

Perspectives of 7th Five Year Plan and Possible Roles of the Financial Sector to Stimulate Growth

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Abstract

This paper explains the guiding principles of the Seventh five year plan. In particular, the vision to achieve middle income status of the country by 2021. It underscores that this will remain a core development objective. The macro-economy is facing different socio-economic challenges from overheating of the economy and adverse developments in the stock market. But the corrective policy actions suggested in the plan will minimize the damages and restore macroeconomic stability. The paper observed that while the above record of progress is comforting, the government needs to understand that the reform agenda is unfinished. The GDP growth rate is healthy but below the targeted rate in the Sixth Plan. Progress in improving the investment rate is less than satisfactory and must be strengthened to accelerate the growth rate in order to achieve the middle income status envisioned in Vision 2021 and the nation's first Perspective Plan.

The Plan Perspective

We all know that the Article 15 of the Bangladesh Constitution requires that the country should follow the path of a planned economy for realizing its development objectives. Accordingly, to fulfill this constitutional obligation and also to transform Bangladesh into a middle income country by 2021 a long term Perspective Plan named “Perspective Plan of Bangladesh (2010-2021): Making Vision 2021 a Reality”, has been articulated. The Perspective Plan is a vision for the nation that gives us a road map for accelerated growth and portrays broad approaches for eradication of poverty, reducing inequality, and human deprivation. This long term development plan is being implemented through two successive Five Year Plans; Sixth Five Year Plan (FY 2011-15) and Seventh Five Year Plan (FY 2016-20). The Sixth Five Year Plan adopted a strategic approach to development that combines all instruments at the disposal of the government including rules, regulations, safeguards, institutions and public investment with a view to helping secure the major development targets of the Sixth Plan. The Seventh Plan would be seen as a continuation of the development strategy articulated in the Sixth Plan and for successfully achieving those targets the significance of the Financial Sector is indispensable. The preparation of the 7FYP is in progress at the behest of National Economic Council, Planning Commission chaired by the Prime Minister.

Sixth Plan core targets were: increasing agricultural productivity, spurring manufacturing and service sector growth, stabilizing the macro-economy to reduce poverty at a faster rate.

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It is well-known that economic development and the maturity of the financial sector are strongly correlated. That’s why the Bangladesh government has given immense weight to this sector in its plan document. In the 6th Five Year Plan emphasis has been given on improving prudential regulations and oversight/supervision responsibility/capacity of the Central Bank. It also emphasized on strengthening the quality of banking system as well as the performance of the State-owned Commercial Banks (SCBs) by ensuring better management and accountability by strengthening the oversight of the Bangladesh Bank. This was because of the high Non Performing Loans (NPL) ratio for SCBs. Although some progress has been made in recovering loans, this remains a major challenge for the SCBs.

Table: Ratio of net NPL to Total Loans of SCBs

| 2005-06 | 2009-10 | 2012-13 |
|---------|---------|---------|
| 14.5 | 1.9 | 8.1 |

Source: Bangladesh Bank

Financial Sector Performance

The reason for this concern is both state owned and private commercial banks are suffering from nonperforming loans due to exposure to the stock market, stalemate in investment, and partly due to strengthening of provisioning requirements by Bangladesh Bank. All the performance indicators of the banking sector has shown downward trend since December 2011. During the period, the health of public sector banks has deteriorated at a faster rate compared to the private sector banks. The NPL ratio was improving steadily until December 2011 after which it started to increase.

This deterioration of gross non-performing loan (NPL) ratio of the banking system as a whole and particularly for the state-owned commercial banks causes the sharp drop in capital adequacy ratio also. The capital-to-asset ratio exhibited an upward trend for the last 2 decades till December 2011 after which there is a downward trend for the overall banking sector as well as the State Owned Commercial Banks. It is seen that while there is a falling trend for both, the capital to asset ratio has dropped sharply for the State owned Commercial Banks from 11.68% in December 2011 to 8.13% in December 2012, and thereafter dropped to 1.2 in June 2013 which should be considered as alarming for the health of the Financial Sector.

The financial cost of the increasing share of non-performing loans and the corresponding provisioning requirements impacted on the return on assets (ROA) and the return on capital (ROC) for the whole banking system, and state-owned banks in particular. The ROAs and ROCs for all banks including the state-owned commercial banks have been improving over last two decades until December 2011, when the trend reversed with continued fall in both the indicators for all categories of banks in subsequent quarters. The deterioration was more substantial for the state-owned banks from a peak of 1.34% in 2011 to -0.56% in 2012. If the stock market does not rebound very strongly, loan loss provisions and profitability of commercial banks may deteriorate further in future.

Further deterioration in the health of the banking sector—particularly on account of higher loan loss provisions--may lead to a widening of the interest rate spread. Recent loan loss in

the state-owned banking sector has compromised the credibility as well as the performance of the banks. If the performance of state-owned banks becomes worse, the interest rate spread of the state-owned commercial banks may be wider and the private banks will therefore adopt similar increases in the interest rate spread in their banks even though the magnitude of their non-performing loans is lower. This may potentially undermine government’s efforts to bring down the interest rate structure and the interest rate spread below 5% for the benefit of private sector investors.

Improving Macroeconomic Scenario

Over the last four years, Bangladesh showed outstanding performance in Macroeconomic arena. The annual average growth rate of GDP was more than 6.33 per cent. With a revenue growth of more than 21 per cent and share of revenue in GDP being 13.5 per cent, the country surpassed all the previous milestones in the sector. Foreign exchange reserve reached a more than stable figure of 19.2 Billion USD. Moreover, the current account balance is positive for a long time. Despite all this promising indicators, the investment scenarios of the country show some dampen figures.

Sluggishness of the overall rate of investment is of great concern. The Sixth Plan recognized the critical importance of this growth driver and accordingly sought to increase the investment rate from 24% (2009) to 32% of GDP by June 2015. However, the results so far show that the investment rate has increased only marginally to 28.7% (using new base year 2005-06).

Looking forward, what really matters for investors is the general investment climate and competitiveness of the economy. High priority needs to be given in improving the security situation and restoring political stability in a sustainable manner for boosting private investment and moving toward a path of economic recovery. Another possible reason may be the looming good governance by the present government. The Anti-Corruption Commission (ACC) got momentum than ever. A number of Banking scams are coming under penalty. This may induce some local investors to become dormant for a while. They like to do business in a more relaxed environment of wait and see.

Despite the continuing efforts for making the environment for protecting the investors and its continued favorable macroeconomic conditions, Bangladesh has failed to become an attractive destination for FDI compared to its regional comparators. Despite some recent improvements, Bangladesh’s average (5-year average) net FDI level of less than 1% of GDP is the worst among the regional comparators. FDI flows in Bangladesh have been primarily limited to telecommunications, energy and investments in Export Processing Zones (EPZs). Recent expansion of telecommunication networks and the thrust on the power sector have helped sustain the growth in FDI. Reflow of foreign portfolio investment in the stock market following the market correction and some limited merger and acquisition by foreign firms in the garment sector outside EPZs have also contributed to the increased FDI level in FY13. Given the medium and long term growth prospects of

Bangladesh economy and its cheaper labor force, a large number of foreign investors are interested to invest in the EPZs and Private Economic Zones. However, in many instances these investors turn back and move to other destinations(Myanmar, Cambodia and Vietnam) due to non-availability of industrial land with proper infrastructure (gas, electricity, road connectivity, sewerage etc.). Urgent attention needs to be paid in this issue.

Resource Mobilization Targets in 6FYP

However, realization of the Sixth Plan objectives entailed involvement of both the private sector and the public sector. Although private sector continued to play its dominant role in the economy, public sector was mobilized to foster an economic environment more conducive for higher private sector production, investment, consumption and savings. Total investment under the Plan is amounted to Tk. 13.47 trillion in constant FY2011 prices. Much of the investment is undertaken by the private sector (10.39 Trillion Taka), although public sector investment plays a bigger role in catalysing much greater private sector investment under the Plan. Private sector investment (including through PPP programs) accounts for 77.1% of the total investment under the Plan, much of that from domestic sources. External financing for private investment, primarily in the form of foreign direct investment (FDI) is expected to grow, but will still remain modest in relative term at about 4.0 %. Of total investment, 91% has been postulated to be coming from domestic resources and the rest 9% would be coming from external source.

Table: Financing of Sixth Five Year Plan Investment (FY2011 prices)

| Items:(Billion Taka) | Total | Share (%) | Public | Share (%) | Private | Share (%) |
|-------------------------|---------|-----------|--------|-----------|---------|-----------|
| Total Investment | 13469.4 | 100 | 3075.8 | 100 | 10393.6 | 100 |
| Domestic Resources | 12215.3 | 90.7 | 2239.6 | 72.8 | 9975.7 | 96.0 |
| External Resources(net) | 1254.1 | 9.3 | 836.2 | 27.2 | 417.9 | 4.0 |

Source: Sixth Five Year Plan Projection

Like the Sixth Plan, in the Seventh Plan also majority of the public sector investment is supposed to be financed from domestic sources comprising savings of the government sector, capital receipts, self-financing by the public enterprises, and borrowing from the domestic banking and nonbank sources. Use of external financing for project and budget support will be done flexibly within the context of prudent management of the external debt. This will mostly entail loans from the official bilateral and multilateral sources on best possible terms. The scope for a limited borrowing from the international capital market by the private sector may also be possible.

Total public sector spending under the SFYP, including spending on account of provision of public services and transfer payments and subsidies, is projected to be Tk. 9.6 trillion or 19.6% of GDP. The Plan envisaged a significant increase in the size of the government spending in relation to GDP in order to broaden the basic economic and social services

across the country and improves the quality of public service delivery. The size of the public sector in Bangladesh is relatively small and the task of improving the quality and coverage of public service delivery will require a larger and more proactive role with a bigger domestic resource base to finance it in a sustainable and noninflationary manner. Banks can play significant role in this regard.

Seventh Plan will be a Continuum of the 6FYP

The Sixth Plan made a major change in the approach to economic planning in Bangladesh that has served Bangladesh well. Instead of setting detailed physical targets and milestones, the Sixth Plan adopted a flexible indicative approach to planning. This was well suited to the needs of the present economic environment of the country, where more than 90% of the economic activities are privately owned and additionally more than 80% of total investment is in the private sector. Like the Sixth Five Year Plan, the Seventh Five Year Plan will also follow the dependency more on the private sector. While public investment is an essential complement to private investment, GDP growth, human development and poverty reduction, policies and institutions are even more important to stimulate the private sector and achieve a higher level of equity. Government policies and institutions are essential to set a level playing field for all citizens, to protect the rights and interests of the under-privileged, and to provide an equitable mechanism for resolving all disputes.

Ensuring adequate levels of domestic credit for the private sector over the Plan period, within the aggregate limits of the targeted broad money expansion will require containing credit to the government (net) and other public entities within reasonable limits. The fiscal deficit targets under the Plan, while sustainable will however require sizable new borrowing from the banking system. If needed, the Government may have to seek additional external financing to avoid any crowding out of the private sector. Particularly important in this respect will be to limit credit to the loss making public enterprises which would potentially crowd out private sector credit and at the same time lead to the accumulation of nonperforming assets of the state-owned commercial banks. Loan provisioning to the SCBs also need to be gradually reduced by the Finance Division.

Focused Initiatives by the Central Bank Needed

It is appreciated that, to improve the efficiency of the banking system, strengthen the financial position of banks and ensure effectiveness of monetary policy, Bangladesh Bank has adopted a Strategic Action Plans (SAP) for 2010-14. Under those plans, strategy 7 stresses on enhancing regulatory and supervisory framework against money laundering. This is supposed to be done by meeting the international standard for AML & CFT (Anti-Money Laundering/Combating the Financing of Terrorism); strengthening of Financial Intelligence Unit (FIU); enhancing of regional and international cooperation; coordinating among law enforcement and related agencies; taking membership of EGMONT group. However, more careful initiatives should be taken in this regard.

The high level of reserves can play a very important role in accelerating the economic recovery of Bangladesh. Therefore, a number of major initiatives to boost domestic

economic activity in the short term and major infrastructure projects to sustain higher growth over the medium term should be undertaken. Any bold initiative will require massive imports and related foreign currency denominated financing, a part of which can be covered through use of reserves. Additional fiscal stimulus and resurgent private sector investment demand can only be sustained without being constrained by external sector financing if the foreign exchange reserve level remains high and comfortable. The high level of reserves will also help maintain and further improve Bangladesh’s sovereign rating, which will help catalyze higher foreign direct investment (FDI) in Bangladesh. In all respects, the high reserve level will help Bangladesh’s strive for attaining the middle-income status in the post-political crisis period. However, happy days of increase in reserve may not be there if there is continuous decline in remittances unless there is accelerated surge in export earnings.

Bangladesh has been able to manage stable sovereign rating by both Moody’s and S&P over the four consecutive years 2010-2013 due largely to stable economic growth supported by massive fiscal reforms and accommodative monetary policy. Despite, there has been double digit inflationary pressure throughout the FY 2011 owing to external factors and substantive growth of net foreign asset in the previous fiscal year, overall monetary sector registered balanced performance up until 2012-13.

The key objective of the monetary policy during the Sixth Plan period was to allow monetary aggregates to expand in a manner consistent with the growth and inflation targets envisaged under the Plan. In the Seventh Plan also, monetary policy stance should be targeted achieving higher economic growth as well as managing inflation. It means that, the broad money growth (M2), inflation, reserve money growth, private sector credit growth, public sector credit growth, government borrowing etc. all these should be targeted to achieve the growth target of the government not only targeting inflation alone. If the growth is higher then, some inflation could be accepted.

The priority for Bangladesh Bank should be to keep its focus on price stability by bringing down inflation. Also Bangladesh Bank’s on and off site supervision needs to be strengthened and banks need to be more cautious about the quality of loans and thereby reduce the proportion of non-performing loan (NPL), if the interest rate spread is to be brought down in a systemic and sustainable manner.

The core theme of the Seventh Plan is proposed to be “accelerating growth with equity”. This would suggest that utmost attention will be given to the ways that the GDP growth rate could be accelerated from the levels achieved in the Sixth Plan and how income distribution might be significantly improved. Higher GDP growth and better income distribution will ensure a faster pace of poverty reduction. Emphasis will be placed on improving the growth drivers and on policies, institutions and programs that will support the lowering of income inequality. The reduction in income inequality is not an easy challenge but the government is committed to making strong efforts in this regard. Financial sector can help improve both the quantity and quality of real investment and thereby increase income per capita and also boosting credit flows to SMEs for faster economic growth.

Considerably more effort will be needed in the Seventh Plan to accelerate the national rate of investment. Attention will need to be put to both public and private investment. The Seventh Plan will review the experience of the Sixth Plan in increasing the investment rate, identify the constraints and suggest ways the investment rate could be accelerated. This will likely require greater attention to public resource mobilization including tax reforms, a well-articulated foreign borrowing strategy to mobilize resources from official aid as well as private foreign capital, better incentives for domestic and foreign private investments, and improvement in the planning and implementation of public investment programs.

In today’s modern Bangladesh the availability of financial services through the banking sector is a major determinant of private investment. The banking sector has on average done well and contributed to the growth of private investment. Several initiatives have also been taken to make finance more inclusive through micro-credit and other specialized programs of the banking sector. Despite these efforts, the availability of credit in rural areas remains a challenge. The Seventh Plan will take stock of the ongoing efforts to provide credit to the poor and suggest further actions that could be taken to strengthen financial services to this target group.

For Growth Focus should be on SMEs

For accelerating growth the Sixth Plan has sought to transform the production structure of Bangladesh from a primarily agrarian one to a more modern manufacturing and organized services type economy. For this reason it has given emphasis on spurring the development of the SME sector in manufacturing. International experience shows that during the early phase of industrialization a dynamic SME sector, particularly the small enterprises, is critical to push the growth of the manufacturing sector and to create more jobs in manufacturing. If properly nurtured, the small manufacturing enterprises in rural and urban areas can be a very good source of product diversification and finding niche of exports. They are also a critical element to enhance the inclusiveness of growth and thereby reduce income inequality. Therefore, the Seventh Plan will focus on facilitating the growth of this subsector and financial sector can contribute a lot for boosting up this subsector.

The Dream Desire

The Vision 2021 and the associated Perspective Plan will continue to provide the guiding principles of the Seventh Plan. In particular, the vision to achieve middle income status by 2021 will remain a core development objective. We have seen that the macro-economy faced challenges from overheating of the economy and adverse developments in the stock market. But corrective policy actions minimized the damages and restored macroeconomic stability. While the above record of progress is comforting, the government needs to understand that the reform agenda is unfinished. The GDP growth rate is healthy but below the targeted rate in the Sixth Plan. Progress in improving the investment rate is less than satisfactory and must be strengthened to accelerate the growth rate in order to achieve the middle income status envisioned in Vision 2021 and the nation’s first Perspective Plan.