# Chapter V

## State of the Bangladesh Economy in FY07: An "Election Plus" Agenda for the Second Caretaker Government

# 1. INTRODUCTION

The caretaker government (CTG) of 2006-2007 has been constituted for the second time, coinciding with declaration of a State of Emergency and its tenure till date remains somewhat undetermined. Article 58D of Bangladesh Constitution allows the CTG to take policy decisions in case of necessity for the discharge of its functions, along with providing support for holding of a free and fair election. In his first address to the nation, the Chief Adviser highlighted a number of issues which are crucial for holding a free and fair election, but also dealt with short and medium term issues of economic development and good governance. The present interim reports on the state of the Bangladesh economy in 2006-07 and the "Election Plus" economic agenda has been prepared in this context. The report has two components: (i) recent trends in the economy and their implications for the remaining part of FY2007, and (ii) identification of a set of structural and institutional economic issues which need to be addressed for creating an electoral environment that promotes participation of clean and competent candidates.

# 2. STATE OF THE BANGLADESH ECONOMY IN FY2007

## 2.1 Public Finance

### Revenue Earnings

Data covering the first half of FY2007 reveals modest achievement in overall revenue earnings. Revenue mobilisation in this period was 41.6 per cent of the total annual target, compared to 42.2 per cent collection during the corresponding period of FY2006. During the July-December period of FY2007, National Board of Revenue (NBR) collected 39.2 per cent of its annual target, while non-NBR and non-tax components demonstrated encouraging results achieving 46.9 per cent and 50.6 per cent of total annual targets respectively. Disaggregated data available till November 2006 indicates an encouraging growth of 20.8 per cent in the case of income tax collection. Earning from customs duties, on the other hand, reveals a disturbing scenario registering an insignificant growth of 3.7 per cent during July-November of FY2007 over the corresponding period of FY2006.

The major challenge before the new CTG will be to raise the international trade taxes. Concurrently, it will also have to sustain the robust growth of VAT and income tax and will have to identify new sources of revenue earnings for strengthening the fiscal balance. Now it is possibly the most opportune moment to revamp the tax administration, revisit tax code, strengthen the large taxpayers unit (LTU), and expand collection from non-VAT domestic sources. The CTG may seriously review the current tax policy and administration to enhance mobilisation as such initiatives are also called for to achieve the performance indicators in the revenue sector under the Poverty Reduction Growth Facility (PRGF). This will be commensurate with the policy stance of fighting corruption and discouraging the use of black money in the election.

### Revenue Expenditure

There is apprehension that revenue expenditure will overshoot the target, particularly on account of debt servicing, and in the case of salaries and allowances (carryover of the Pay Commission award, 100 per cent pay out to MPO teachers and payment to community teachers). Latest available figure shows that non-development expenditure stood at Tk 218.2 billion, i.e. 50 per cent of the total annual target.

Restraining government borrowings and constant monitoring of the revenue and project expenditures decisions (e.g. in the case of Block Allocations) should be the path to be followed by the CTG.

### Annual Development Programme (ADP)

Latest aggregate level data available for the

July-December of FY2007 shows an ADP expenditure of TK 5,398 crore, which was 20.8 per cent of total annual ADP target for the fiscal year. This matches the trend of the previous fiscal years, and was to a large extent accounted for by restrained expenditure by the CTGs during the November-December period. During the first four months (Jul-Oct) of FY2007, 32 per cent of the local currency component was released, which showed a pre-election rushed disbursement of the outgoing government. The former CTG has, however, responded rationally to the situation and suspended fund disbursement to the new projects, and scrapped the administrative power of different ministries in releasing funds for implementing locally funded new and ongoing development projects. Recent data on ADP implementation confirms the improvement in the overall implementation situation, with no new fund release in the month of November, the first month under the former CTG.

The new CTG needs to take a closer look at the ADP projects with a view to cancelling or suspending projects without approval, and projects with no or insignificant fund release. Instead, emphasis should be given on foreign aided projects.

### Budget Deficit

According to the latest official data, budget deficit experienced a substantial growth of 36.7 per cent during the first four months of FY2007 over the corresponding period of the previous fiscal year. The budget deficit was 5.5 per cent as a share of GDP vis-à-vis 4.5 per cent for the same period of FY2006. A more worrying picture is that during July-October period net borrowing by the government from the banking system experienced a whopping 69.8 per cent growth, while the non-banking source posted a 155.1 per cent growth over the same period of the previous year. Latest available figure shows that government exceeded the annual target for borrowing for the first six months of FY2007 by 14.1 per cent. On the other hand, net foreign financing experienced a negative growth of 87.5 per cent during July-October of FY2007.

There will be substantial increase in the government expenditure in the coming months owing to the forthcoming election. The new CTG will thus need to pursue the objective of fiscal prudence by increasing revenue (particularly customs duty) as well as curbing expenditure from less important heads. More energetic efforts will be needed to increase foreign financing with a view to reducing domestic borrowing. There appears to be a dilemma as regards financing domestic debt in view of low foreign aid disbursement, i.e. low cost and high inflation vs. high cost and high inflation. Since not much can be done with revenue expenditure, CTG needs to cutback the ADP, freeze funds for approved but unimportant projects, freeze funds for approved but undisbursed projects and give priority to foreign aided projects.

## 2.2 Monetary Sector

### Money Supply, Reserve Money and Liquidity

Money supply (in terms of M3) posted a growth of 19.5 per cent at the end of October 2006. Reserve money posted a rise of 26.2 per cent, while excess liquidity of the scheduled banks stood lower at Tk 8,207.82 crore at the end of October 2006.

The fall of liquidity in the banks may have originated from the over-financing of the investment demand and/or mopped up by the government to fill in foreign aid shortfall. This issue also needs to be looked at from the perspective of (seasonal) volatility of call money rates.

### Domestic Credit

FY2007 is continuing with the high and unsustainable rate of domestic credit growth which registered an 18.8 per cent growth on a point-to-point basis over the corresponding figure of FY2006.

**Government Sector Borrowing:** At the end of October of FY2007, total outstanding domestic credit to the public sector increased by 19.7 per cent, within which the government borrowing, accounting for 83.7 per cent of the total public sector credit, posted a rise of 20.6 per cent. Credit to other public sector, on the other hand, rose by 15.5 per cent during the period under consideration. Sale of NSD certificates during this period registered a 23.2 per cent growth, while the repayment of the principal amount increased by 1.8 per cent only. As mentioned earlier, latest available statistics shows that the Government borrowing has exceeded Tk 60 billion during the first half of FY2007, which is 14.1 per cent higher than the budgetary target for the full fiscal year.

**Private Sector Borrowing:** At the end of October 2006, total outstanding domestic credit to the private sector posted a moderate 18.2 per cent growth on a point-to-point basis. Within the total credit to the private sector, 93 per cent came from the banking sector, while the rest 7 per cent came from the non-bank depository corporations (NBDCs).

**Industrial Loan:** Data on industrial term loan for the first quarter of FY2007 recorded a 30.4 per cent growth in total disbursement. With a 23.0 per cent increase, private commercial banks (PCBs) (domestic) remain the single largest contributor in term loan disbursement with a 58.0 per cent share in the total disbursement. On the other hand, disbursement of working capital increased marginally by 3.1 per cent during this period. PCBs (domestic), with the largest contribution, recorded a 15.9 per cent growth during this period.

The improving political scenario of the country may stimulate the economy and increase investment demand, which is already corroborated by the upward movement in the capital market. Besides, in a pre-election period, the CTG will need to follow a cautious approach in industrial loan disbursement, without penalising good projects.

### Loan Default Scenario

Total classified loan for July-September registered a 10.9 per cent growth over the corresponding period of FY2006. While foreign banks (FBs) made significant progress in reducing the total classified loan, with a negative growth rate of 41.3 per cent, nationalised commercial banks (NCBs), PCBs and development finance institutions (DFIs) recorded worsening of the default loan by 13.4, 10.4 and 5.9 per cent respectively over the corresponding period of FY2006. The loan default scenario may get better in the second quarter as rescheduling of default loan increased at the time of the election schedule declared previously.

### Agricultural Credit

During July-November period, total disbursement stood at Tk 1,754.2 crore, which is 8.5 per cent lower than the disbursement during the comparable period of FY2006. Conversely, recovery is 208.4 per cent higher than the corresponding figure of the previous fiscal year. Thus, in net terms, credit flow to the agriculture sector dropped significantly by 208.4 per cent.

### Consumer Price Inflation and Price Hike

While the first two months of FY2007 showed some positive signs with declining trends in the inflation rate, inflation rates were on the upward move again. At the end of October, general, food and non-food inflation rates on a point-to-point basis were 7.30 per cent, 9.00 per cent and 4.76 per cent respectively. While general inflation at the national level went down to 6.37 per cent in November 2006, a marginal increase of inflation rates for non-food items was observed both in urban and rural levels.

The new CTG should strongly monitor and supervise the markets for essential products to locate the "syndicates" controlling the markets and take necessary measures against them. Since the Finance Adviser is also holding the portfolio of Ministry of Commerce, there should not be any problem regarding coordination among these two ministries. Regular monitoring of major distribution channels, such as importing and wholesaling points, would give positive results.

### Interest Rate

The commercial lending rate stood at 5.7 per cent as on November 2006, compared to 3.21 per cent at the end of FY2006. Deposit rate (3 to 6 months), however, could not protect its real value yet and remained negative in real terms since February 2006. But real deposit rate continued to show corrections, recovering from (-) 2.03 per cent in July 2005 to (-) 0.21 per cent in November 2006.

Increasing interest rate to tame inflation has become a routine monetary tool in government's monetary policy arsenal. Centre for Policy Dialogue (CPD) finds it to be an inadequate policy proposition since it facilitates rise of lending interest rate but not the deposit interest rate. Hence, the CTG needs to monitor the widening gap between commercial lending and deposit rates.

### Exchange Rate Situation

Taka continued to remain marginally overvalued against most of the currencies following the adoption of floating exchange rate. For example, Taka was overvalued by 12.23 per cent against the EURO, 5.19 per cent against the US dollar, and 6.57 per cent against the Indian Rupee in November 2006. Taka has depreciated more against the EURO compared to the US dollar.

It is desirable to have an orderly depreciation of Taka instead of a sharp decline. Bangladesh Bank thus needs to carefully monitor the exchange rate movement.

## 2.3 Real Sector

### Agricultural Production and Food Security

Production of *Aus* stood at 1.75 million metric tonne in FY2007 which fall short of target by 21.2 per cent.[1] Though the harvest of *Aman* rice has been completed, Bangladesh Bureau of Statistics (BBS) is yet to provide any production estimates. There is an apprehension that production of *Aman* rice would be lower than that of the last year.

It is also pertinent here to mention that, total import of foodgrains and rice during July-December of FY2007 was respectively 2.6 and 24.7 per cent less than that of comparable months in FY2006.

To ensure food availability and food security, the CTG thus needs to ensure availability of fertiliser, diesel and power for irrigation of *Boro*, which provides more than half of the total rice production in the country.

### Industry

Quantum index of production (QIP) of medium and large-scale manufacturing industries indicated a significant 14.0 per cent average growth in industrial production during the July-September period of FY2007. Weighted average growth in terms of physical volume in major industries also shows an impressive growth of 15.5 per cent during the July-September period of FY2007. Most of the sub-sectors achieved high to moderate growths garment 37.7 per cent, fertiliser 26.2 per cent, cotton textiles 21.5 per cent, jute textiles 17.5 per cent, and drugs and pharmaceuticals 14.9 per cent.

Taking note of recent investment trend, expressed through term loan disbursement, export demand and capital machines imports, one may safely envisage moderate to high manufacturing growth in the coming months.

### Foreign Investment

During July-October of FY2007, Bangladesh experienced a 15.6 per cent decline in foreign investment. An amount of $204 million came as foreign investment, of which $200 million came as foreign direct investment and the rest $4 million came as portfolio investment. Net financial account showed a net outflow of (-) $67 million during this period, which is significantly less than the $289 million outflow experienced during the corresponding period of the last year. Major sources of outflow in FY2007 included $149 million as MLT amortisation payment, $83 million as other capital and $212 million as trade credit.

The outgoing government's apathy to finalise several FDI proposals in a pre-election period and the recent political unrest sent a wrong signal to the foreign investors. To reinforce their confidence, the CTG needs to start fresh negotiations with prospective foreign investors (see next section of the paper for the CPD proposal on FDI).

[1] Production data from BBS and target data from Department of Agricultural Extension (DAE).

### Capital Market

During the political uncertainty, the Dhaka Stock Exchange (DSE) observed a decrease in all of its share price indices during the first half of FY2007. However, the new CTG has restored the confidence and brought momentum to the market. The DSE all price index started to rise immediately after political restoration and stood at 1427.74 on 22 January 2007. Both the DSE turnover and market capitalisation hit all time high at Tk 119.06 crore and Tk 34,547 crore respectively on the same day. The Chittagong Stock Exchange (CSE) is also following the same trend. The Securities and Exchange Commission (SEC) officials have termed this market behaviour as normal.

However, a cautious monitoring is needed to avoid any surprises, as the market is also showing some irregularities. For instance, share prices of the "Z" category companies are rising at an alarming rate; daily turnover is higher compared to share index which suggests multiple transactions of the same share in a given period; among top 10 turnover leaders of calendar year 2006, six are yet to declare dividend in the fiscal year 2007; and DSE20, the index of top shares, is performing below the all share price index. Government may put a ceiling on the transaction and/or value of "Z" category share, to avoid any "1996 type incident." On the other hand, at the present market is demonstrating maturity in its behaviour compared to the 1996 period. Accordingly, a cautious approach is required so that due vigilance is maintained without jeopardising the current momentum.

## 2.4 External Sector

### Export

During July-November of FY2007 export earnings registered a growth of 25.8 per cent. The export value of Knitwear registered an impressive 31.2 per cent growth, frozen foods and woven garment also posted significant growth of 29.3 per cent and 24.5 per cent respectively. While both primary and manufacturing products experienced moderate to low price increase by 6.8 per cent and 2.3 per cent, impressive 16.7 per cent and 23.7 per cent respective growth in the volume index helped to retain the growth. With apparel orders losing some momentum in July-October 2006, export earning growth may suffer some setback in the coming months.

### Import

Total imports during the July-October period of FY2007 posted a growth rate of 17.6 per cent. Significant growth was registered by *POL* (37.0 per cent) and *Crude petroleum* (28.3 per cent). On the other hand, settlement of letter of credits (LCs) registered a growth of 20.6 per cent during July-November of FY2007, while fresh openings of import LCs also suggest higher imports (20.8 per cent) in the coming months.

### Foreign Aid

Flow of foreign aid decreased drastically (by 48.6 per cent) in terms of disbursement during July-October of FY2007. Low off-take foreign aid has created severe pressure on domestic sources of borrowing during the early part of FY2007. While the disbursement of $49.7 million by the IMF (took place in November 2006) under the sixth instalment of Bangladesh's PRGF arrangement helped, the World Bank has recently made it known that it will disburse only fifty per cent of the Development Support Credit IV ($100 million). According to the budgetary targets, about $1.8 billion (i.e. 2.6 per cent of GDP) of foreign assistance will be necessary to underwrite the programmed fiscal deficit. Of this amount, $0.4 billion will come as grant and $1.4 billion as loan. Even if the IMF disbursement of $49.7 million is included, total foreign aid disbursed during the first four months meet only 12.3 per cent of the targeted assistance. Thus, it is obvious that there will be a shortfall of foreign aid inflow during the current fiscal year.

Foreign aid flow is emerging as the Achille's heel of the macroeconomic framework. Under the current circumstances, the new CTG can no longer wait for the new elected government for the fuller disbursement of the DSC IV. The CTG needs to initiate fresh negotiation with the World Bank/IMF as regard the disbursement of loan and targets set by the WB and IMF.

**Remittances**

FY2007 began with a high note on remittance flow. During July-December period of FY2007, total workers' remittance stood at $2,862.2 million, registering a growth of 31.4 per cent. November inflow ($598.3 million) is the highest remittance earnings in a single month ever.

**Foreign Exchange Reserves**

FY2007 showed positive growth of the reserves from the very beginning and maintained this momentum over the subsequent months, thanks to higher remittance earnings. The latest available figures for FY2007 show that foreign exchange reserves stood at $3,543.4 million at the end of November, registering a growth of 46.6 per cent over the corresponding period of FY2006.

**Balance of Payment (BoP)**

Trade balance situation improved during the July-October period of FY2007 compared to the matching period of FY2006 thanks to high export growth (23.4 per cent) and a relatively restrained import growth (17.6 per cent). On the financial account, BoP experienced a net outflow of US$67 million during the first four months of FY2007 against a larger outflow of US$289 million during the same period of FY2006. Surplus in the current account balance, together with improved trade deficit and lower outflow in the financial account, has led to a surplus in the overall balance to the tune of US$82 million at the end of the first four months of FY2007 compared to the matching period of FY2006.

While continued high flow of workers' remittances during the second half of FY2007 is expected to provide farther support, anticipated higher imports and slowing down of export momentum due to the recent political crisis accompanied by the low inflow of foreign assistance may have negative impact on the BoP position in the coming months. Consequently, addressing the BoP situation remains one of the major macroeconomic concerns for the remaining part of FY2007.

## 3. STRUCTURAL AND INSTITUTIONAL MEASURES

The CTG will perhaps be required to take a number of structural and institutional measures to create a conducive environment for promoting participation of clean and competent candidates. A number of them will fit in the domain of economic management and will have implications for resource utilisations:

### 3.1 Anti-Money Laundering Act

The Anti-Money Laundering Act needs to be effectively made use of in order to pre-empt financing of elections through unaccounted money generated within the economy and/or coming from outside. Bangladesh Bank has identified a number of cases involving financial frauds, but failed to prosecute those as yet due to inadequacy of the criminal procedure (CrPC). In fact, the Anti Corruption Commission (ACC) has also not been vested with specific powers relating to prosecution of money laundering activities. This issue needs to be urgently addressed by the CTG.

### 3.2 Beneficiaries of Tax Amnesty

It may be recalled that a special tax amnesty scheme was implemented during FY2006, which allowed people to declare their unaccounted wealth and have it legalised by paying tax at the rate of 7.5 per cent (instead of the highest rate of 25 per cent). It has been reported that more than 7,000 tax payees took advantage of this scheme and declared unaccounted wealth amounting to more than Tk 4,000 crore. The NBR has, till date, understandably declined to divulge the identity of these privileged people. However, in the interest of fair play in election financing, it is logical to demand that the NBR publishes, from the full list of people who took advantages of tax amnesty in FY2006, names of those who will be participating in the upcoming national election. This measure will definitely allow flow of important information to the voters as they choose their representatives who also deal with public money.

### 3.3 Redefining Loan Defaulters

Recent experience reveals that the current mechanism is not adequate to restrict loan defaulters from participating in the election. Redefinition of loan defaulters' is required to prevent them from getting away with minimum rescheduling and later defaulting again. It is pertinent here to note that a number of big and known loan defaulters got green signal from the Returning Officers/EC at the time of now annulled election schedule. A few banks also acted in a malafide way in this regard. Bangladesh Bank should be given the authority to appeal against such decisions made by the Returning Officers and an extended requisite time period must be set to finalise these legal issues. Bangladesh Bank should provide due oversight and vigilance in this regard.

### 3.4 CIB Reports for Election Candidates

As per current provisions of the Representation of People Order (RPO) 1972, candidates are obliged to get a "clean" report from the Credit Information Bureau (CIB) of the central bank to prove their eligibility to participate in the election. The recent experience regarding the postponed election suggests that most of the candidates receiving adverse CIB report were able to get a stay order from the High Court. Indeed, a stay order (keeping the case in abeyance) makes the prospective candidate "eligible" to participate in the election. Under the circumstances, the CTG may pursue the Chief Justice to add a couple of benches (over and above the current one) for speedy hearing of these cases for their final disposal, instead of issuing stay orders. The bench may also like to notify and hear the banks before issuing such stay order, as the banks usually have the latest status on loan refragment.

### 3.5 Support to Disclosure Provisions under RPO (1972)

The new CTG will need to provide necessary institutional support to the Election Commission as it proceeds to implement various disclosure provisions stipulated in the RPO (1972) and in its subsequent amendments. These provisions include, on the one hand, electoral financing and expenditure related issues and, on the other hand, background information on the candidates. The NBR, Bangladesh Bank, utility service providing agencies (e.g. electricity, telephone, water and gas) and the Auditor and Comptroller General's office should help the Election Commission to verify the information submitted by the candidates. In this connection to it, the new CTG must proceed to help EC for vacating the stayed order of the Supreme Court on the "eight information" required from election candidates. RPO (1972) needs to be suitably amended to strengthen the provisions of full directive and access to information i.e. restricting participation of immediately retired government official (civil and military) as election candidates, enforcement of guidelines for election expenses, etc.

### 3.6 Enactment of the "Right to Information Act"

The proposed "Right to Information Act" needs to be reviewed and finalised at the earliest to allow the CTG fighting against corruption, creating environment for free and fair election and installing accountability in public life. In view of enactment of "Right to Information Act" relevant provisions of the Official Secrets Act also need to be updated.

### 3.7 Operationalisation of Public Procurement Act

The new CTG should take immediate steps to improve the legal framework and operational provisions related to the Public Procurement Act, 2006. Wide use of information and communication technology (ICT) to establish an e-procurement culture, role of the watchdog institutions and civil society and the media should be encouraged and promoted so that they can play an active role in ensuring transparency and accountability in public procurement.

### 3.8 Headline Enactment of Promotion of Political Participation Act

To improve transparency in financing of political and electoral activities, a law may be enacted, styled as *Promotion of Political Participation*, which would provide legal mandate to the Election Commission for registering political parties and seeking information on their sources of financing and nature of expenditure. Such legal framework is also required for the benefit of the political parties, as it will secure their party logo, election marks and other legal rights.

### 3.9 Fiscal Responsibility Act

The new CTG should immediately initiate measures for enacting a Fiscal Responsibility *Act* for ensuring sustainable macroeconomic and fiscal balance, and to raise the level of public savings for development.

### 3.10 Restructuring of NCBs

The draft Corporatisation Act sent for vetting (via Finance Ministry) needs to be cleared by the Law Ministry at the earliest. Towards implementation of the long term management plan, the bank managements need to be given clearance regarding necessary recruitments. It may be recalled that Sonali Bank is currently not slated for corporatisation as it performs an important role in the financial market, including treasury functions for the government. The new CTG should settle the rest of the Rupali Bank privatisation process including the auditing disparity. However, the decision on the proposal of Saudi counterpart to buy the rest of the government share may be left for the next elected government to decide.

### 3.11 Revitalising the Power Sector

The new CTG has decided to carefully scrutinise all the hastily-approved projects passed by the previous government, and ascertain whether there are gross flaws or violation of rules and regulations before giving any positive nod in support of the approved companies. One may now expect that the CTG will take a medium term action plan to recoup the lost opportunities and to build capacity considering future demands. Special importance should be given in electricity production and CTG may even initiate new projects to ease the current power crisis in addition to load management and curbing system loss. As the previous CTG declined to ratify the decision of the outgoing elected government to raise the energy price, the new CTG may like to re-examine it to reduce the fiscal burden.

### 3.12 Revisiting the FDI Proposals

Flow of foreign direct investment, accelerated in 2006, has been stagnant in recent, but may improve following attainment of political stability. TATA had already stopped pursuing its project and willing to resume its negotiating for the next elected government. Regarding investment proposal of the TATA group, the new CTG may constitute a high-powered competent committee which, building on outcomes of earlier rounds of negotiations, should recommend best possible economic price for natural gas to be supplied, and to settle other issues and then leave it to the elected government to take a final decision. To ascertain the future of the proposed Fulbari Coal Project, CTG could think of setting up an independent committee of experts and local stakeholders which will assess the economic viability and social and environmental impact of the project. Again, the elected government can take a final decision of the matter.

## 4. CONCLUSION

The task of creating an environment for free and fair election will have to go beyond traditional electoral measures and has to involve institutional and structural reforms, a number of these falling in the domain of economic policies. These measures will focus on three major areas: (i) improving the environment for free and fair elections; (ii) strengthening the efficacy of anti-corruption measures; and (iii) supporting reform of political institutions.

The Finance Ministry will soon embark upon preparation of the budget for FY2007-8. It is imperative that the Finance Ministry gives due consideration to these proposals which will have implications for both resource mobilisation and resource allocation. It is in this sense that we have called our proposed