Macroeconomic Performance, Near and Medium Term Prospects

Global Economic Outlook, Impact on Bangladesh Economy

1.1 The world economy slowed in 2011, although emerging and developing countries continued to experience robust economic growth. This deceleration however, reflects a weakening in some advanced economies. Among these advanced economies, the contraction in activity in Japan and the slowdown in the United States more than offset the strengthening of the euro area and the UK. Global inflation continued to accelerate, driven by rising commodity prices, primarily in the emerging and developing countries where food and energy goods weigh more heavily in the consumer basket.

1.2 The IMF's latest forecast suggests that the world economy will slow to average growth rate of 4.0 percent in 2012, from over 5.0 percent in 2010 (Table 1.1). This forecast was revised downwards from 4.3 percent mainly due to the worsening of the outlook of the Japanese economy. It also indicates that recovery from the global recession will not be uniform : in advanced countries GDP growth is expected to be around 1.6 percent, against 6.4 percent in emerging economies. The main risk factors for the former are the persistent weakness of the labour and real-estate markets in the United States, and the sovereign debt pressure in the euro area. In the emerging and developing economies fears are linked to the risk of overheating and a possible inflationary spiral.

1.3 According to the IMF's latest estimates in June 2011 global inflation rose from 3.5 percent in the last quarter of 2010 to 4.0 percent in the first quarter of 2011; more than 0.25 percentage point higher than projected in the April 2011 forecast. Inflation is further expected to accelerate in both developed and emerging countries to 2.6 percent and 7.5 percent respectively in 2011 (1.6 percent and 6.1 percent in the previous year) mainly because of larger-than-expected increases in commodity prices. However, core inflation i.e. excluding food and fuel also crept up in a number of economies; it remained relatively

Table 1.1 Overview of the World Economic Outlook projections

(Annual percentage change)

	2009	2010	Projections	
			2011	2012
World output	**-0.7**	**5.1**	**4.0**	**4.0**
Advanced economies	-3.7	3.1	1.6	1.9
United States	-3.5	3.0	1.5	1.8
Japan	-6.3	4.0	-0.5	2.3
Germany	-5.1	3.6	2.7	1.3
United Kingdom	-4.9	1.4	1.1	1.6
France	-2.6	1.4	1.7	1.4
Italy	-5.2	1.3	0.6	0.3
Canada	-2.8	3.2	2.1	1.9
Newly industrialised Asian economies	-0.7	8.4	4.7	4.5
Emerging and developing economies	2.8	7.4	6.4	6.1
Developing Asia	7.2	9.5	8.2	8.0
China	9.2	10.3	9.5	9.0
ASEAN-5	1.7	6.9	5.3	5.6
World trade volume (goods and services)	**-10.7**	**12.8**	**7.5**	**5.8**
Imports				
Advanced economies	-12.4	11.7	5.9	4.0
Emerging and developing economies	-8.0	14.9	11.1	8.1
Exports				
Advanced economies	-11.9	12.3	6.2	5.2
Emerging and developing economies	-7.7	13.6	9.4	7.8
Commodity prices (U.S. dollars)				
Oil	-36.3	27.9	30.6	-3.1
Nonfuel	-15.7	26.3	21.2	-4.7
Consumer prices				
Advanced economies	0.1	1.6	2.6	1.4
Emerging and developing economies	5.2	6.1	7.5	5.9

Source: World Economic Outlook. September 2011, IMF.

unchanged in the United States and Japan and rose moderately in the euro area. Among emerging and developing economies, inflation pressures have become increasingly broad-based with accelerating demand side pressures reflecting a higher share of food and fuel in consumption.

1.4 The stance of monetary policy in developed economies remained accommodative. In June 2011 the Fed confirmed that, given ample spare capacity and stable inflationary expectations, official rates will probably continue to be held at exceptionally low levels for an extended period of time. The Bank of Japan, faced with the persistent downturn in the economy, left the monetary policy reference rate corridor unchanged at 0 to 0.1 percent and the Bank of England left its policy rate unchanged at 0.5 percent. On the other hand, the central banks of the emerging and developing countries gradually tightened monetary conditions from early 2010 onwards. Faced with evidence of economic overheating and deteriorating inflation expectations, the monetary tightening intensified from spring 2011. The bank interest rate was raised by a total of 3.3 percentage points in India (to 8.0 percent), 1.5 percentage points in Pakistan, 3.5 percentage points in Brazil (to 12.25 percent) and 4.8 percentage points in Chile (to 5.25 percent). Fearing that wider interest rate differentials could further encourage speculative inflows of capital from abroad and in order to address rising inflation, some countries adopted other measures to absorb liquidity, such as raising banks' compulsory reserve requirements. The Indian authorities increased the CRR ratio by 1.0 percentage point to 6.0 percent. The Bank of China increased the ratio by 6.0 percentage points to 21.5 percent, compared to an increase of only 1.25 percentage points in the reference interest rate to 6.6 percent. In Turkey the ratio was raised by 10.0 percentage points to 16.0 percent on sight and short-term deposits, against a small reduction in the official interest rate. In Russia the authorities raised the compulsory reserve ratio on liabilities denominated in foreign currency by 3.0 percentage points to 5.5 percent and the official interest rate by only half a point, to 8.25 percent. In many cases the interventions were accompanied by macro-prudential measures aimed at restricting the flow of credit to sectors that showed signs of overheating (including the property sector). In countries with more open financial systems and flexible exchange rates, such as Brazil, upward pressure on the exchange rate were countered by imposing taxes on capital inflows in order to discourage those of a speculative nature. Despite the restrictive measures, monetary conditions are still expansionary in many cases. Real interest rates have fallen in several countries, specially in Asia, and have turned negative in India, South Korea, Russia and Turkey. Although the growth in the monetary aggregates has slowed, it is still rapid, specially in countries where authorities have continued to counter upward pressures on exchange rates by accumulating only partly sterilised foreign currency reserves.

1.5 In 2011 world financial markets underwent another spell of volatility, triggered by uncertainty over the outlook for US economic growth and renewed sovereign debt strains in some euro-area countries. The ensuing portfolio reallocation contributed to a fall in the yields on government securities of countries not involved in the public debt crisis, a stock market correction and a modest increase in the risk premiums on bank and corporate bonds.

Developments in the Bangladesh Economy

1.6 Consolidating the strong recovery that emerged in FY10 and benefiting from external demand that remained favourable, the Bangladesh economy moved on a path of rapid and sustained growth in FY11. The Bangladesh Bureau of Statistics (BBS) estimates real GDP growth for FY11 at 6.7 percent, the highest ever recorded since FY90. Industry sector had the strongest growth gain from 6.5 percent in FY10 to 8.2 percent in FY11, supported by strong growth exceeding 40.0 percent both in exports and imports. Services sector output growth edged up to 6.6 percent in FY11 from preceding year's 6.5 percent. Agriculture sector output growth eased down from the FY10 high of 5.2 percent to lower but still strong and above trend, recorded 5.0 percent growth in FY11. Reflecting the strong economic activity, domestic demand increased in relation to GDP by 0.83 percentage points; of which investment in machinery and equipment has been the most dynamic factor reflecting capacity pressure, higher profit and strong external demand. Private consumption picked up pace in FY11 resulted from strong increases in industrial production specially of medium and large scale manufacturing production, a high growth in agriculture and continued expansion of services activities . The uptrend in CPI inflation from the global slowdown induced low of FY09 continued in FY11, but less steeply than in FY10. While point to point CPI inflation increased in FY10 by as much as 6.4 percentage points from the FY09 low of 2.3 percent, the increase in FY11 was 1.5 percentage points to 10.2 percent. The annual average (headline) CPI inflation rose to 8.8 percent by the end of FY11, well above the 8.0 percent level projected in the revised FY11 national budget; mainly due to high and volatile food and non food commodity prices in global markets. The annual average non food CPI inflation (which can be considered as 'core' inflation) remained low and declining however, down to 4.2 percent at close of FY11 from 5.5 percent at the opening. In response , besides employing policy interest rate (repo, reverse repo rate) BB's monetary policies seek to influence real sector prices also via quantity theory based money stock targeting; monetary programmmes chalk out target growth paths for broad money (M2) and its sub aggregates, implemented by day to day management of growth path of reserve money (currency in issue and balances of banks with BB). This approach is felt necessary because of inadequacy of well functioning transmission channels from financial prices to real sector prices in domestic markets which are still at early stage of development, and also because unlike economies fully open on capital account, money stock targeting is feasible in economies like Bangladesh maintaining controls on capital flows.

Growth Performance

1.7 In FY11, output and investment activities increased substantially. Provisional estimate by Bangladesh Bureau of Statistics (BBS) shows that the real GDP growth rate stood at 6.7 percent which was equal to initial projection of 6.7 percent, following 6.1 percent growth in FY10. The growth was underpinned on the supply side, by the strongest growth in industry and services sectors, with a modest growth in agriculture sector. Agriculture sector output growth declined from 5.2 percent in FY10 to 5.0 percent in FY11, which is still above-trend level. The animal farming, forestry

and related services, and fishing subsectors attained higher output growth rate of 3.5, 5.4 and 5.4 percent respectively in FY11 as compared with 3.4, 5.2 and 4.2 percent respectively in FY10. The crops and horticulture sub-sector achieved lower growth rate of 5.0 percent in FY11 as compared with 6.1 percent in FY10.

1.8 The industry sector grew by 8.2 percent in FY11 compared to 6.5 percent in FY10. This growth of industry sector was supported by the spectacular performance of the exports sector which grew by 41.7 percent. Imports growth was also 41.8 percent in FY11. Manufacturing subsector grew by 9.5 percent in FY11 as compared with 6.5 percent in FY10. Large and medium scale sub-sector growth edged up to 10.4 percent in FY11 from 6.0 percent in FY10 but small scale industry sub-sector growth edged down from 7.8 percent in FY10 to 7.3 percent in FY11. The growth in power, gas and water supply sub-sector was 6.0 percent in FY11 from 7.3 percent in FY10. The growth in the construction sub-sector increased from 6.0 percent in FY10 to 6.4 percent in FY11 mainly due to higher demand in the housing sector.

1.9 Growth in the services sector increased to 6.6 percent in FY11 from 6.5 percent in FY10, with strong growth in different sub-sectors such as wholesale and retail trade, transport storage and communication, public administration and defence, education, health and social works. However, the growth in the financial intermediations sub-sector declined and in real estate, renting and business activities remained unchanged in FY11 compared to FY10.

1.10 On the demand side, real domestic demand increased by 6.6 percent in FY11, compared with 6.1 percent in FY10. Of the two components of domestic demand, growth in consumption decreased marginally to 5.3 percent in FY11 from 5.4 percent in FY10. On the other hand, investment demand grew by 9.8 percent in FY11 compared with 7.9 percent in FY10.

Savings and Investment

1.11 Gross fixed investment increased marginally to 24.7 percent of GDP in FY11 from 24.4 percent in FY10 (Chart 1.1), with private investment accounting for 19.5 percent of GDP, up from 19.4 percent, while public investment increased to 5.3 percent from 5.0 percent of GDP. Rising investment expenditure as largely concentrated in the areas of machinery, power sector and transport equipment and construction, had a capacity expansion effect on GDP. National saving rates fell from 30.0 percent of GDP in FY10 to 28.4 percent in FY11. About two-third of this decline was due to slowdown in the growth in foreign savings, defined as the current account surplus including workers remittances, declined to 14.8 percent of GDP in FY11 from 15.8 percent of GDP in FY10. Domestic saving also showed a similar trend, falling from 20.1 percent in FY10 to 19.6 percent in FY11, as a result of an increase in expenditure. The domestic savings-investment gap as percentage of GDP, correspondingly, increased from 4.3 in FY10 to 5.1 in FY11, whereas national savings-GDP ratio decreased to 28.4 percent in FY11 from 30.0 percent in FY10.

Price developments

1.12 Inflation in FY11 rose by 8.8 percent from 7.3 percent during the same period last year. Mainly rise in food inflation to 11.3 percent at the end of FY11 from 8.5 percent at the end of FY10 contributed to the rise in

overall inflation, while non-food inflation declined to 4.2 percent at the end of FY11 from 5.5 percent at the end of FY10. On the other hand, point to point basis CPI inflation rose to 10.2 percent at the end of FY11 from 8.7 percent at the end of FY10. The upward trends of inflation mainly stemmed from the upward trends in the global prices of both food and non-food items. Adverse weather conditions disrupting output in many regions around the world were pushing up global prices of food commodities. Due to high food price inflation in neighbouring fast growing India and prevailing high international prices of food commodities, local prices were high and rising even after a good harvest of *Aus* and *Aman*. Import-based commodities such as wheat, sugar, edible oil and pulse followed movement of international prices. Strong growth performance in emerging developing economies was propping up global prices of energy and non-food industrial commodities as well. Government continued to take measures to curb inflation such as ensuring supply of necessary commodities in the market as well as close monitoring of the marketing system, open market sale (OMS), reducing tariffs on import of some of the essential commodities, giving subsidies to agricultural inputs (fertiliser, seeds, electricity for irrigation) to reduce agricultural production costs. Similarly, Bangladesh Bank raised repo, reverse repo interest rates in four steps totalling 2.25 percentage points in FY11, besides raising cash reserve ratio (CRR) for banks by 0.5 percentage point from 5.5 percent to 6.0 percent in December 2010.

Money and Credit Developments

1.13 Output and investment activities in the economy paced up sharply in FY11, pushing up demand for credit quite sharply both in the public and private sectors (39.9 percent and 25.8 percent y-o-y respectively). The upward trends in the global prices of both food and non-food items and pickup in output and investment activities in domestic economy have been increasing inflationary pressure even after good domestic food production. Therefore, to reduce inflationary pressure Bangladesh Bank increased repo, reverse repo interest rates in four steps totalling of 2.25 percentage points in FY11 to 6.75 percent and 4.75 percent respectively from 4.50 percent and 2.50 percent in FY10. Besides, Bangladesh Bank raised cash reserve ratio (CRR) and statutory liquidity ratio (SLR) for banks by 0.5 percentage point to 6.0 percent and 19.0 percent respectively in December 2010. Sharp increase in the domestic credit demand and import payment created liquidity pressure in the domestic money market and foreign exchange market. Bangladesh Bank injected substantial amount

Table 1.2. Sectoral GDP growth rates

(at FY96 constant prices: percent)

	FY91-FY00 (Average)	FY01-FY10^R (Average)	FY10^R	FY11^P
1. Agriculture	**3.2**	**3.5**	**5.2**	**5.0**
a) Agriculture and forestry	2.1	3.7	5.6	4.8
i) Crops and horticulture	1.8	3.3	6.1	5.0
ii) Animal faming	2.5	4.5	3.4	3.5
iii) Forestry and related services	3.6	5.0	5.2	5.4
b) Fishing	8.2	2.7	4.2	5.4
2. Industry	**7.0**	**7.5**	**6.5**	**8.2**
a) Mining and quarrying	6.0	8.3	8.8	4.9
b) Manufacturing	6.9	7.5	6.5	9.5
i) Large and medium scale	7.0	7.4	6.0	10.4
ii) Small scale	6.8	7.8	7.8	7.3
c) Power, gas and water supply	5.5	7.1	7.3	6.0
d) Construction	7.5	7.5	6.0	6.4
3. Services	**4.5**	**6.1**	**6.5**	**6.6**
a) Wholesale and retail trade	5.7	6.6	5.9	6.1
b) Hotel and restaurants	5.5	7.3	7.6	7.6
c) Transport, storage and communication	4.6	7.6	7.7	7.9
d) Financial intermediation	4.8	8.2	11.6	9.4
e) Real estate, renting and otner business activities	3.5	4.2	4.0	4.0
f) Public administration and defence	6.8	7.2	8.4	9.6
g) Education	6.1	8.4	9.2	9.5
h) Health and social works	4.0	6.4	8.1	8.3
i) Community, social and personal services	2.8	3.7	4.7	4.8
GDP (at FY96 constant market prices)	**4.8**	**5.8**	**6.1**	**6.7**

Source: Bangladesh Bureau of Statistics.
R=Revised, P=Provisional

of Taka and USD liquidity to ease down the liquidity pressure in the banking system. Bangladesh Bank injected Taka totalling of 80.4 billion by repo, USD 0.96 billion net sales in the interbank foreign exchange market, and USD 0.43 billion short term overdrafts to banks at the end of FY11.

1.14 Broad money (M2) growth stood at 21.4 percent in FY11, which is marginally lower than the 22.4 percent growth recorded in FY10 and higher than the target under the programme. The growth in broad money was mainly driven by higher growth in net domestic assets (NDA). Net domestic assets of the banking system increased by 25.0 percent in FY11 resulting from 28.4 percent growth in domestic credit against the target of 18.8 percent and previous year growth of 17.6 percent. The credit to public sector increased substantially by 39.9 percent in FY11 compared with projected growth of 29.2 percent and negative growth of 5.2 percent in FY10 mainly due to lower inflow of foreign assistance. Credit to private sector also grew substantially by 25.8 percent in FY11, which is higher than the 24.2 percent growth in FY10 and also higher than the programme level of 16.5 percent for FY11.

1.15 Of the components of broad money on the liability side, growth of the time deposits (22.7 percent) was higher than that of the currency and demand deposits (17.2 percent). The income velocity of money declined to 1.79 in FY11 from 1.91 in FY10, indicating increased monetisation and financial deepening in the economy.

1.16 The declining trend of interest rates that persisted over a couple of years till FY05 reversed in FY06 which continued in FY07. Thereafter, weighted average interest rate on bank advances started to decline and

Chart 1.1

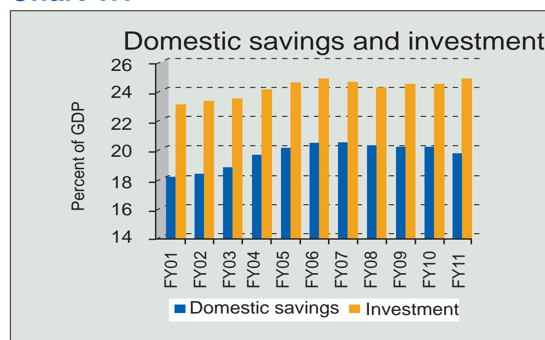


Chart 1.2

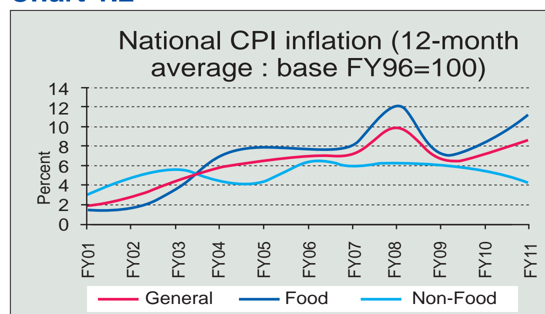


Chart 1.3

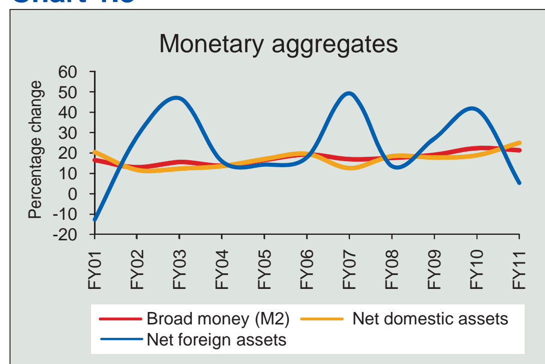
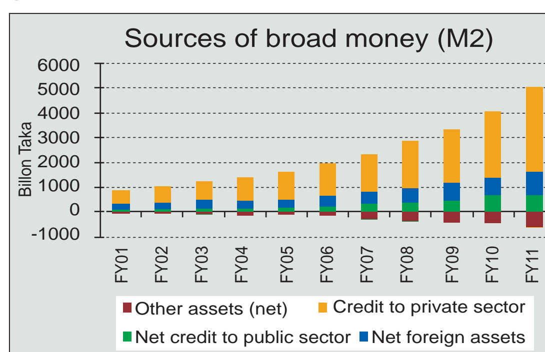


Chart 1.4



continued the trend till FY10 and then increased to 12.4 percent at the end of June 2011 from 11.3 percent at the end of June 2010, while the deposit rate increased to 7.3 percent as of end June 2011 from 6.0 percent as of end June 2010.

Public Finance

1.17 The government continued its budget deficit policy in FY11 with a higher level of financing in larger-scale infrastructure investments. The Government's gross revenue collection in the revised FY11 budget was Taka 951.9 billion, increasing 25.4 percent from the FY10 actual revenue, mostly from tax revenue. Regarding expenditures, as result of increased public investment activities, the government expenditure in the revised FY11 budget increased to Taka 1300.1 billion, indicating an increase of 28.0 percent from the FY10 actual budget. Overall budget deficit (including grants), in the revised FY11 budget was Taka 306.0 billion, equal to 3.9 percent of GDP, with net domestic borrowing of Taka 248.2 billion and foreign financing equivalent to Taka 57.8 billion.

1.18 Revenue receipts grew by 25.4 percent in FY11 against 9.7 percent growth in FY10 and in GDP percentage it rose to 12.1 percent of FY11 GDP from 11.0 percent of FY10 GDP. A heartening feature of FY11 revenue growth is the robust 36.2 percent increase in income tax receipts, a progressive turn in the revenue regime still largely reliant on regressive indirect taxes.

1.19 Public expenditure in FY11 grew by 28.0 percent, against 7.9 percent growth in FY10 and in GDP percentage it rose to 16.5 percent of FY11 GDP from 14.7 percent of FY10 GDP. The current expenditure in FY11 surpassed initial allocations for a number of accounts, namely social sector, public order and safety, agriculture sector, transport and communication, local government and rural development and housing.

Chart 1.5

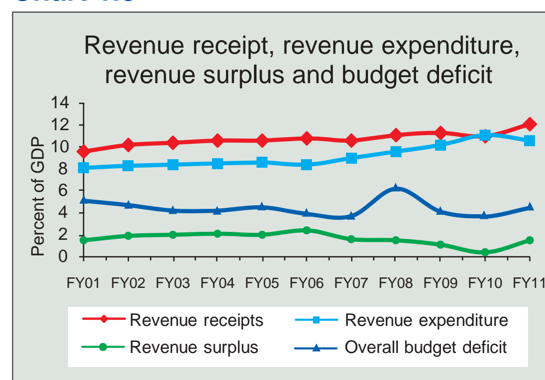
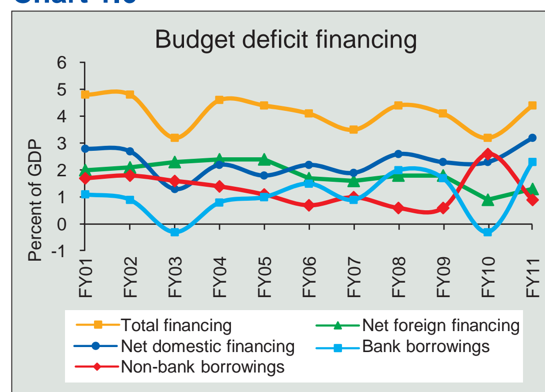


Chart 1.6



1.20 Overall budget deficit excluding grants increased to 4.4 percent of GDP in FY11, from 3.7 percent of FY10 GDP. Domestic financing of the deficit increased to 3.2 percent of GDP in FY11, from 2.3 percent of FY10 GDP; foreign financing covered the remainder of the deficit.

External Sector

1.21 On the external front, exports and imports picked up sharply in FY11 respectively by 41.7 and 41.8 percent y-o-y, against 4.2 and 5.4 percent growth rates of FY10. Trade deficit widened to USD 7328 million in FY11, from USD 5155 million of FY10. Services, income and transfers account registered a surplus of USD 8323.0 million owing to an increase in workers' remittance inflows and reduction in deficit in income account.

As a consequence current account was in a surplus of USD 995.0 million. Capital and Financial account was in a deficit of USD 984.0 million, due primarily to decline in other investment as well as foreign direct investment. On the other hand, portfolio investment and capital transfer increased in FY11, capital account recorded a surplus of USD 600.0 million during the year. While taking into account net errors and omissions, the balance of payments registered a deficit of USD 925.0 million. Gross international foreign exchange reserves at end-year stood at USD 10912.0 million.

1.22 Exports earnings recorded a high 41.7 percent growth during FY11 after a slower 4.2 percent growth in FY10. The high growth in exports of key items like ready-made garments, raw jute, jute goods, leather and frozen foods helped to attain higher export growth during FY11. Among the RMG export items, woven garments and knitwear grew by 40.2 percent and 46.3 percent respectively. Export of raw jute and jute goods increased by 82.0 percent and 28.1 percent respectively. Upsurge in the international price level and increased demand for Bangladeshi low-end products partly helped to increase export earnings.

1.23 Import payments recorded healthy 41.8 percent growth during FY11 compared to a slower 5.5 percent growth recorded in FY10. The import payments were higher due to higher imports of food grains, capital machinery and some intermediate goods; and partly to higher international prices. Expressed as proportion of GDP, export earnings increased to 20.7 in FY11 from 16.2 in FY10, while import payments increased to 27.4 in FY11 from 21.3 in FY10.

1.24 Despite moderation in growth of workers' remittance inflows to 6.0 percent in FY11 from 13.4 percent of FY10, BoP current account balance registered a surplus of USD 1.0 billion; substantially lower than the FY10 surplus of USD 3.7 billion. With deficits in services, income and trade accounts, the FY11 current account surplus was attributable mostly to inflows of workers' remittances, rising to USD 11.65 billion in FY11, from USD 10.99 billion of FY10.

Chart 1.7

Chart 1.8

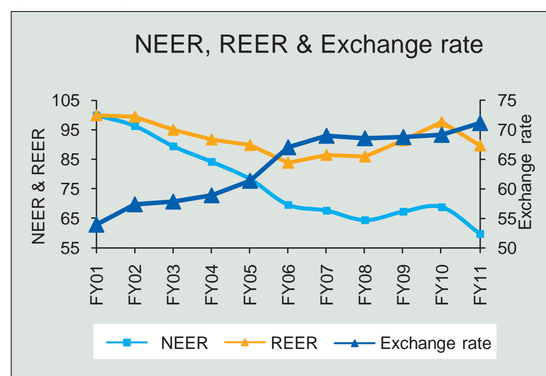
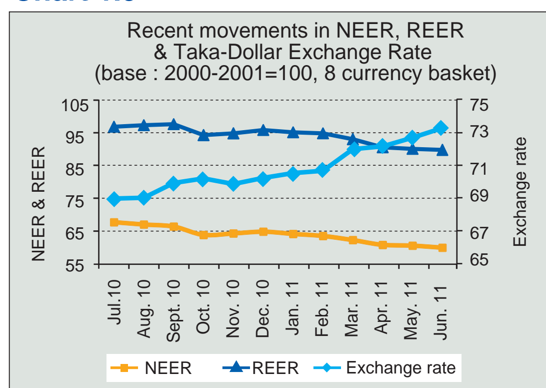


Chart 1.9



1.25 The overall balance of FY11 BoP stood in deficit of USD 0.93 billion, against surplus of USD 2.87 billion of FY10. Gross foreign exchange reserves held by the Bangladesh Bank rose by USD 0.16 billion to USD 10.91 billion at the end of FY11, comprising about 3.7 months of import cover.

1.26 The domestic foreign exchange market showed some volatility during FY11 with escalated demand pressure in foreign exchange markets rather sharply in FY11, from both public and private sectors; while slowdown in workers' remittance inflows, widening trade deficit from strong import growth, and declining capital account inflows built up substantial stress on liquidity in foreign exchange markets. Bangladesh Bank's interventions in the market were aimed at easing demand pressure with liquidity at appropriate levels. The pressure on exchange rate of Taka was eased partly by BB's net sale of USD 962.5 million from reserves, to limit inflationary consequences of excessive Taka depreciation. With this partial easing, Taka depreciated against USD by 6.3 percent in FY11. The nominal exchange rate of Taka stood at Taka 74.15 per US dollar as of end June 2011, from Taka 69.45 per US dollar as of end June 2010. In nominal effective term against a trade weighted eight currency basket (base: 2000-01=100), Taka depreciated by 13.1 percent in FY11, while the real effective exchange rate of Taka depreciated by 8.1 percent.

1.27 Outstanding external debt of Bangladesh increased to USD 21.45 billion as of end June 2011, from USD 20.34 billion as of end June 2010. However, as ratio of GDP the outstanding external debt declined to 19.4 percent of GDP as of end June 2011, against 20.3 percent of GDP as of end June 2010.

Financial Sector Stability

1.28 Bangladesh's financial system has benefited from sustained economic development of the country over the past years. Benefited from accelerated GDP growth in FY11 the banks have further strengthened their funding base over the year, leaving them better placed to meet future credit demand and support economic growth. Bank asset quality also remains strong despite an increase in non-performing loans. Despite strong commodity prices and credit demand interest rates have fallen. In addition, quantitative easing measures had been taken by Bangladesh Bank aimed at bolstering the stability of exchange rate. Financial markets continually benefited from the sustainability of the fiscal position. In response government offered fiscal stimulus to increase the pace of growth of the economy that contributed financial sector activities to grow further. In the H2FY11, BB turned to trying to tame inflation with the prudential liquidity policy, helped banks to substantially improve their balance sheets. Most of the banks now comfortably meet regulatory requirements for core funding. Banks profitability also improved in FY11. According to the recent stress test results, banks and insurance companies are resilient to relevant risks despite the significant conservative settings of the two stress scenarios. This is due not only to a high initial capital buffer, but also to the ability to generate income even in an adverse scenario.

Near and Medium Term Outlook for the Bangladesh Economy

1.29 The prospects of the Bangladesh economy are favourable over the near and medium term, provided there is no let-up in the process of increasing foreign demand,

strengthening the supportive macroeconomic policies and subduing inflation. The main task is to nurture the growing economy and turn it into a sustained and vigorous expansion, while keeping inflation low. A distinguishing feature of the economy's development in the next few years will be an upturn in investment activities. The efforts of industry to improve quality, reorganise production and compete in higher- technology sectors and products, combined with the programmes implemented by the Government to upgrade the economy's overall efficiency to international standards, will support the demand for capital goods in the short to medium term. The contribution of investment in capital machinery to GDP growth will thus remain high in the coming years, while that of momentum for investment in construction is expected to continue strongly.

1.30 Domestic demand remains buoyant in the economy, supported by faster poverty decline (by nearly two percent annually) reported in recent BBS Household Income and Expenditure Survey (HIES 2010). Demand from abroad for the predominantly low-end apparels and other manufactured exports from Bangladesh has recovered well, even in the mature advance economies on slower track of global recovery. Access to new export markets in fast growing emerging economies are widening, and newer items like maritime vessels are entering in the export basket. Industry sector output growth is therefore likely to be well supported in FY12 by both domestic and external demand. The prevailing buoyant market prices of food crops, dairy and poultry products are providing stimulus for agriculture sector output growth. Promotion of SME and agricultural lending to the poorer population segments under BB's financial inclusion campaign is helping to generate output growth on the supply side as well as employment and income growth on the demand side. In this context attaining or exceeding the 7.0 percent real output growth for FY12 targeted in the national budget wouldn't seem too difficult, subject of course to the usual provisions of benign climatic conditions, rapid further easing of power and gas shortages, timely and adequate availability of necessary financing and physical inputs, and stable social and political environment.

1.31 Increase of annual average (headline) CPI inflation has remained slower in FY11 than in FY10, with its non-food component actually declining, point-to-point CPI inflation has also eased slightly in June 2011. Nevertheless, point-to-point CPI inflation has remained beyond comfort zone in double digit since March 2010. The food price component of both annual average and point-to-point CPI inflation are in double digit since December 2010 causing considerable hardship for the low income majority of the population, despite satisfactory growth in domestic output of major food crops including rice, potato and wheat. With global prices of food commodities including rice, wheat, sugar and edible oil's high and volatile, the food CPI inflation situation is much the same in other developing countries, including India, the neighbouring large economy. In the open global trade regime, prices of rice and other food commodities in domestic markets in Bangladesh are impacted by trends of global prices, even though imports constitute only a small portion of total domestic rice consumption. Global food and non food commodity prices are still high and volatile, but episodes of downward jolts have begun to appear recently; presumably from combined impact of reversal of global crisis related expansionary stances in fiscal and monetary policies in most countries including major

mature advanced economies and fast growing emerging economies like China and India. This new worldwide trend of fiscal and monetary restraint can be expected to have cooling off impact on global commodity price trends in H1 FY12, in turn moderating domestic food price inflation in Bangladesh. Meanwhile government has been selling food grains from public stock at lower prices to relieve low income people from hardship of high food prices. Against the expected moderation of domestic food CPI inflation in H1 FY12, non-food CPI inflation may increase if the subsidised user prices of gas, electricity and petroleum are revised upward to relieve government's mounting budgetary burden. Given these realities, even as BB remains proactive in curtailing excess demand from undue monetary expansion, attaining the targeted decline of CPI inflation to 7.5 percent in FY12 from the end FY11 level of 8.8 percent may prove challenging.

1.32 From actual decline in FY10, Government's borrowing from the domestic banking system rose sharply by 39.9 percent in FY11, characteristically exceeding rather than falling short of initial projections, despite healthy growth in revenue receipts. The main reason was the decline in external financing and nonbank borrowing through National Savings Scheme (NSS) instruments, of which net sales plummeted with downward revision of profit rates. While overall budgetary deficits (3.9 and 4.5 percent of GDP for FY11 and FY12 respectively) are not particularly worrisome, there is room for rebalancing of the 6.0 percent to 94.0 percent Treasury bill-bond composition planned for FY12 borrowing. Secondary trading in Treasury bonds has not yet developed significantly in the local market, primary dealer banks required to take up Treasury bonds in primary auctions end up laden with high volumes of practically illiquid assets. Treasury bills being short term (tenors up to one year) are much easier for banks to carry in their books as these are much more easily tradable in the secondary market; and with lower yield these are also a cheaper borrowing option for the government. Raising the share of bills in the bill-bond composition of government borrowing from the banking system (say, 30.0 percent-70.0 percent) may be both are convenient for banks and cost saving for the government. Secondly, the planned volume of FY12 domestic non bank borrowing is less than a third of the planned volume of bank borrowing; with modest further improvement of return rates on NSS instruments (over the recent rather marginal improvements on some of these) it should be possible to borrow more through higher sales of NSS instruments, easing the demand pressure on banks. The reduced demand pressure on banks will mean correspondingly lower borrowing cost (lower yield rate on T-bills/bonds in auctions) there may be no net increase in borrowing cost in such rebalancing of bank and non-bank government borrowing. Borrowing by nonfinancial State Owned Enterprises (SOEs) is escalating fast in recent years, and has grown 32.0 percent in FY11. Many loss making unviable non financial SOEs closed down earlier at considerable cost in severance payments and loan liabilities are being reopened with newly borrowed funds. It is unclear whether the reopening decisions was based on proper viability appraisals or whether performance of these reopened SOEs are being monitored closely. This merits being an area of priority attention, as does ensuring efficiency and preventing wastefulness in utilisation of the rapidly rising ADP expenditure allocations. Towards easing the growing public sector borrowing demand

from the modest domestic savings pool in FY12 and beyond, it may be timely now to initiate steps for raising external financing by longer term bond issues in international markets for the larger public sector infrastructure projects that will generate own income streams for debt servicing; as the processes require several months of preparatory work.

1.33 The high, above forty percent FY11 growth in both exports and imports following a couple of years in global financial crisis induced low slowdown cannot sustain for long, and is projected to ease down to around 15.0 percent in FY 12, both for exports and imports. Growth in workers' remittance inflows is likely to increase double digit in FY12, as there being indication of major positive change in outlook for migrant manpower demand in job markets abroad. BoP current account balance, maintaining surplus throughout FY11 despite heavy import related pressure, is projected to swing into deficit in FY12, with tepid growth in workers' remittance inflows falling short of the increasing deficits in trade, services and income accounts. With net balance in capital and financial account in negative, overall balance is posted negative in FY11, and projected to remain negative also in FY12, which would put pressure on international reserves. Consequently, exchange rate of Taka is likely to continue to be under some pressure in FY12, reserves are projected to decline slightly by close of FY12. The projected BoP outcomes for FY12 are trend based; with scope of improvement with appropriate policy efforts successfully promoting exports and attracting capital and workers' remittance inflows.

1.34 Smooth adjustment of money and credit markets to the demand pressures and stresses anticipated for FY12 and beyond will require attention to prevailing imperfections and incompleteness in the markets. Issues meriting immediate attention include the following: In FY11 rise in Treasury bill/bond yields was less than with proportionate rise in issue volumes. Market value of stocks of bills/bonds decline with yield rate rise; BB rules required banks to hold a high 75.0 percent of bill/bond stocks in trading books. Losses to be booked on required daily marking to market valuation of the stock of bills/bonds in trading book made banks averse to seeking yield rise. To redress this loss in flexibility of bill/bond yields, BB reduced the required trading book portion of total bill/bond stock to 50.0 percent. There is room for further easing of this requirement, even 25.0 percent of total stock held in trading book may now be sufficient for secondary market trading. Demand base for long dated Treasury bonds in entities with long term liabilities (life insurers, provident and pension funds) remain undeveloped, rendering these bonds virtually illiquid. Policy measures requiring former sector employers to maintain fully funded pension/provident fund schemes which helped to create the demand base required for active secondary market in Treasury bonds. Issuance of asset backed corporate securities, thus far only sporadic, stalled following withdrawal of a tax break on such holdings, and there are transfer fee issues impeding secondary trade in corporate securities. Resolution of these issues will help promote and support development of liquidity enhancing securitisation processes. Islamic banks in Bangladesh cannot participate in the interest based interbank overnight money market. Activation of an Islamic interbank money market can enhance efficiency of utilisation of available liquidity. Consultations on modalities of doing so have already been initiated.

1.35 Realisation of the GDP growth expectations for FY12 and beyond will depend importantly on continuing stable domestic growth as also on steady growth in external demand. The recent slowdown risks from lingering weaknesses in US economy and debt problems in Europe pose risks for weakening demand for our exports in these markets. Bangladesh will need to be proactive in forging new allowances with fast growing emerging economies elsewhere. Newer job markets abroad will also need to be explored in the faster growing economies to make good for weaker demand for expatriate manpower in North America, Europe and Middle East.