Centre for Policy Dialogue
Independent Review of Bangladesh's Development (IRBD)
Dhaka: December 29, 2002

State of the Bangladesh Economy 2002-2003
An Interim Report[1]

Debapriya Bhattacharya[2]
Executive Director, CPD

I. Introduction

Benchmark conditions during FY02. At the beginning of the fiscal year 2001-2002 (FY02), the *Centre for Policy Dialogue* (CPD), in its annual *Independent Review of Bangladesh's Development* (IRBD), benchmarking the initial conditions of the economy observed that "the economy is facing possibly the most severe exigency since the macro-economic crisis of the late 1980s. The twin shocks emanating from the yawning fiscal deficit and deteriorating balance of payment has exposed the entrenched vulnerabilities of the Bangladesh economy. Both the successes of the macro-economy, achieved during 1990s, viz. stability and growth are in peril".

CPD-IRBD 2002 raised the question "whether the emerging negative trends in the macro-economy will lead to an extensive loss of employment and income for a protracted period, or whether the present predicament is a short-term phenomenon to be overcome through prudent policy management and institutional reforms".

Year closing assessment of FY02. At the end of the FY02, as part of its reaction to the National Budget for FY03, the CPD undertook a year-ending assessment of the economy. Three major

[1] The paper has been prepared under the Centre for Policy Dialogue's (CPD's) programme *Independent Review of Bangladesh's Development* (IRBD). This is an interim version of the IRBD FY03 which focuses on the state of the national economy during the first half of the fiscal year 2002-2003.

[2] The author is particularly grateful to *Mr. Syeed Ahmed*, Research Associate, CPD for his competent research assistance in developing and managing the CPD-IRBD database. Contribution of *Mr. Noor Mohammad Wasi Uddin*, Programme Associate, CPD in data collation and analysis is gratefully acknowledged.

observations were recorded in this assessment on FY02. *First,* deterioration in the fiscal balance has been harnessed. *Second*, pressure on balance of payments has been partly contained. *Third*, recessionary trends continue to afflict the economy. CPD's review emphasised scored that the inability to address the prevailing stagnation in the investment scenario may jeopardise the recent gains.

National Budget for FY03. It was open to speculation whether the Budget for FY03 would be able to catalyse investment growth. <u>However, it was further pointed out in CPD's review that, in spite of all the positive measures taken under the Budget FY03, investment will still remain constrained due to lack of reforms, particularly in improving performance in the trade-supportive infrastructure, financial sector, public administration, and last but not the least, because of the deteriorating law and order situation</u>.

Interim IRBD FY03. More than five months have elapsed since the foregoing observations were made. During this period, the government has resorted to rather non-conventional measures to improve the law and order situation. A number of government committees are trying to give shape to reform measures in different areas of economic management. <u>Now with the results of the first quarter (and in some cases for four/five months) of the FY03 behinds us, we may seek to identify and interpret the initial signals</u>.

It is in this context that the present paper reviews a set of major variables defining the state of the Bangladesh economy. The analysis, based on official data, is divided into five broad parts. It sequentially addresses the developments in the *fiscal, credit and monetary sector, real economy,* and *external sector*. The review concludes by highlighting some issues which in the coming months will serve to influence the performance of the economy.

II. Trends in Fiscal Sector

Revenue. In FY02, a total amount Tk. 276.70 billion was collected as revenue, of which the National Board of Revenue (NBR) tax component accounted for about 75 per cent, non-NBR tax – a little above 4 per cent, and non-tax revenue – around 21 per cent. The total collection, in spite of being about 14.5 per cent higher over the earlier year's receipts, was about 2.8 per cent short of the target.

The National Budget, with a projection of about 19.6 per cent growth, fixed a target of Tk. 330.84 billion to be collected as revenue in FY03. The largest contribution to this growth is expected to originate from non-NBR tax revenue (45.8 per cent), followed by non-tax revenue (32.1 per cent). Full implementation of the target for FY03 is expected to push up the share of revenue in GDP to a little above 11 per cent which still leaves Bangladesh with one of the lowest Revenue-GDP ratios, even amongst the low income countries.

Data for the first five months (July-November) of FY03 indicate that the fiscal year enjoyed a kick-start in terms of revenue collection. After a slow start in the month of July, the collection geared up in the subsequent months. Revenue receipts under the NBR were about 23.47 per cent above levels collection during the matching period of FY02. This was about 1.6 per cent higher than the corresponding target and accounted for 36.43 per cent of the annual target of the NBR.

During the aforementioned period (July-November 2002), both *import related* and *internal trade related revenue* collections exceeded their respective target, with the gains more pronounced in case of the latter. Internal trade related revenue collection was 6.72 per cent above the target – thanks to high collection of local Value Added Tax (VAT) and Supplementary Duty (SD). In contrast, collection of both import related VAT and SD remained below the target possibly due to sluggish import growth. (However, import duties were collected 13.85 per cent above the target).

It may be the noted that *income tax* collection has suffered a shortfall to the extent tune of 10.5 per cent during the period July-November, 2002. Recent initiatives of the NBR to identify potential tax payers are yet to translate into actual yield.

In this connection, one has to take note of the fact that, in the backdrop of less than expected import growth, there may be an attempt to achieve the aggregate target of revenue receipts through enhanced collection of internal trade related taxes (i.e. local VAT and SD). Reliance on such devices may exert recessionary pressure on the domestic investment situation.

It needs to be further pointed out that information for the period under review was not readily available for *non-NBR tax revenue* (Stamp Duty, Land Revenue, Taxes on Vehicles etc.) and *non-tax revenue* (Administrative Fees and Charges, Dividend and Profit, Interest etc.) receipts which together constitute about a quarter of the total target. It is held that performance in thee two areas will, at the margin, define the success of aggregate revenue collection at the end of the fiscal year.

Public Expenditure. Public expenditure happens to be one of the major areas of government finance in Bangladesh for which real time data is almost totally absent. Revenue expenditure data becomes provisionally available only at the end of the fiscal year along with the budget documents. Information on implementation of the *Annual Development Programme* (ADP) is actually available with three to four months time lag, only when the *Executive Committee of the National Economic Council* (ECNEC) endorses the report of the *Implementation, Monitoring and Evaluation Division* (IMED).

Thus, in the context of the absence of any up-to-date information, one may recall that the budget for FY03 provides for a conservative revenue expenditure growth of 5.64 percent supplemented by an ambitious target of ADP expansion in the order of 23.3 per cent. The programmed ADP constitutes about 43 per cent of the total public expenditure outlay for FY03.

The total public expenditure in Bangladesh as a share of GDP is still low in comparison to other low-income countries – programmed to be approximately 15.0 per cent in FY03. Thus, it is not the overall size of the public expenditure, but its composition and quality which remain a matter of greater concern. *First*, the ADP is routinely under-achieved. The government slashed down the ADP for FY02 by Tk. 30 billion, and yet could not fully implement the scaled down figure. Thus, a development expenditure target of Tk. 192 billion for FY03 could be a daunting figure to chase. It may very well be possible that the proposed mid-term review of the budget will revise the original ADP target downward. *Second*, whatever may be the size of the ADP, it is the prioritisation and selection of the included projects as well as the quality of their envisaged expenditure lines which have always remained suspect. *Third*, in the backdrop of weak implementation of the ADP whilst the revenue expenditures have systematically crossed the budget limit, the composition of public expenditures is assuming an unhealthy structural rigidity. The revenue expenditure-basket is assuming an immutable character where three-quarter of the revenue budget remains committed to salaries and allowances, subsidies and transfers, and interest payments.

However, indirect evidence, such as the trend in government borrowing (as discussed later) suggests that the government has been following a tight expenditure policy during the first quarter of FY03. Inspite of the comfortable revenue collection situation, it is quite prudent on the part of the government to pursue such a conservative approach to budgetary management, given the softness in the foreign exchange reserve. In case of any exigency, this will also allow the government to cutback on expenditures (possibly ADP) to maintain the fiscal balance. However, this implies that a substantial part of the programmed expenditure will be back-loaded, taking away the smoothness in the expenditure trend.

Hopefully, necessary inputs from the *Public Expenditure Commission* will be forthcoming in time to bring about the necessary adjustments in the revision of the governments' outlay for the rest of the current fiscal year.

Fiscal Deficit. The crawling increase of the overall budget deficit as a share of GDP was harnessed in FY02 by bringing it down to around 4.4 per cent from about 7.0 per cent in FY01. This was largely done by slashing down public expenditure.

The budget for FY03 plans to bring down the share further to less than 4 per cent of which about 48 per cent will be financed from domestic sources and the rest through foreign financing. As we shall see later, the government has been able to avoid, to date, borrowing from the banking sector to finance its fiscal deficit. It will be, however, very important to observe to what extent the government will be successful in drawing down on its foreign aid pipeline to underwrite the deficit.

As of date, it seems the fiscal deficit target for FY03 has high possibility of being achieved – although possibly, through trimming of development expenditure.

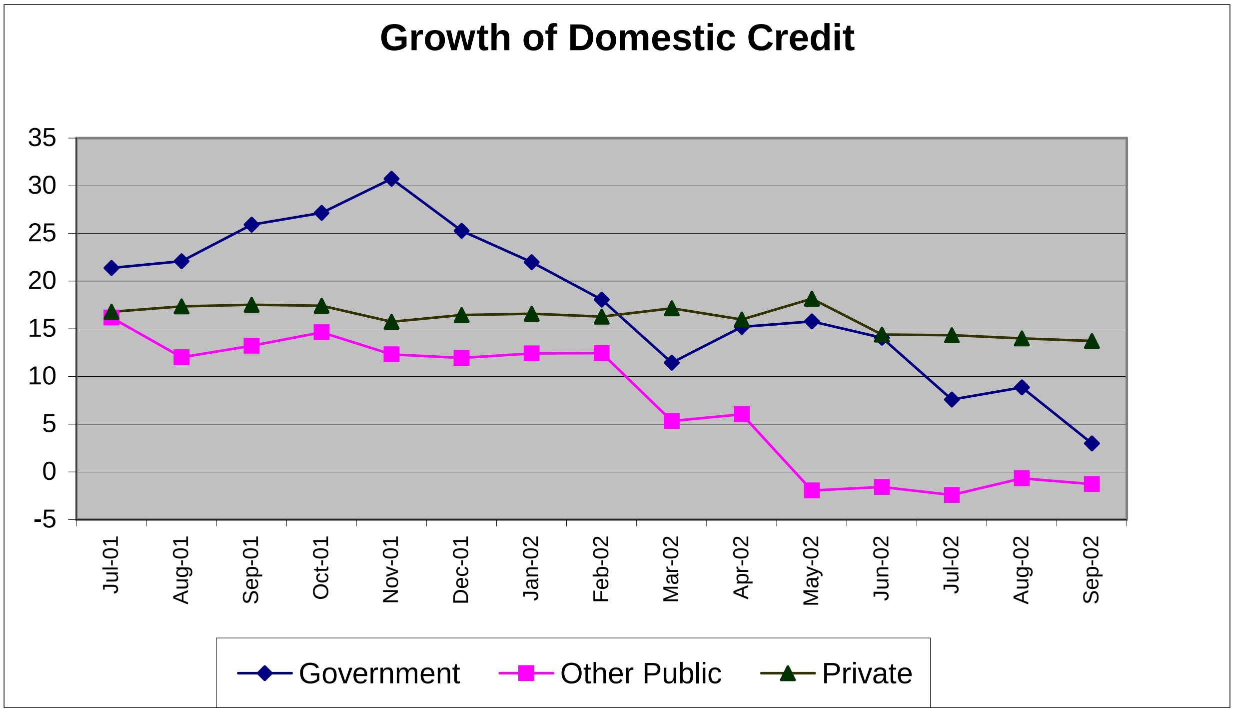
The foregoing review of the trends in the fiscal sector reveals that the process of consolidation, which set in FY02, has progressed further during the first five months of the FY03. One may, however, raise the question whether such a tight public (development) expenditure policy is going to encourage any depressive effect on the investment situation. It is by now largely accepted that quality investment from the government source "crowds in", rather than "crowds out" private investment in developing economies.

Scrutiny of the trends in the monetary sector presented in the following section would give us some clues about the obtaining situation in this regard.

III. Developments in the Monetary Sector

Domestic Credit Expansion. Following expansion of domestic credit at the high rate of more than 17.6 per cent in FY01, domestic credit growth was brought down to below 13 per cent in FY02 as part of the overall strategy of fiscal consolidation. The most disturbing feature of the credit growth in FY01 had been greater increase in borrowings by the government and quasi-government sector in comparison to the private sector. In contrast, both the aggregate and inter-sectoral balance was largely restored in FY02.

Figures for the first quarter of FY03 reveal that the domestic credit flow has further slowed down recording an aggregate growth of 10.1 per cent, which happens to be the lowest since FY94. Imposition of "hard budget constraint" on state-owned enterprises has resulted in a negative growth of 1.3 per cent for "other public bodies", whereas credit growth was only 3 per cent in the government sector. In contrast, credit growth in the private sector has been about 13.7 per cent in FY02.



The low offtake of credit by the government during July-September 2002 is indicative of the low level of government expenditure in this period. <u>However, a close look at the monthly data suggests that there had been a secular slowdown in the rate of credit growth in the private sector since May 2002</u>. Our subsequent analysis of the latest available figures on term loan disbursement will show that, this is a reflection of a slowdown in private sector investment.

Government Borrowing and Public Debt*.* High levels of government borrowing from the Bangladesh Bank as well as from the scheduled bank dominated the macro-economic concerns since FY00. Total domestic outstanding debt as a share of GDP secularly rose from 13.0 per cent in FY00 to 16.6 per cent in FY02. During this period one observes a change in the fiscal stance of the government as it moved away, partly, from borrowing from the banking system to raising of funds through sale of savings certificates to the public and treasury bonds to non-bank financial institutions. The latest figures (as of November 6, 2002) show that there had been a net reverse flow to the banking system (including both Bangladesh Bank and scheduled banks) from the government to the tune of Taka 1500 million.

Notwithstanding such positive trends in government borrowing from the banking sector, total domestic outstanding debt has increased, as of August 2002, by about Tk. 62 billion on a point to point basis. This has happened due to incremental borrowing by the government through sale of National Savings Directorates (NSD) Certificates.

Outstanding liabilities of government through sale of NSD Certificates, at end September 2002, stood at about Tk. 264 billion, recording an increase of Tk. 45 billion over the same month of the preceding year. This implies that the reduction of the rate of interest of the NSD Certificates in June 2002 had a transitory effect on their sale, which has started to pick up since August 2002. Such a trend, once again, is expressive of the limited viable investment opportunities in the Bangladesh economy. This also implies that the government's desire to push the small savers to wards the capital market through decreasing the rate of assured return on public savings instruments has not as yet yielded its results.

Since there is no effective ceiling on the sale of NSD Certificates, the government is ending up acquiring debt, even when it does not need it. Consequently, the government is using high cost borrowing to underwrite its domestic financing needs. Some would, however, maintain that this is better than mopping up liquidity in the banking sector by the government to the detriment of private sector investment.

Agricultural Credit. The agricultural credit delivery system, since the post-1998 flood programmes, had been low on disbursement and high on recovery. This resulted in net outflow of resources from the rural areas through the institutional credit system.

During the period of July-September, 2002, against an approximate 10 per cent growth in agricultural credit disbursement, recovery grew by almost 12 per cent. This implies that, an amount of Tk. 1.64 billion was withdrawn from the rural economy. On the other hand, the rate of default with respect to agricultural loans worsened further reaching more than 63 per cent at the end of September 2002.

Industrial Term Loan. Curiously, in contrast to the agricultural credit, industrial term loan disbursement had been usually positive in net terms. For instance, in FY02, against a disbursement of Tk. 35.05 billion, recovery was Tk. 32.13 billion. However, this trend was reversed during the first quarter of FY03.

In comparison to a 47 per cent increase during July-September 2001, term loan disbursement decreased by 18.4 per cent in the first quarter of FY03. The recovery has also slowed down in July-September, 2002, although at a lesser degree. Thus, one observes two emerging trends in industrial credit at the beginning of FY03 – *first*, the inter-temporal growth in disbursement rate has become negative; and, *second*, the reduced volume of disbursement is lower than the amount recovered during this period.

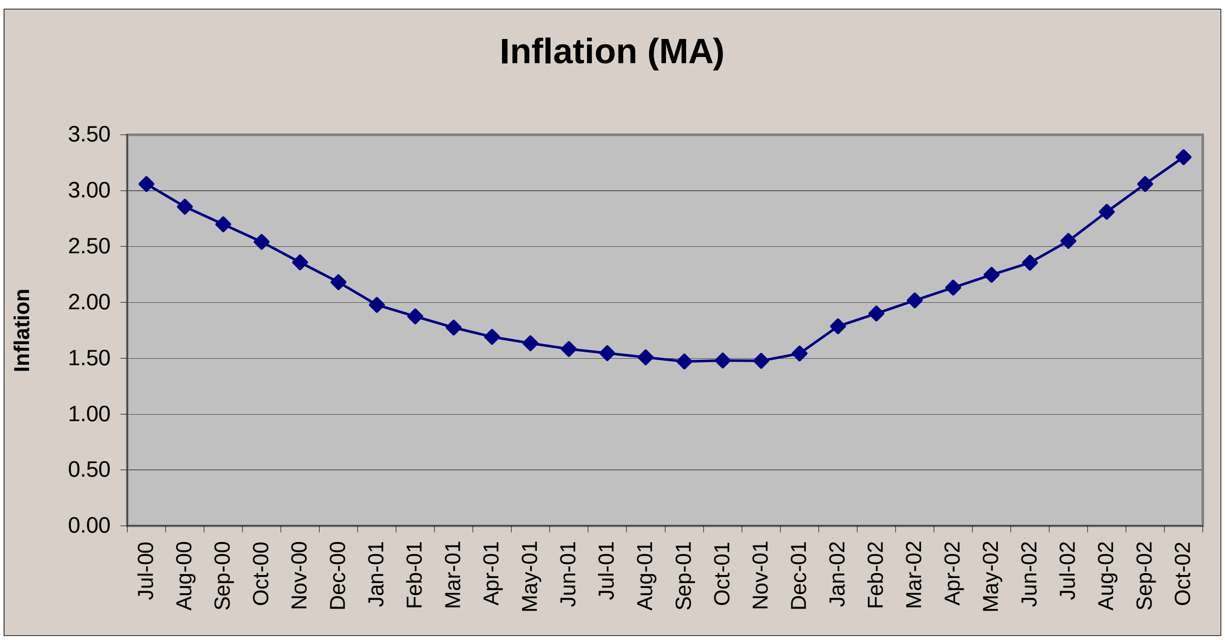
One could have drawn solace from the obtaining situation attributing it to higher collection of outstanding loans, if only the flow of fresh industrial loan had not fallen so drastically. However, such a decline can be largely explained by the deepening of stagnation in the manufacturing sector. The trend in credit expansion in the private sector, mentioned earlier, corroborates the foregoing observation. Our subsequent analysis of recent trends in imports will also validate such a claim.

In the meantime, overdue as a percentage of the outstanding industrial term loans have decreased from about 38.6 per cent (July-September, 2001) to 34.2 per cent (July-September, 2002). One waits to see to what extent the recommendations of the *Committee set up to deal with defaulted loans* will be able to contribute to removing this structural impediment from the country's banking sector.

Inflation. The recent trend of creeping growth in the inflation rate comes as a surprise in the backdrop of the contractionary monetary policy pursued by the government in the past months. One wonders whether the lagged response of inflationary pressure generated by the expansionary policy pursued in FY00 and FY01 is finally catching up with the Bangladesh economy.

The general inflation rate based on *Consumer Price Index* (CPI), on point to point basis, increased from less than 3.0 per cent in June, 2002 to about 4.6 per cent in October, 2002. However, two disturbing features of the recent rise in the price level may be noted. *First*, the inflation rate during July-October, FY03 period had been higher in the rural area in comparison to its urban counterpart. *Second*, curiously, increase in food price during the abovementioned period had been again higher in the rural area along with the non-food price.

The trend in inflation rate – expressed through a moving average of 12 months observations – demonstrates a neat U-shape expressing a rising CPI. The point of departure of the present upward moving trend is September 2001, since when the inflation rate (moving average) has doubled from 1.47 per cent reaching 3.30 per cent in October 2002 – the highest in the last 28 months.



Of course, there is no reason yet for panic because of the current level of inflation. Indeed some would say that a "little inflation" is good for stimulating investment.

However, the recent moderate rise in price level is largely a "cost push", rather than a "demand pull" phenomenon. Increase in price of fuel, public utility rates and exchange rate adjustment may have been responsible for this. Temporary disruption in the domestic supply chain due to limited floods may have contributed to it as well.

In sum, it may be emphasised that in the backdrop of an overall conservative monetary policy, one observes low offtake of private sector credit, particularly industrial term loans. Whilst inflationary pressure remains moderate, one should not end up with the worst of the two worlds epitomised by "stagflation" – stagnation coupled with inflation.

IV. Performance of the Real Economy

Foodgrain Production. Since the spectacular post-flood growth to the tune of 17 per cent in FY00, the foodgrain production growth rate came down in the subsequent years. As per final estimate of the Bangladesh Bureau of Statistics (BBS), actual food grain production for FY02 was 25.91 million metric tons (Aus - 1.81 million metric tons, Aman - 10.73 million metric tons, Boro - 11.77 million metric tons, and wheat - 1.61 million metric tons) which was 7.75 per cent lower than the operational target of 27.92 million tons. More importantly, the total foodgrain production in FY02 was 3.14 per cent lower than that of FY01, while the rice production was 3.07 per cent less.

In this backdrop, foodgrain production target for FY03 has been set at 28.08 million metric tons comprising 1.84 million tons of Aus rice, 11.46 million tons of Aman rice, 13.03 million tons of Boro rice and 1.75 million ton of wheat. Foodgrain production target for FY03 is marginally higher (0.57 per cent) than the preceding year's target, and 8.36 percent above the actual food grain production (25.91 million ton) in FY02.

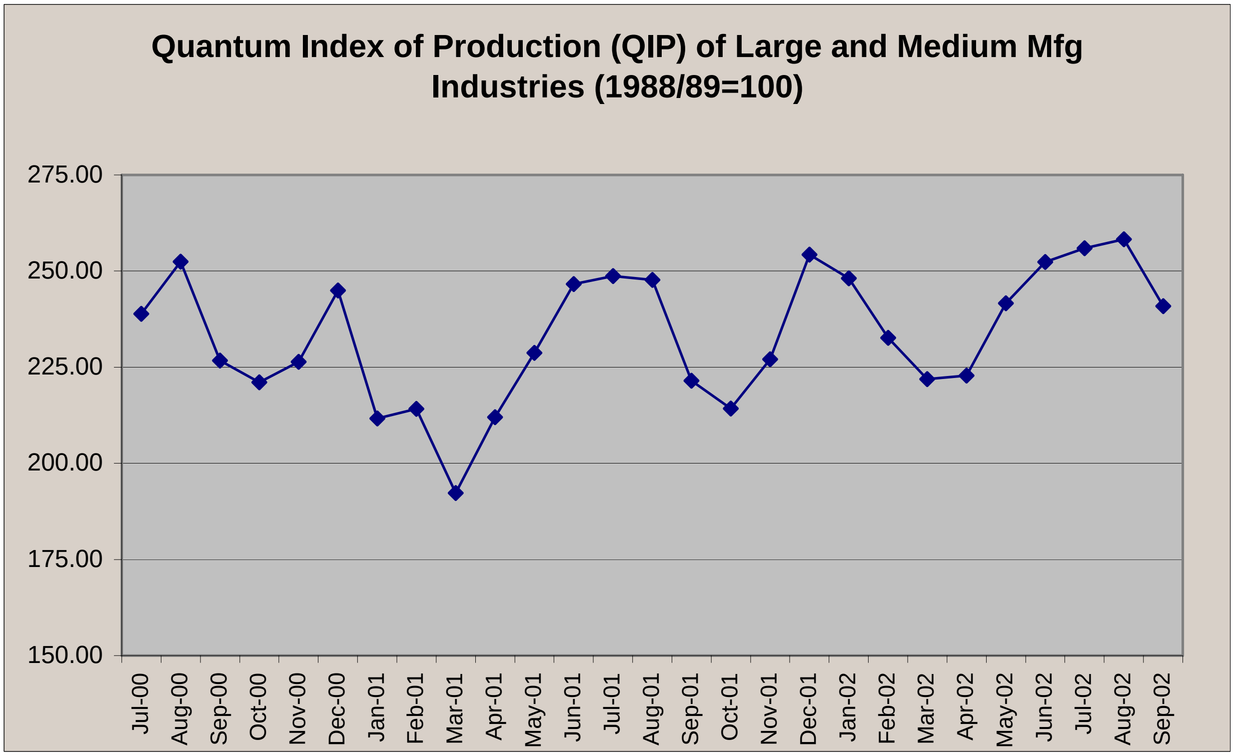
The recently harvested Aus yielded a production of 1.94 million metric ton which is about 5.4 per cent more than that of the last year and 5.4 per cent above the relevant target. However, it is the production of Aman and Boro which defines the food situation of the country as they accounts for more than 93 per cent of total annual rice production.

The production target for Aman rice in FY03 has been fixed at 6.8 per cent higher than that of actual production in the preceding year. Early forecast says that Aman production had been good, but whether it has achieved the target is yet to be ascertained. It may be pointed out that foodgrain import has increased significantly during the recent months. In FY03 (July-September), import of foodgrains amounted to 0.522 million metric ton, the matching figure for FY02 was 0.315 million metric ton, recording about 65 per cent increase. Information on opening of new letters of credit (L/C) indicates that import of foodgrains is going to increase further in the coming months. During the period July-October, 2002, value of new L/Cs opened for importing foodgrains amounted to about $162.7 million recording a 258 per cent growth over the comparable figure for FY02.

Manufacturing Production. Since the floods of 1998, the manufacturing sector has slowly recovered recording 4.8 per cent, 6.3 per cent and 5.0 per cent growth in FY00, FY01 and FY02 respectively. In all these years, the growth of the large and medium scale industries was relatively subdued in comparison to the small and cottage sector.

The manufacturing sector during FY02 was greatly affected by the severe deceleration of the export-oriented apparels sector. The export sector marginally recovered in December 2001, with the ending of the RMG quota year; but the flicker did not translate into a trend. The *Quantum Index of Production* (QIP) of the medium and large scale units for FY02 was 3.35 per cent more than that of the previous year.

The clear winners of FY02, in terms of physical production growth, included *cement* (29 per cent), *pharmaceuticals* (16 per cent), *cotton fabric* (11 per cent), *jute sacking* (10 per cent). In contrast, *fertilizer* (-16 per cent), *jute hessian* (-12 per cent) and *paper* (-6.5 per cent) pulled the manufacturing sector down in FY02.



The QIP during July-September, 2002 grew by 5.17 per cent over the matching period of the previous year. Although the QIP of September 2002 is 6.73 per cent lower than that of the preceding month, it is still 8.74 per cent higher on point-to-point basis.

Production data for the period July-September, 2002 suggest that the frontrunners in terms of production growth had been, once again, *pharmaceuticals* (25.9 per cent), *cement* (11.8 per cent) and cotton fabric (6.0 per cent). Fertiliser sector, with 11.7 per cent production growth, seems to have recovered. The *paper* industry continues to be in a a state of doldrums as its production fell by another 12.7 per cent during July-September 2002. Curiously, inspite of the improved performance of the export sector during the first quarter of FY03, RMG production increased by only 0.1 per cent. (As we shall see later, while knit RMG demonstrated growth, woven RMG suffered decline.)

Slowdown in offtake of term loan coupled with fall in import of capital goods (discussed subsequently) do not make one very optimistic about the prospect of manufacturing growth in the near future.

Foreign Investment. According to CPD's estimate, in FY02, Bangladesh received a net amount of $114.71 million as foreign investment, of which $65 million came as foreign direct investment (FDI) in the domestic tariff area and another $55.7 million in the EPZ. Reinforcing the earlier trend, portfolio investment recorded a net outflow of $6 million.

Net flow of FDI experienced a fall of about 61 per cent in FY02. In contrast, foreign investment in the EPZ recorded a more than 15 per cent increase in FY02, continuing the recovery since the drop in FY00, consequent to the controversy surrounding the trade union rights issues in the country's EPZs.

Available figures indicate that a meagre $7 million was received by Bangladesh as net FDI inflow during the months of July-August, FY03, which is 30 per cent less than the comparable figure for FY02 (which itself was disappointingly low).

Thus, in spite of all the pro-active policy procurements and expensive road-shows, foreign investment continues to shy away from Bangladesh. It is to be seen how much the recent reinvigorated efforts of the Board of Investment (BOI) yield result during the rest of the year.

Foreign Aid. Foreign aid commitment and disbursement in FY02 were $879 million and $1250 million respectively. The commitment was 57.2 per cent lower than the previous year, whereas the disbursement was 8.7 per cent less.

Higher level of disbursement, in comparison to commitment, may indicate that Bangladesh has been finally successful in drawing down from its burgeoning foreign aid pipeline – the opening balance for FY03 being $5.7 billion. Regretably, further queries show, that the higher disbursement figure was, at the margin, underwritten by flow of costly suppliers credits.

Total foreign aid commitment for FY03, as of November 2002, is $292.23 million of which project aid accounts for 95.4 per cent. Conversely, total disbursement during July-August 2002 amounted to $188.56 million with project aid constituting about 80 per cent. To date, in FY03, there had been no fresh commitment and disbursement of food aid. <u>It is quite apparent that the conservative approach demonstrated in FY02 by the development partners by way of holding back of fresh foreign aid commitments continued to remain largely valid during the first half of FY03</u>.

The total outstanding external debt of Bangladesh as of June 2002 was $16.65 billion (a little above 35 per cent of GDP), which was 2.5 per cent higher than the previous year. The repayment of external debt in FY02 amounted to $555 million with 26.7 per cent accounting for debt servicing. The debt serving liability (DSL) for FY02 was 9.33 per cent of merchandise exports and 6.5 per cent of total foreign exchange earnings, i.e. including foreign remittances.

Capital Market. The recovery of the capital market remains painfully slow since the boom and bust episode of the 1996. During the period January-September, 2002, the weighted average share price index of the Dhaka Stock Exchange (DSE) increased by only 0.5 per cent. During this period, enlisted issues increased by 8 in number and market capitalisation increased by 14 per cent in Taka terms.

The capital market in Bangladesh remains shallow, and is yet to emerge as a major source of equity financing in the industrialisation process. <u>The discrete benefits offered in the budget for FY03 along with cuts in the interest ratio of the NSD certificates have as yet failed to bring back the small investors to the secondary market of shares and securities</u>.

V. External Sector Behaviour

Imports. The slowdown of imports in FY02 was due to a combination of factors which included regulatory measures taken by the government to release pressure on the depleting foreign exchange reserve and decline in import of raw materials for the RMG sector due to drastic fall of exports. Thus import payments recorded a negative growth of 8.9 per cent in the elapsed fiscal year (FY02).

Sluggishness in import trend seems to have continued during the first quarter of FY03. Import payments for July-August, 2002 had been 5.6 per cent less in comparison to the depressed benchmark of the matching period in FY02. Data on settlement and opening of L/Cs for the period July-September 2002 indicate continuation of the depressing trend in imports. However, the recently released information on L/C operation during the period July-October 2002 has suggested some upward movement in import growth.

Analysis of information on L/C settlement for the period July-October 2002 reveals import growth of 5.8 per cent (in US Dollar term) over the matching period of FY02. However, this moderate growth in aggregate import has been achieved due to robust growth of consumer goods import (73.6 per cent) including high growth of foodgrain import (125.9 per cent). Conversely, imports of capital machinery and intermediate goods, as per the L/C settlement figures for July-October, 2002, fell by 34.1 per cent and 8.8 per cent respectively. If one excludes foodgrain import, the increase in L/C settlement value comes down to 3.6 per cent.

Analysis of the figures relating to opening of new L/Cs (July-October 2002) suggests an increase by 4.03 per cent in comparison to the corresponding figure for FY02. It is to be noted that this sign of import dynamism was largely underwritten by phenomenal growth of consumer goods (118.2 pr cent) including a surge in foodgrains import (258.0 per cent). Some growth was also observed in cases of industrial raw material (12.4 per cent), machinery for miscellaneous industries (18.5 per cent) and intermediate goods (5.9 per cent), while new L/C opening for capital machinery fell by 19.7 per cent. Once again, the growth in value of freshly opened L/C is diminished to only 0.03 per cent, once foodgrain imports are accounted for.

More importantly, the apparent import growth is an illusion as import trend suffered a serious set back in October 2001 following the terrorists attack in the USA on September 9, 2001. Thus, the point-to-point growth by 26.5 per cent in opening of new L/C in October 2002 is largely due to use of a depressed benchmark. Only real time actual data for subsequent months will show whether we are dealing with a real import recovery.

In the backdrop of substantial recovery of the foreign exchange reserve and partial recovery of the RMG exports, one is tempted to attribute the continued sluggishness in imports to stagnation in investment, which is corroborated by evidence on decline in term loan disbursement. Interestingly, the slowdown in import has come in FY02 and in early FY03 without any substantial devaluation of the national currency.

Exports. In FY02 exports declined by 7.4 per cent – the first ever such decline in the last two decades. The fall in export earnings was experienced across the broad, by almost all export items.

It is heartening to observe that exports during July-October of FY03 have recorded a comeback, registering 9.07 per cent growth. This recovery was spearheaded particularly by growth of *knitwear* (22.9 per cent), *frozen food* (22.1 per cent), *raw jute* (53.9 per cent) and *jute goods* (37.9 per cent). The export of *tea, leather products* and *woven RMG* declined by 28.9 per cent, 19.1 per cent and 1.1 per cent, respectively.

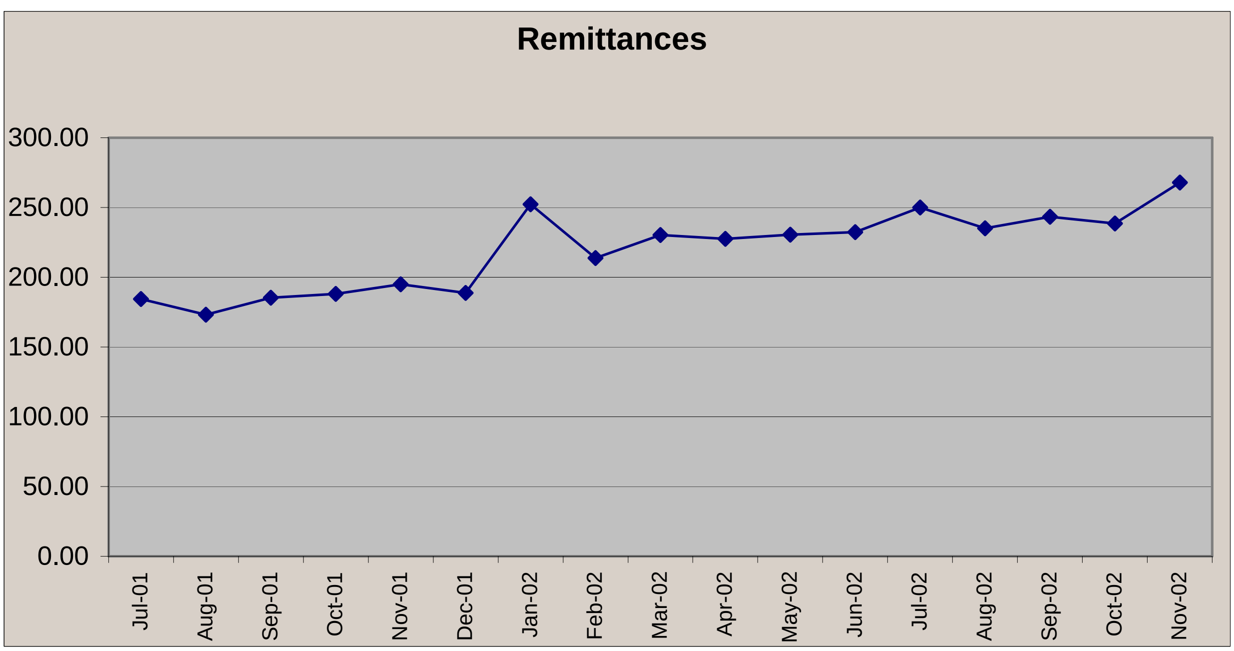
The net fall in receipts from woven RMG exports is the major current concern regarding Bangladesh's exports. It seems the advent of the third phase of quota integration (which started in January 1, 2002) under the WTO *Agreement on Textiles* is foreshadowing the impact of full phase-out of the *Multi-Fibre Arrangement* (MFA) for Bangladesh. It may be pointed out that under the third phase of ATC two items of Bangladesh's export internal have been made quota-free and Bangladesh has lost out significant market shares to China and India in both these commodities. Thus, there is a urgent to comprehensively review the textile and RMG related issues to undertake integrated and focussed policy measures.

It seems that the export performance of the primary goods sector had been better than its manufacturing counterpart in the recent months. The primary goods sector has experienced a growth of 23.3 percent in July-October FY03, while the growth in manufacturing sector was only

7.9 per cent. Moreover, primary sector has achieved 40.2 per cent of its overall target for FY03, whereas manufacturing has secured 31.8 per cent of target.

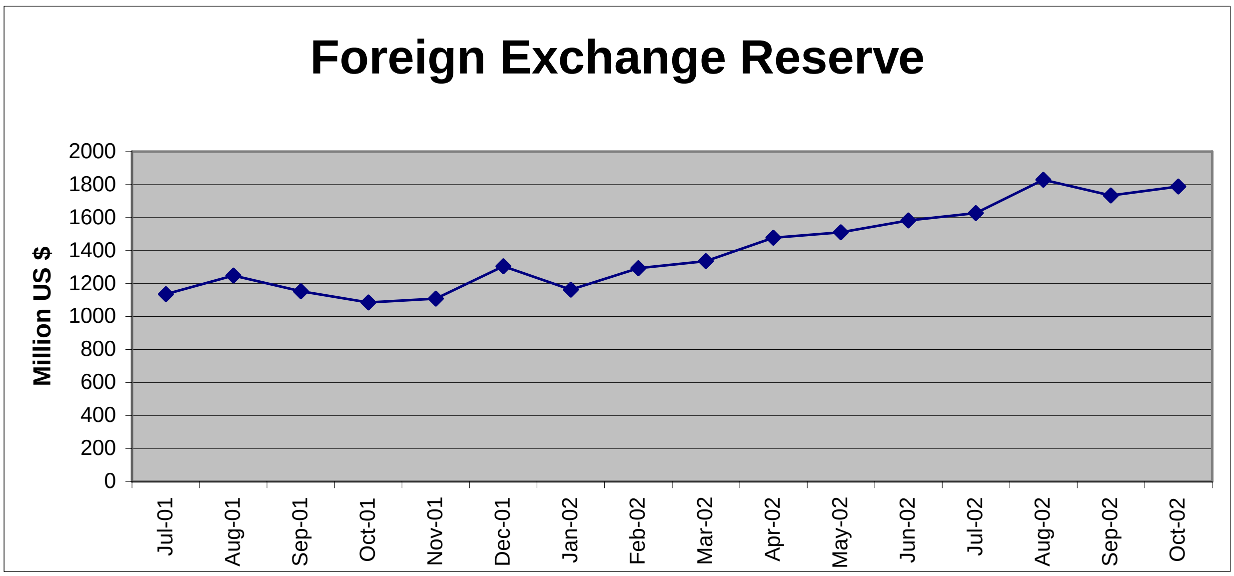
However, it is to be noted that the recent recovery of the export sectors is driven by increase in volume (about 19 per cent) and underwritten by fall in price index (more than 9.7 per cent) of the exportables. The international market is currently relatively comfortable for primary sector exports from Bangladesh as its price index fell by 1.3 per cent in comparison to 10.5 per cent decline experienced by the manufacturing sector. In these circumstances, it will be a challenging task to attain significant export growth in the coming months with a continuing deceleration in the price level of manufacturers.

Remittances. Remittances, in the recent past, have emerged as the saving grace of Bangladesh economy. In FY02, the country received the record inflow of more than $2.5 billion registering an annual growth of about 33 per cent. Fortuitously, the buoyant trend in remittance inflow has sustained during the period July-November, 2002, when it recorded a growth of 33.4 per cent over the matching period of the previous year. In November, 2002, the country received $268 million as foreign remittance which is an all time record.



Whilst some quarters attribute this recent surge in remittance inflow to the sequence of events which followed the 9/11 terrorist attacks on the USA, there are reasons to believe that this is largely due to the institutional and legislative measures taken in the country to redirect remittance flow to the official banking channel.

Foreign Exchange Reserve. The drawdown on the foreign exchange reserve which set in FY95 was reversed in FY02. The forex reserve bounced back to $1.58 billion at the end of FY02 from $1.11 billion in November 2001, registering a growth of 21.3 per cent.



The positive trend in the growth of foreign exchange reserve continued during July-October 2002 and reached $1.79 billion at the end of the period. The point to point growth in October 2002 was as high as 64.8 per cent.

As it is evident from our foregoing analysis, further strengthening of the foreign exchange reserve has taken place in the early part of FY03 thanks to export resurgence, surge in workers' remittances and fall in imports. <u>It needs to be appreciated that, given the obtaining situation, the country was able to avert serious balance of payment crisis, without any emergency foreign exchange support from the International Financial Institutions (IFIs)</u>.

Balance of Payment. Given the movement of various external sector variables described earlier, Bangladesh's balance of payment situation, during July-August, 2002 has also improved further. Trade balance recorded a smaller deficit of only $4 million, and current account recorded a higher surplus ($396 million) thanks mainly to workers' remittances. The overall balance of payment showed a surplus of $296 million against the deficit of $65 million in July-August 2001.

VI. Concluding Observations

A brief review of the early signals of the FY03 allows us to conclude that the three major macro-economic trends observed by the CPD at the close of FY02 have strengthened further. Concretely they are as follows.

First, the fiscal balance has experienced further consolidation during July-November 2002 due to collection of revenue (NBR component) in line with the target set by the budget. This process was complemented by high control exercised by the government on public expenditure, particularly with respect to ADP. This has contributed to restrained borrowing by the government, albeit temporarily, from the banking system. Although borrowing from the public through sale of NSD Certificates has increased in the said period. In this connection, ability to incrementally to draw on foreign sources of financing for underwriting the fiscal deficit will provide necessary breathing space to the monetary policy.

Second, the country's balance of payment has also improved further due to continued high flow of foreign remittances, partial recovery in the export sector and depressed growth in import payments. Consequently, foreign exchange reserve, although still not above the safe limit, has also demonstrated incremental growth. However, there is no scope to ignore the vulnerability of the external balance given the fragility of export resurgence and the unpredictability which generally characterises the remittance flow. Low disbursement of foreign aid and deceleration of FDI have accentuated the vulnerability of the external balance.

Third, signs of investment stagnation has become more manifest during the initial months of FY03. Deepening of investment stagnation is borne out by the fall in term industrial loan disbursement as well as import of capital machinery. Higher level of L/C opening in October 2002 (on point to point basis) does foretell real growth in import as imports practically collapsed in the preceding year at this time subsequent to the terrorist attacks in the USA. It is symptomatic that excess liquidity of scheduled banks at end-September, 2002 stood at Tk. 75.10 billion, i.e. 14 per cent more than that of end June, 2002. High demand for NSD Certificates and increase in time deposits in the schedule banks, in spite of interest rate rationalisation, suggest that investors' confidence level continues to be abysmally low. The moribund state of the stock market further reinforces this observation.

Thus, strengthening of the macro-economic fundamentals and the fiscal stimuli provided in the budget for FY03 have had no discernible effect in dynamising the micro-economic behaviour in Bangladesh during the period July-November, 2002.

One of the new developments of the first quarter of FY03 had been the creeping rise in the inflation rate with its rural bias. Whilst the current inflation rate continues to remain moderate, it might become an issue if the government changes its fiscal stance.

Need to Strengthen Domestic Demand. Under the circumstances, how will the government respond with policy and institutional measures in the coming months to achieve its GDP growth target set at 6 per cent for FY03? It is maintained that given the fragility of the export scenario as well as the obtaining depression in the manufacturing sector, the government may have to consider taking measures to prop up domestic demand. *However, attention to cultivate domestic demand does not have to come through the neglect of our export promotion drive.*

Three major vehicles of augmenting domestic demand would be fiscal stimuli, credit expansion and public expenditure. The government has already exercised, up to a point, the first option (fiscal stimuli) through the National Budget for FY03. Regarding the second, our review has shown that the trend in agricultural credit flow has remained quite lacklustre during the elapsed months. *One possibly needs to recreate the successful experience of the rural credit delivery exercise undertaken following the devastating floods of 1998.*

With respect to the use of public expenditure as a tool for rejuvenating domestic demand, it may be underscored that the government currently enjoys some elbow room for a moderate expansionary policy, thanks to the conservative approach pursued in the last year. *However, if the economy responds to such trigger mechanisms, it will not only expose itself to the risk of losing its grip on the fiscal deficit situation, but also unleashing high pressure on the soft exchange reserves in response to an investment driven import resurgence-up*.

PRSP Outcome and Alternative. Under the circumstances, one of the important factors defining the choice of the macro-economic policy stance during the second half of FY03 will be the outcome of the *Interim Poverty Reduction Strategy Paper* (I-PRSP) preparation exercise. *If the government can negotiate some soft term foreign financing, at least by March FY03, then it will be in a relatively comfortable position regarding its development expenditures and the need for an accelerated private investment stimuli-up.*

However, some of the pre-conditions set by the IFIs for accessing such funds are also fraught with high risk. The demand for a free float of the exchange rate is a case in point. *In this connection, the government will be well advised not to opt for a tight package of policy conditionalities; rather, it should retain its flexibility by committing itself to appropriate but autonomously derived reform measures.*

Alternatively, in anticipation of a possible absence of new and enhanced foreign aid flow, the government may like to urgently revisit its public expenditure package and priorities through the proposed mid-term review of the ADP and redesign its approach to investment stimulation by assessing the impact of incentives offered in the National Budget for FY03. *The government may also like to consider more pro-active use of the levers available in the financial sector.*

Whatever may be the case, the government, by early next year (January-February 2003) has to focus its attention on evolving an expedient strategy to translate its recent macro-economic gains into micro-economic dividends.