY07.

Industrial credit utilisation (as measured by term lending) appears to have grown at a slower pace in FY06 than in recent years. However, overall banking system's credit to the private sector registered a strong growth of 18.3 percent in FY06 compared with 17.0 percent in FY05. Even allowing for inflation, the *real* credit growth would be deemed more than sufficient to allow economic growth that was actually realised in FY06. Thus even though credit to the public sector has grown even faster, there has been no sign of "crowding out" of private investment. The monetary program of BB calls for a moderation in the growth of domestic as well as private sector credit (in the 15 and 14 percent range, respectively), but it is too early to discern the new trend. While domestic credit has grown slower in the first two months of FY07 vis-à-vis that of FY06, the 12-month growth (i.e., August'06 over August'05) has been 19.8 percent. Private sector credit, on the other hand, has grown by 5.1 percent in FY07 on a two-month comparison, but the August-over-August 12-month growth has been 18.1 percent.

The stock market saw an increase of 18 new listings (equity and debt) in FY06, with an incremental value of BDT 11.9 billion worth of new capital, which is merely 3.9 percent of the new domestic credit expansion in FY06. These figures suggest that bank and non-bank credit still remain the principal source of financial capital in the economy, and there is little possibility of a major shift unless FDI takes off in a big way. The first two months' of FY07 saw net FDI inflow of USD 125 million which is mere 3.3 percent higher than in the corresponding period of FY06.

Figure 5.3 : *Growth Rate of Industrial Products*

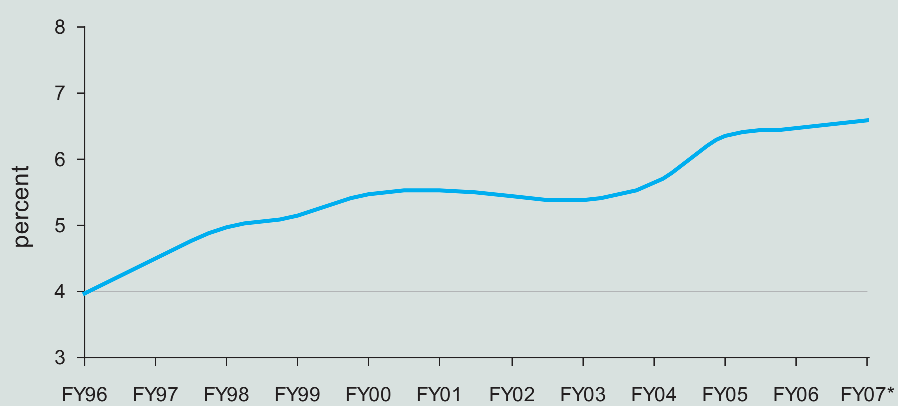


* *PAU Projection.*

The trend analysis suggests that the industry sector is expected to grow at the rate of 8.56 percent in FY07. However, the sub-sectoral analysis indicates that the construction component is likely to grow above the trend line (at 9.1 percent), whereas the manufacturing sector will grow in line with the previous year's growth (i.e., at 11.0 percent). All other sub-sectors are expected to grow at the trend level. Thus taking the detailed sub-sectoral analysis *into account, this Review would put the likely industrial growth for FY07 to lie in a range of 9.5 to 10.5 percent, which is well above the trend average recorded over the past ten years. Should the RMG labour dispute be resolved soon, it is even likely that eventual industrial growth may well exceed the range predicted here.*

Services: While a good part of the service sector activity remains structured around agricultural and industrial sectors of the economy (e.g., transportation, port and warehouse services tied to foreign trade), there are service sector components that have been growing much faster than either industry or agriculture. The latter examples include telecommunication (especially mobile phone), computer and internet (connected with the submarine cables), education, health care and the like. Financial intermediation, another faster growing component, however, is closely linked to development in both agriculture and industry. All of these sectors have grown faster than GDP growth over the past several years, and it is anticipated that this process will continue into FY07. Growth of investment in these sectors may be taken as indicative of future growth of the related service sub-sectors.

Figure 5.4 : *Growth Rate of Service Sector*



** PAU Projection.*

The expansion of the service sector share of GDP is also explained by the growth of urbanization as well as increasing activities in trade and commerce. The addition of retail space for domestic, commercial and foreign trade activities in response to buoyant demand is also indicative of continuing growth in these areas. All these developments show evidence of sustained activity in the growth points of the service sector in FY07, and collectively these units represent a major component of the service sector output.

This Review expects FY07 service sector to build on the past year's performance, and thus yield a growth rate of 6.6 to 6.8 percent.

The above sectoral predictions are put together in Table 5.1 Overall, it is seen that this *Review*'s outlook for growth projection for FY07 is in the range of 6.6 to 7.1 percent.[104]

[104] It may be noted that the first-ever issue of MPR released by Bangladesh Bank in October 2005 predicted FY06 growth to be in the range between 6.3 and 6.8, which proved to be the most accurate of early forecasts proffered by various agencies.

Table 5.1 : *FY07 GDP Projection (Constant Prices)*

Sector	GDP Share in FY06 (%)	Average Growth FY97-FY05 (%)	FY06 Growth (%)	FY07 Growth Projection Range	
				Low	High
Agriculture	21.8	3.83	4.5	2.8 (0.61)*	3.4 (0.74)*
Industry	29.0	7.18	9.6	9.5 (2.75)*	10.5 (3.04)*
Services	49.2	5.49	6.5	6.6 (3.24)*	6.8 (3.35)*
Overall GDP	**100.0**	**5.57**	**6.7**	**6.6**	**7.1**

Source: PAU staff estimates

**Numbers in the parenthesis indicate sectoral contribution to overall GDP growth.*

5.2 Outlook for Exchange Rate Stability

5.2.1 : Recent Movements in the Exchange Rate

While the foreign exchange market remained under pressure over the first three quarters of FY06, with the Taka losing about 9.4 percent of its nominal value against the US Dollar within this period, the behaviour during the 4th quarter was rather stable.[105] The volatility was mainly caused by a mismatch between net demand and supply of foreign exchange in the L/C market.[106] Indeed, the currency gained back some of the loss such that the FY06 depreciation (in USD terms) came down to 8.5 percent. It is plausible that the depreciation contributed to the record growth of exports and remittances over the fiscal year, and particularly in the 4th quarter, which led to a large (USD 341 million) positive current account balance (CAB) for the quarter. However, the financial account, which traditionally has been robust in recent years, ended the year in a small deficit (USD 24 million). The primary reason was that “other” investment flows (inclusive of medium and long-term loans), but excluding FDI and portfolio investments, turned negative in every quarter of the fiscal year.[107] However, given the sizeable CAB, the overall balance of payments (BOP) turned strongly positive in the 4th quarter (USD 402 million), and led to an overall surplus of USD 365 million in year-end BOP, thereby setting the foreign exchange reserves on a healthier footing. These developments allowed for the much needed stability in the foreign exchange market in the last quarter of FY06, and resulted in a minor appreciation of the currency as already noted.

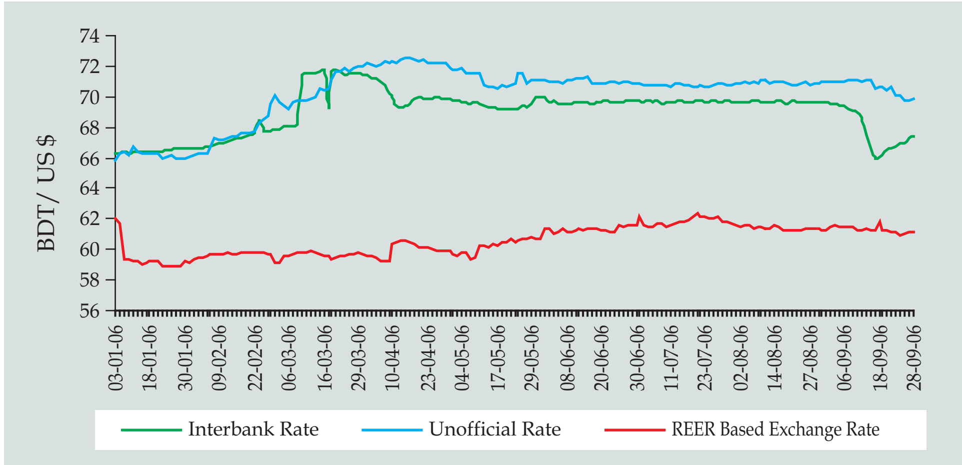
This weakening trend of the Taka in FY06 is also reflected in the REER-based exchange rate, which suggests that the currency has remained undervalued as measured by market rates. The June 30, ’05 spread between the REER-based rate and the weighted average inter-bank rate stood at BDT 6.1 per USD; the spread widened to BDT 11.7 on March 30, ’06, and it then gradually shrank until reaching close to the end-FY05 value on September 28, ’06 (BDT 6.3). The recent movements in the Taka-Dollar exchange rates have been illustrated in Figure 5.5.

105 The end month Taka-Dollar exchange rate (mid-value of commercial bank transactions) which stood at 63.75 in June 2005 depreciated to 70.35 by March 2006, and ended the fiscal year at 69.67. The inter-bank rates on these dates were 63.74, 71.43, and 69.73, respectively.

106 The previous issue of MPR (October '05) did correctly foresee "that the recent weakening of the currency to persist well into FY06".

107 In other words, the positive FDI (combined with the minor portfolio investments) flows were outweighed by the negative flows of "other investment".

Figure 5.5 : *Movements in Exchange Rates*



5.2.2 : Near Term Outlook for Exchange Rate Stability

The early indications gleaned from a review of trade data over the first two months of FY07 is positive; exports over this period have risen by 31.3 percent (as opposed to 3.44 percent in the comparable period of FY06), while imports have grown at about the same pace as last year's (17.1 vs. 18.1 percent). This has resulted in a further narrowing of the trade balance. First quarter remittance growth of 24 percent, although behind last fiscal year's record for the comparable period, has also been strong. These developments have led to a strong CAB of USD 414 million during July-August, '06.

In spite of continuing negative balances in services, income and financial accounts, the overall balance of payments (BOP) over this period turned into a surplus of USD 107 million vis-à-vis a deficit of USD 194 million in FY06 principally on the strength of a strong CAB. Correspondingly the official reserves moved up to USD 3.6 billion, which had stood at USD 2.9 billion a year ago. The trend is expected to continue over the balance for this fiscal year. Recently efforts have been underway to offload the majority share of Rupali Bank to a Saudi group for USD 330 million, which would help to further boost the reserve position. It is therefore abundantly clear that in this stable BOP environment, the pressure on the currency has disappeared, and indeed it gained in value by 3.4 percent within the first quarter of FY07.[108] It is to be noted as well that in spite of some gains over the past several months, the REER-based exchange rate still remains well below the market rate preserving the relative attractiveness of the domestic currency vis-à-vis that of its trading partners.

On the understanding that the current impasse in the employer-employee tension in the RMG sector will be resolved quickly and amicably, and that the parliamentary transition process proceed smoothly, there is good reason to expect that positive early-FY07 developments will emerge more forcefully over the remainder of the year, and further anchor the BOP environment and the

[108] The end month Taka-Dollar exchange rate (mid-value of commercial bank transactions) which stood at 69.67 in June '06 appreciated marginally to 67.30 September '06. The inter-bank figures are very similar: 69.73 and 67.44, respectively.

attendant stability of the domestic currency. Policy surveillance will of course be necessary to guide the domestic credit growth, mobilization of bank deposits, and revenue collection efforts of NBR.

5.3 Outlook for Price Stability

5.3.1 : Recent Behaviour of Inflation

During FY06, expansion of domestic credit, currency depreciation, and the elevated level of world commodity prices exerted inflationary pressures on both demand and supply sides in the domestic market. The 12-month moving average inflation rose modestly in the 4th quarter of FY06 from 7.02 percent in March '06 to 7.16 percent in June '06, staying slightly above the 7-percent mark that has been set as the central bank's ceiling as announced in the first issue of the Monetary Policy Statement of January 2006. Examining the 12-month point-to-point data, an interesting pattern emerges between food and non-food inflationary development in FY06. While non-food prices rose persistently in the first three quarters (especially in rural areas), and moderated in the fourth quarter, food prices started to move up sharply in the fourth quarter. Having grown at 6.31 percent during the first nine months, food prices shot up by 15.6 percent in the 4th quarter (at annualized rates). It may be noted that while world price of rice, soybean oil and sugar rose rapidly during the first six months of calendar '06 (at annualized rates of 20, 25 and 36 percent respectively), the corresponding domestic prices failed to reflect much of it. Most of the realized increase in prices in the 4th quarter of FY06 appears to be due to rise in the price of fish, legumes (pulses), potatoes, spices and vegetables, when domestic supply of vegetables is generally of fewer varieties than at other times of the year. More generally, in recent years export of vegetables and fresh water fish appear to have been propped up by the export subsidy, which is believed to be partly responsible for persistent food inflation. Given the domestic shortage, it would be relevant to ponder whether to continue with such policies that probably hurt wellbeing of the average person.

As inflation remained stubborn, Bangladesh Bank continued its tightened stance, which as reviewed in chapter 3, led to several hikes in the key policy rates. Further, repo operation was held only in January and May during the fiscal year. By contrast, Bangladesh Bank used its reverse repo tool more frequently to mop up excess liquidity from the market. The tighter monetary management may have contributed to the decline in non-food inflation as measured by 12-month point-to-point index, which fell from 6.57 in March to 5.73 percent in June '06.

5.3.2 : Near-Term Outlook for Inflation

Before engaging in a discussion of the likely price development in FY07, a broad remark on the level of inflation in a growth environment may be reiterated. In an era of growing economic integration, domestic prices of tradables in emerging economies are increasingly following global price trends. Consequently, the major divergence between domestic and global inflation trend arises out of the price behaviour of non-tradables. Consumer price inflation in developing economies like Bangladesh over the medium term can thus be expected to be somewhat higher than in mature industrial countries as the historically lower price levels of non-tradables gradually increase with rising income (BB, 2006a)

In view of the tightened bias of monetary policy, the early indications of FY07 credit market developments are encouraging; during the first two months of the new fiscal year domestic credit expanded by 1.41 percent (i.e., at an annualized rate of 8.46 percent) as opposed to the corresponding growth of 2.0 percent (i.e., 12.0 percent annualized) in the last fiscal. While both public and private credit have grown slowly, it is the public share that has contributed most to the overall slowdown in credit growth. Deposit mobilization by DMBs progressed at 1.65 percent (as opposed to 1.32 percent in FY05) over the two-month period of this fiscal, which is ahead of total domestic credit expansion.

The above credit market development took place in a calm environment in the inter-bank call money market where the rate actually fell by 20 basis points as of end-September '06 (from 7.56 to 7.36 percent). The 1-2 day reverse repo rate however increased within the first quarter of FY07 by 46 basis points (from 6.04 to 6.50). Yield on T-bills of 28- and 91-day maturities also rose by 14 and 12 basis points as of September '06 since the end of FY06.

(a) Food Inflation: CPI in Bangladesh is composed of two sub-indices, food and non-food inflation, each of which in turn are broken down to rural and urban sub-indices. Thus in order to gain an insight into price developments currently underway, this *Review* examines prices at the disaggregated level.

Food prices in FY06 (point-to-point) rose by 8.57 and 9.35 percent, respectively, in rural and urban areas, a good part of which occurred in the final quarter of FY06. The first quarter of the new fiscal saw a slight moderation of food prices; the annualized change in food inflation came to 14.07 and 12.67 percent, respectively, in rural and urban areas (vis-à-vis 16.41 and 14.27 percent in the last fiscal).[109] The differential rate between rural and urban food inflation typically reflects the differential weight of cereals in the two indices. The above figures resulted in 12-month September-over-September *national* food inflation of 8.25 percent against the FY06 figure of 8.81 percent, while the rural and urban rates turned out at 7.96 and 8.93 vis-à-vis FY06 rates of 8.57 and 9.35 percent, respectively. The small decline in point-to-point inflation figures cited above led to a small decline in the FY07 first quarter *12-month average* food inflation at the national and rural level (7.55 and 7.30, respectively, vis-à-vis FY06 closing level of 7.76 and 7.62), though urban inflation rose a little (from 8.09 to 8.14 percent) between the two quarters. On a more positive note, to the extent domestic food prices relate to international commodity prices, the stable foreign exchange situation is likely to prove a restraining force in FY07.[110] Another plausible source of moderation is the reduction of import duty on selected essential goods announced in the national budget for FY07 which may provide a cushion against some of the seasonal shifts in prices.

Thus while the above discussion suggests some moderation in food inflation in FY07, it is difficult to be precise in predicting the eventual food inflation because of seasonality (e.g., the increase in selective food items during the Ramadan, and more generally, crop cycles), effects of climatic conditions on the yield of major

[109] It must be noted that during the first quarter of FY06, a serious monga situation prevailed in the northern region of the country.
[110] Recall that in Chapter 4 it was observed that the exchange rate is highly correlated with both food and non-food prices.

cereals, supply management of inputs (e.g., power, diesel and fertilizer), and retail distribution issues (e.g., prevalence of market syndicates) at the field level. Chapter 4 also noted the likely impact of diesel prices on the domestic price of both food and non-food components. While crude oil prices have edged down during September-October ’06 and the future contracts for December deliveries reflect current prices, at the domestic level, the large existing subsidy on diesel and kerosene would likely call for further revisions in the administered prices of these products even if world prices remain unchanged.[111]

Lack of competition at the retail level leading to high middlemen profit is frequently pointed out as a source of inflation. While monetary policy is unable to deal with such developments except through prudent credit management, a systematic analysis would be a worthwhile undertaking. Looking at the recent producer prices, it is seen that the index rose in a stable pattern of 4.73, 4.71 and 4.73 percent, respectively, in FY04, 05 and 06. Given the corresponding increase in CPI of 5.83, 6.49 and 7.16 percent, respectively, one would be tempted to conclude that the intermediation profits have been on a secular growth path. However, the lack of comparability between the two indices (in terms of commodity classification and coverage) renders a direct inference of this nature inappropriate, though a broad impression remains.[112]

Based on an analysis of the data since January ’04, this Review predicts the FY07 point-to point food inflation to lie in the range of 6.50-7.00 and 6.10-6.60 percent, respectively, for the rural and urban sectors. The implied figures for the 12-month average food inflation, both at the sectoral as well as the national level are shown in Table 5.2. These projections suggest that the national 12-month point-to-point food inflation in FY07 is expected to lie in the range of 6.38-6.88 percent, while the corresponding 12-month moving average is also seen to moderate down to the 7.19-7.69 percent range.[113]

(b) Non-food Inflation: FY06 non-food inflation came to stand at 6.07 and 4.86 percent, for the rural and urban sectors, respectively, on a point-to-point basis. The moderating trend in non-food prices in the fourth quarter of the last fiscal (at annualized rates of 4.0 and 4.3 percent, respectively in the two sectors) reversed during the first quarter of FY07. The new annualized rates are 6.84 and 6.90 percent, respectively, which are, however, significantly lower than the corresponding first quarter FY06 rates of 10.98 and 8.31, respectively. Part of the recent increase may be due to the delayed adjustment of transportation and related charges arising out of upward revisions in administered energy prices that formally took effect on June 9, 2006.[114] Further adjustments are also likely later in the current fiscal year. While non-food prices rose faster in the rural sector in FY06, the last 6-month pattern has been the opposite, the outlook for urban inflation however remains mixed.

Based on the trend analysis, this *Review* expects non-food prices to continue to moderate further during FY07 due to the restrained policy stance of the central

[111] The selling price of diesel and kerosene has been estimated at 65-66 percent of the import costs incurred by BPC (ADB, 2006).
[112] Presently the producer price index merely tracks industrial goods, and hence its relationship with food inflation is tenuous.
[113] The predicted FY07 inflation figures cited in the text and in Tables 5.2-5.3 are 9-month ahead projections based on an analysis of the trend implicit in the price data over the past 33 months (i.e., from January '04 to September '06, inclusive). Thus it captures the data for the post- float currency regime.
[114] In this round the price of petrol and 'octane' went up by 30 percent while that of kerosene and diesel by 10 percent.

bank as well as other sobering elements such as the stable currency environment, and the outlook of global energy prices. *Point-to-point non-food prices are projected to rise in FY07 by 5.20-5.70 and 4.70-5.20 percent, respectively, for the rural and urban sectors*. The implied figures for the 12-month average inflation are shown in Table 5.2.

Therefore, based on a detailed sector-wise projection of expected inflation as presented in Table 5.2, this Review predicts that the 12-month national point-to-point non-food inflation is unlikely to deviate much from the 5.06-5.56 percent range, which should lead to 12-month average inflation of between 4.86 and 5.36 percent.

Table 5.2 : *Inflation Outlook, FY2007*

Type of inflation	Sector	Food		Non-Food		General CPI	
		FY06 (Actual)	FY07 (Projection)	FY06 (Actual)	FY07 (Projection)	FY06 (Actual)	FY07 (Projection)
12-month point-to-point	Rural	8.57	6.50 -7.00	6.07	5.20-5.70	7.67	6.02-6.52
	Urban	9.35	6.10-6.60	4.86	4.70-5.20	7.20	5.38-5.88
	National	8.81	6.38-6.88	5.73	5.06-5.56	7.54	5.83-6.33
12-month moving average	Rural	7.62	7.10-7.60	6.90	5.00-5.50	7.36	6.32-6.82
	Urban	8.09	7.40-7.90	5.14	4.50-5.00	6.68	5.92-6.42
	National	7.76	7.19-7.69	6.40	4.86-5.36	7.16	6.20-6.70

Sources: PAU staff estimates

The above projections therefore lead to an overall prediction of 12-month average general CPI inflation in FY07of 6.20 to 6.70 percent, well below the end-FY06 figure of 7.16 percent.

What can be said about the likely path of price developments over the next three quarters? The trend analysis performed here yield monthly inflation forecasts in a rather smooth fashion. Hence in order to predict the quarterly inflation outlook, this *Review* has added an element of seasonality in food price forecasts. Keeping the predicted rise in the price index over the entire fiscal year unchanged, the distribution of price increases has been altered to reflect the persistent drop in inflation after the November/December harvest season, and the elevated level of food prices early in the 2nd and in the 4th quarter. The results are presented in Table 5.3. The 12-month average inflation appears rather stable over all quarters though a mild decrease is observed in the second and fourth quarters.

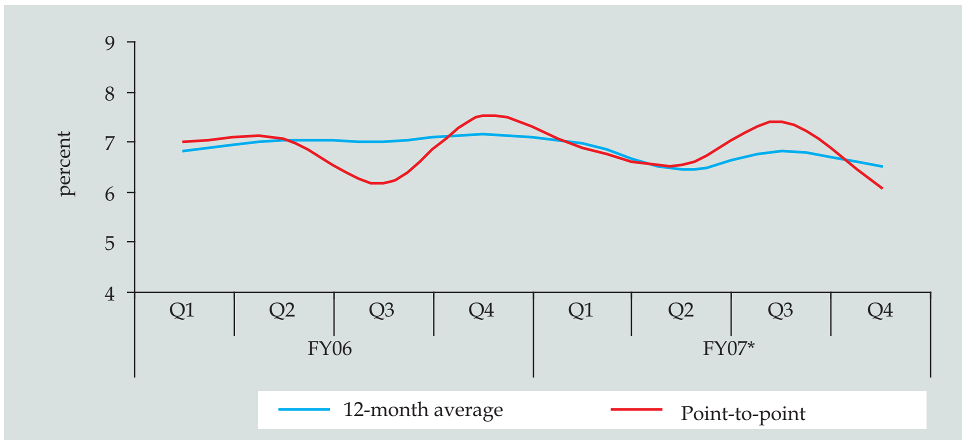
It should be noted that the above predictions do not take into account any of the shocks cited earlier. In particular, should the administered price of energy products be revised up sometime within the next two quarters, both food and the non-food inflation, and hence the headline inflation too will experience an upward shift.

Table 5.3 : *Quarterly Price Development (National CPI)*

Type of inflation	FY06				FY07 Projection*			
	Q1	Q2	Q3	Q4	Q1	Q2*	Q3*	Q4*
12-month moving average	6.83	7.04	7.02	7.16	6.97	6.25-6.75	6.60-7.10	6.20-6.70
Point-to-point	7.01	7.07	6.17	7.54	6.89	6.30-6.80	7.20-7.70	5.83-6.33

Sources: * PAU staff estimates

Figure 5.6 : *Quarterly Inflation (National CPI), FY06-07**



** The FY07 figures are the mid-points of the projected range shown in Table 5.3*

5.4 Conclusion

This *Review*'s outlook for growth projection for FY07 (of between 6.6 and 7.1 percent), while a little higher than alternative projections proposed by other agencies, appears to be in line with the MTMF expectation (of 6.8 percent). This outlook for growth is based on the anticipation of strong growth of aggregate demand, which will be matched by aggregate supply significantly aided by higher expected output growth in the industrial and service sectors. While the growth of remittances stimulate consumption and investment spending, on the supply side it also promotes industrial growth by providing a stable foreign exchange environment for the smooth operation of the L/C market. As has been the case in the recent past, industrial growth would continue to be spurred by robust growth of exports (especially RMG).

The expected moderation in price developments in FY07 are premised on the continuation of Bangladesh Bank's policy of restrained monetary and credit expansion, a sobering outlook of world energy prices, the cautious policy stance of the Federal Reserve, and the strengthening of the Bangladesh foreign exchange reserves and hence enhanced currency stability. It is important to note that the broader predictions on price and output developments in FY07 are also contingent on sustained domestic stability especially in the parliamentary transition process, congenial labour relations in the RMG industry, and discipline in the financial sector.

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Appendix : Tables on Net Trade Outlook

Table A5.1 : *Major Destination-wise RMG Related Export Growth*

Growth (in percent)	FY05	FY05				FY06	FY06			
		Q_1	Q_2	Q_3	Q_4		Q_1	Q_2	Q_3	Q_4
Exports of RMG	**12.9**	**26.3**	**12.2**	**9.5**	**4.2**	**23.1**	**3.0**	**29.9**	**29.9**	**33.3**
European Countries	10.8	25.3	13.7	4.4	2.2	-4.6	-19.8	-2.0	3.1	1.6
USA	20.7	27.5	13.1	29.2	12.9	35.3	13.4	58.2	35.0	42.6
Other Countries	-2.7	29.2	-16.4	-21.0	-12.3	298.1	151.3	424.1	405.6	369.1

Source: Export Promotion Bureau (EPB)

Table A5.2 : *Growth Pattern of Major Import Components (value terms in million USD)*

Items	FY03	FY04	FY05	FY06	Weight of Imported Items in FY06
Rice Grains & Other Food Items	1169 (68.93)	1,296 (10.86)	1,609 (24.15)	1,374 (-14.61)	0.0932
Crude Petroleum & POL	887 (22.68)	1,022 (15.22)	1,603 (56.85)	2,004 (25.02)	0.1359
Construction Material	591 (4.97)	618 (4.57)	849 (37.38)	1190 (40.16)	0.0807
Textile Sector	1769 (6.69)	2201 (24.42)	2628 (19.40)	2971 (13.05)	0.2015
Capital Machinery	568 (2.53)	786 (38.38)	1,211 (54.07)	1539 (27.09)	0.1044
Import by EPZ	727 (15.95)	887 (22.01)	952 (7.33)	1062 (11.55)	0.0720
Others	3947 (6.02)	4093 (3.70)	4295 (4.94)	4606 (7.24)	0.3124
Total Import	**9658 (13.09)**	**10903 (12.89)**	**13,147 (20.58)**	**14746 (12.16)**	**1.00**

Source: Statistics Department, Bangladesh Bank
Note: Figure in the parenthesis represents the growth over the previous year

Table A5.3 : *Sector-wise Comparative Statement of Settlement of Import LCs (million USD)*

	FY05	FY06	Growth		Weights in FY06
			Value	Percentage	
Consumer Goods	1274.94	1030.02	-244.92	-19.21	0.07
Intermediate Goods	1068.95	1188.66	119.71	11.20	0.09
Industrial Raw Materials	4830.47	5310.45	479.98	9.94	0.38
Capital Machinery	1086.52	1347.36	260.84	24.01	0.10
Machinery to Misc. Industry	914.14	1055.98	141.84	15.52	0.08
Petroleum & Petroleum Products	1573.68	1928.17	354.49	22.53	0.14
Others	1914.54	2089.25	174.71	9.13	0.14
Total	**12663.24**	**13949.89**	**1286.65**	**10.16**	**1.00**

Source: Monetary Policy Department, Bangladesh Bank