



# CPD

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**115**

## **Macroeconomic Policy, Price Stability and Inclusive Growth in Bangladesh**

Muhammed Muqtada



**MACROECONOMIC POLICY, PRICE STABILITY  
AND INCLUSIVE GROWTH IN BANGLADESH**

*CPD Working Paper 115*

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Publisher

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**Centre for Policy Dialogue (CPD)** was established in 1993 as a civil society initiative to promote an ongoing dialogue between the principle partners in the decision-making and implementing process. Over the past 25 years, the Centre has emerged as a globally reputed independent think tank, with local roots and global reach. A key area of CPD's activism is to organise dialogues to address developmental policy issues that are critical to national, regional and global interests, with a view to seeking constructive solutions from major stakeholders. The other key area of CPD's activities is to undertake research programmes on current and strategic issues.

CPD's dialogues are designed to address important policy issues and to seek constructive solutions to these problems. In doing so, CPD involves all important cross-sections of the society, including public representatives, government officials, business leaders, activists of grassroots organisations, academics, development partners and other relevant interest groups. CPD focuses on frontier issues which are critical to the development process of Bangladesh, South Asia and LDCs in the present context, and those that are expected to shape and influence the country's development prospects from the mid-term perspectives. CPD seeks to provide voice to the interests and concerns of the low-income economies in the global development discourse. With a view to influencing policies, CPD deploys both research and dialogue which draw synergy from one another.

CPD's research programmes are both serviced by and intended to serve, as inputs for particular dialogues organised by the Centre throughout the year. Major research themes are: Macroeconomic Performance Analysis; Resource Mobilisation and Fiscal Policies; Inclusive Growth and Labour Issues; Trade, Regional Cooperation and Global Integration; Investment Promotion, Infrastructure and Enterprise Development; Agriculture, Climate Change and Environment; Gender, Human Development and Social Protection; Sustainable Development Goals (SDGs); and Governance and Institution.

CPD also conducts periodic public perception surveys on policy issues and issues of developmental concerns. With a view to promoting vision and policy awareness amongst the young people of the country, CPD is also implementing a *Youth Leadership Programme*. CPD serves as the Secretariat of two global initiatives. *LDC IV Monitor* is an independent global partnership for monitoring the outcome of the Fourth UN Conference on the LDCs. *Southern Voice on Post-MDGs* is a network of 50 think tanks, which seeks to contribute to the ongoing global discourse on the SDGs. At the national level, CPD hosts the Secretariat of the *Citizen's Platform for SDGs, Bangladesh*—a civil society initiative that include about 90 Partner organisations, founded with an objective to contribute to the delivery of the SDGs and enhance accountability in its implementation process. In recognition of its track record in research, dialogue and policy influencing, CPD has been selected as one of the awardees of the Think Tank Initiative (TTI) through a globally competitive selection process for two consecutive times.

Dissemination of information and knowledge on critical developmental issues continues to remain an important component of CPD's activities. Pursuant to this, CPD maintains an active publication programme, both in Bangla and in English. As part of its dissemination programme, CPD has been bringing out CPD Occasional Paper Series on a regular basis. It may be noted in this connection that since November 2011, the Series has been re-introduced as **CPD Working Paper Series**. Research work in progress, background papers of dialogues, investigative reports and results of perception surveys which relate to issues of high public interest are published under this series.

The present paper titled **Macroeconomic Policy, Price Stability and Inclusive Growth in Bangladesh** has been prepared by *Dr Muhammed Muqtada*, Visiting Fellow, CPD, and former Director of Policy Planning in the Employment Sector, International Labour Organization (ILO), Geneva <muqtada1@gmail.com>

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During the past two decades, the economy of Bangladesh experienced a fairly sustained macroeconomic stability, and was able to achieve substantial growth in gross domestic product (GDP). However, there is evidence to suggest that, this growth has neither been inclusive, nor has it been able to bring about structural change needed to sustain higher growth. The paper contends that the macroeconomic policy-making would require a rethink in order to meet the above challenges. The present paper reviews the current macroeconomic policy framework, and underscores the need for balancing its usual emphasis on stability, with the need for structural change and social inclusion. This, in turn, would require an expansionary macroeconomic policy, albeit cautious, that focuses robustly on stepped-up investment, job growth, and reduction of inequality and vulnerability. To this end, the paper explores the critical role of monetary, fiscal, external and financial inclusion policies, and how far these could address the above challenges. Macroeconomic policies, focused simply on stability and a status quo budget, cannot deliver the desired employment and inclusion outcomes, unless these also address and accommodate various associated sectoral, labour market and social inclusion measures.



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# Acronyms

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ADP	Annual Development Programme
ALMP	Active Labour Market Policy
BBS	Bangladesh Bureau of Statistics
BDT	Bangladeshi Taka
BGMEA	Bangladesh Garment Manufacturers and Exporters Association
CAR	Capital Adequacy Ratio
EPB	Export Promotion Bureau
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GoB	Government of Bangladesh
G7	Group of Seven
HPNSDP	Health, Population and Nutrition Sector Development Programme
ICOR	Incremental Capital—Output Ratio
IMF	International Monetary Fund
IT	Information Technology
ITC	International Trade Centre
InM	Institute of Microfinance
LDC	Least Developed Country
MFA	Multi-Fibre Arrangement
MFI	Microfinance Institution
MPS	Monetary Policy Statement
MRA	Microcredit Regulatory Authority
MoF	Ministry of Finance
M2	Broad Money
NBR	National Board of Revenue
NGO	Non-Government Organisation
NPL	Non-Performing Loan
NSC	National Savings Certificate
NSSS	National Social Security System
ODA	Official Development Assistance
PCB	Private Commercial Bank
PKSF	Palli Karma-Sahayak Foundation
REER	Real Effective Exchange Rate
RM	Reserve Money
RMG	Readymade Garments
SCB	State-Owned Commercial Bank
SDG	Sustainable Development Goal
SME	Small and Medium Enterprise
SSNP	Social Safety Net Programme

UMIE	Upper Middle-Income Economy
UN	United Nations
USD	United States Dollar
VAT	Value Added Tax
WDI	World Development Indicator
7FYP	Seventh Five Year Plan

## 1. INTRODUCTION

While macroeconomic policies are designed to pursue the broad macroeconomic goals set by planners, there are often serious controversies with regard to what these goals, as well as the policy instruments that are at disposal to achieve these goals, should be—in an individual country. There are intense debates, both among the academia and the practitioners, on the precise role and objectives of macroeconomic policies.<sup>1</sup> These debates are often ideologically charged, concentrating, at the core, on whether macroeconomic policies ought to be defined largely by supply-side and price stability considerations, or whether these should also influence demand-management in the economy. In practice though, the debates do not strictly compartmentalise the macroeconomic goals and policies. Nevertheless, the relative weights of the policies that these ideological positions entail, have political overtones and define political agendas, such as the relative roles of the government and the market economy. Although the practices of macroeconomics in current times recognise and engage both the government and the private sector, there are still stiff conflicts in articulating the dominant policy instruments in the macroeconomic management.

As well known, since the 1980s, macroeconomic policy in both the developed and developing countries, has been predominantly driven by considerations of price stability (i.e. ‘getting prices right’), based on the so-called Washington Consensus. In the context of the economic and political imperatives of the period that followed, inflation-control became the overriding objective to induce stability and growth. In the process, the importance of employment as a central objective of macroeconomic policy was relegated, and hence, also implicitly the associated role of demand-side policies, such as the size of public investment and expenditures, which were the usual hallmarks of macroeconomic planning during the 1950s till the early 1970s.<sup>2</sup>

Bangladesh undertook major macroeconomic reforms during the 1980s, and more vigorously during the 1990s, largely within the framework of the stabilisation and structural adjustment programmes that were shaped by the loan facility agreements with the Bretton Woods institutions. The following sections of the present paper describe how Bangladesh, within a relatively short period of time, managed to curtail its debts and deficits substantially, in order to attain macroeconomic stability and accelerated growth. It may be noted though that, various other factors, including fortuitous circumstances, facilitated both stability and growth. This has greatly supported Bangladesh to ‘graduate’, i.e. move out of the United Nations (UN)-defined category of an LDC—‘least developed country’. Although the economy has been fairly stable and its gross domestic product (GDP) has grown, there is widespread evidence and analysis that this growth has hardly been inclusive.<sup>3</sup> Income and asset inequality has been persistently increasing, and growth so far has not been able to ensure any tangible structural transformation. While Bangladesh is committed to, and poised for, attaining the Sustainable Development Goals (SDGs), and equally, the goal of an upper middle-income economy (UMIE) status, such targets and expectations are likely to confront major macroeconomic challenges.<sup>4</sup> A relatively inadequate private investment—GDP ratio, an unacceptably low revenue—GDP vis-à-vis expanding expenditures on social and physical expenditures, and shaky foundations of export growth and diversification among others, are some of the significant challenges ahead. The present study closely reviews the macroeconomic policy framework, which is (arguably) following a conservative stance to meet its de facto targets of debts and deficits. The study, through an examination of the

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<sup>1</sup>See Stiglitz (2010) and Krugman (1999) on the one hand, and Mauro (2011) on the other, for a discussion from different standpoints, on themes that have gained increasing prominence in recent times.

<sup>2</sup>See, for example, Bhaduri (2005), Epstein (2007), Nayyar (2015) and Pollin (2008) for a vigorous emphasis on the employment objective of macroeconomic policy.

<sup>3</sup>See Khan (2015); CPD (2017a); Khan et al. (forthcoming).

<sup>4</sup>See IMF (2017) for a brief assessment of these challenges.

policy instruments (chiefly monetary and fiscal) argues in favour of, and calls for, a relatively more expansionary macroeconomic policy to be able to meet the economic and social challenges of inclusive growth. Section 2 of the paper provides a brief account of the macroeconomic reforms undertaken in Bangladesh, and their broad impact on growth and stability. Section 3 provides some insights on the problems of promoting inclusive growth in Bangladesh, and how far these are likely to challenge the current status quo of macroeconomic policy-making. In Section 4, the study examines critically the role and limitations of the monetary policy, and its ability to pursue its stated dual objectives of price stability and inclusive growth. Bangladesh, under the current trends in price stability and low inflation volatility, is well-positioned to focus on its other mandate, i.e. facilitating investment and inclusive growth, which would require a more aggressive monetary stance. Given the limitations of the financial sector infrastructure and the need for vigorous mobilisation of financial resources and broad-based credit utilisation, Section 5 takes an in-depth look into the role of financial inclusion and its potential impact on inclusive growth. Section 6 takes a partial look at the role of the fiscal policy in Bangladesh, the limitations posed by the low revenue—GDP, and posits some alternatives towards creating fiscal space for employment and social safety nets. The important role of external stability in promoting stability and import competitiveness, is examined in Section 7. Finally, in Section 8, major conclusions are drawn and policy recommendations are made, based on the learning outcomes of the present study.

## 2. MACROECONOMIC REFORMS, STABILITY AND GROWTH

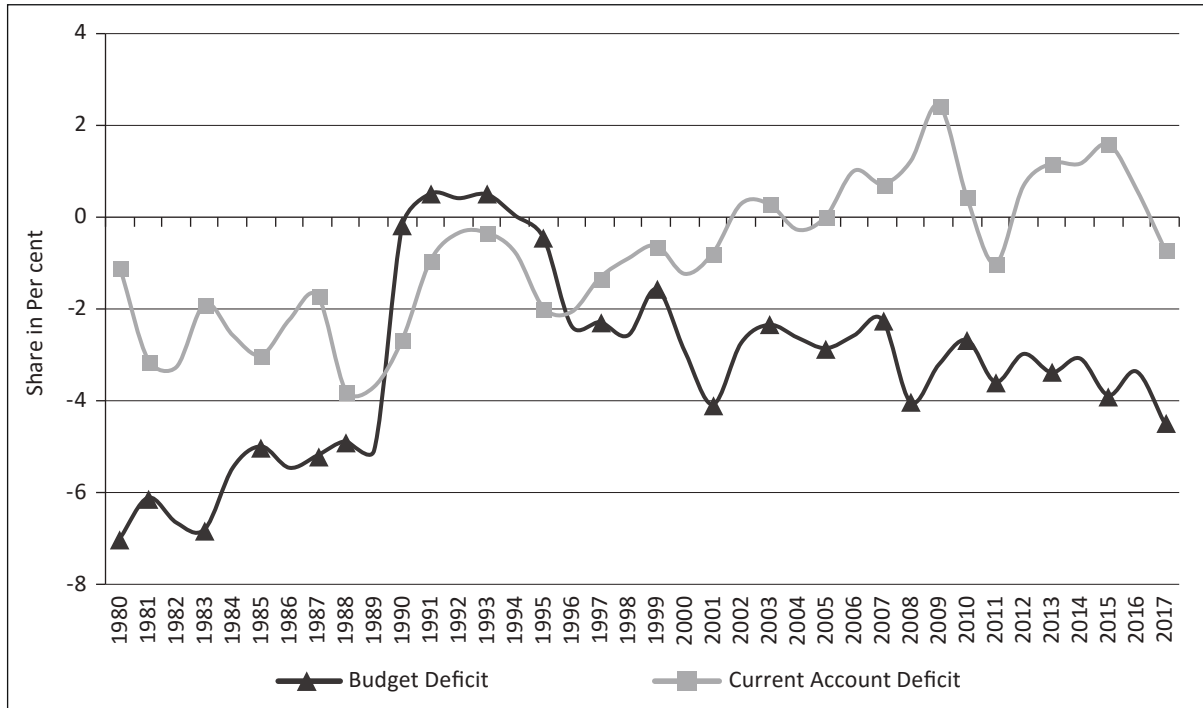
During the 1980s, Bangladesh faced an acute crisis of resource imbalances. In an incipient economy, there were huge burdens on public expenditure relative to the insignificant revenue base, which caused unsustainable fiscal deficits. The large number of loss-making state enterprises in the then largely nationalised economy added to the resource burden, and the country's development expenditures were hugely met through donor resources. Monetisation of government deficits and adverse movements in terms of trade, especially in the aftermath of the second oil-price shock, contributed to a sharp deterioration in macroeconomic imbalances. These led to significant fiscal and current account deficits, and an increase in the inflation rate during the mid-1980s.<sup>5</sup> Fiscal deficit stood at nearly 10 per cent of GDP, while inflation went up to around 12 per cent during the first half of the 1980s. Stabilisation reforms were predominantly focused on restraining fiscal and current account deficits, and lowering the inflation rates. These were accompanied by various liberalisation measures (related to trade and finance) and structural adjustment programmes (e.g. privatisation, rationalisation of sectoral loans and subsidies, among others). While many analysts questioned the pace and sequencing of these programmes, as well as the initial (social) costs and impact on the economy, the reforms had helped the Bangladesh macroeconomic framework gain a stronger footing (Mahmud, 2004; Osmani, 2008; Ahmed and Mahmud, 2006). By the widely accepted indicators of stabilisation, Bangladesh, since the turn of this century, has witnessed a comfortable stretch of macroeconomic stability. Figure 1 shows that fiscal deficits, since the mid-1990s, have been well below the widely accepted yardstick of 5 per cent. The current account has been in surplus during most of this period, except in the very recent past.

The above evidence, together with the fact that growth started to pick up especially since mid-1990s, would tend to suggest that stabilisation measures were largely satisfactory. Bangladesh, in due course, avoided following the strict conditionalities of the Washington Consensus. However, there are debates and unresolved questions on whether, and how far, stabilisation can be achieved through approaches that are more flexible than the guidelines and targets set by the lending agencies. While an unconditional acceptance of the so-called Washington Consensus is now much less observed, the

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<sup>5</sup>For an account of the state of the Bangladesh economy during this early period, see Khan (1995) and Bhattacharya and Titumir (2001).

Figure 1: Budget Deficit and Current Account Deficit of Bangladesh as Share of GDP



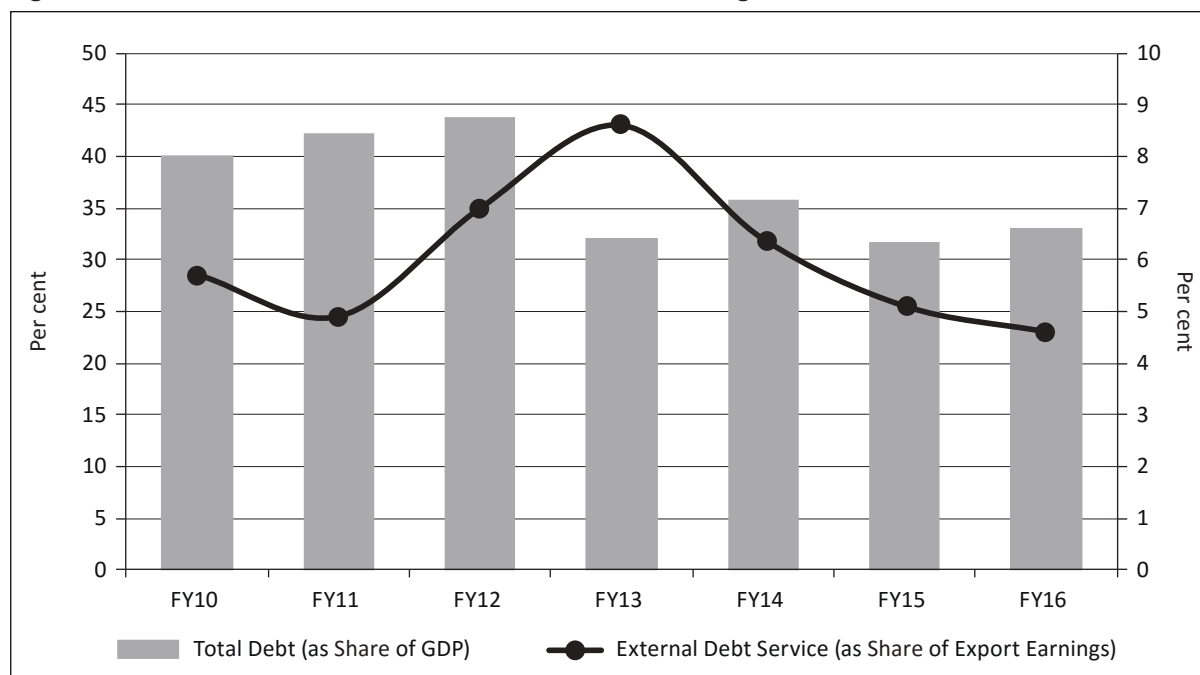
Source: World Economic Outlook Database (October 2017), International Monetary Fund (IMF). Available from: <https://www.imf.org/external/pubs/ft/weo/2017/02/weodata/index.aspx> [Accessed: 2 February 2018].

experience of Bangladesh to some extent shows alternative paths, especially with regard to sequencing and pacing of stabilisation. High inflation is undesirable, so are severe debts. But those countries which could attain better debt sustainability have been able to avoid the conditional path, Bangladesh being a prime example which prudently managed to cut down its dependence on conditional borrowing.<sup>6</sup> Bangladesh could regain a fair rate of growth and price stability without facing a constricted fiscal and import space, and was able to divert resources to development expenditures and targeted poverty programmes. Thus, despite the initial shocks and adverse social and economic effects of stabilisation and structural adjustment reforms, macroeconomic policy-making in Bangladesh has been relatively prudent, through which it attained stability during the post-reforms period of the 1990s. In particular, it is noteworthy that, Bangladesh refrained from fiscal profligacy to drive growth. The economy managed to reduce its debt—GDP ratio to below 35 per cent, and external debt servicing to around 4.5 per cent of export earnings (Figure 2).

One needs to point out that, there were several fortuitous conditions that cushioned the growth effects of the subsequent post-reforms. The global boom of 2002—2007, the falling fuel and commodity prices, and the growing significance of remittances (as per cent of GDP) were vital to sustaining stability and growth. Remittance and ‘net exports’, in particular, have been significant factors for Bangladesh in the growth of national savings and foreign exchange reserves—in reducing the current account deficit, and strengthening the import capacity.

Concurrently with the stabilisation and liberalisation drive, various developments have helped Bangladesh build up its resource balances, both internal and external. Export earnings shot up on the back of escalation in readymade garments (RMG) exports. Concerted policy attention towards, and growth in, food agriculture helped bring down food import bills. Similarly, remittances from migrant

<sup>6</sup>See Easterly (2001) and Muqtada (2014) on how strict macroeconomic reforms during the 1980s in many African countries led to a ‘compression syndrome’, and reduced aggregate demand.

**Figure 2: Total Debt and External Debt Service Scenarios in Bangladesh**

Source: MoF (n.d.b); ERD (2017).

Note: External debt service (as share of export earnings) is shown in the right vertical axis.

workers grew significantly. Thus, trade deficits declined, and foreign exchange reserves grew quite substantially.<sup>7</sup>

### 3. AN INCLUSIVE GROWTH FOR BANGLADESH: MACROECONOMIC POLICY CHALLENGES

The current macroeconomic policy framework, which has been instrumental in attaining an inflation rate of below 6 per cent, a budget deficit below 5 per cent, and an overall debt—GDP ratio of 36 per cent, has been widely acclaimed by analysts as well as donor agencies (IMF, 2017). However, while such stability has facilitated a relatively high and sustained GDP growth rate, inequality has been increasing continuously, and employment generation has been weak and declining. In the light of the country's planned objectives to consolidate an ambitious growth and structural transformation programme to reach the UMIE status by 2031, and towards the provision of jobs for all working-age men and women—the scope of the current macroeconomic policy framework will need to be considerably expanded. The key challenge to the new generation of macroeconomic reforms, would hence, lie in—attaining high sustainable growth; and making growth more employment-friendly and inclusive. This is also consistent with the attainment of the SDGs, to which, Bangladesh, like all countries, is committed. In the context of the present study, this would imply a closer review of the macroeconomic policies that currently exist. Indeed, the imperatives for 'upgrading the macroeconomic policy-making practices and institutions' to be able to attain the ambitious growth targets, as well as the many pursuits under a strategy of inclusive growth, have been emphasised elsewhere (IMF, 2017).

First, Bangladesh, in its Vision 2021, had projected an ambitious pathway for GDP growth, with the country reaching an annual rate of 10 per cent (GED, 2012). This has, however, been moderated in the Seventh Five Year Plan (7FYP)<sup>8</sup>, with a projection of nearly 8 per cent during the Plan period. Experts consider this as not unachievable, but a tall order nonetheless. According to various projections, the

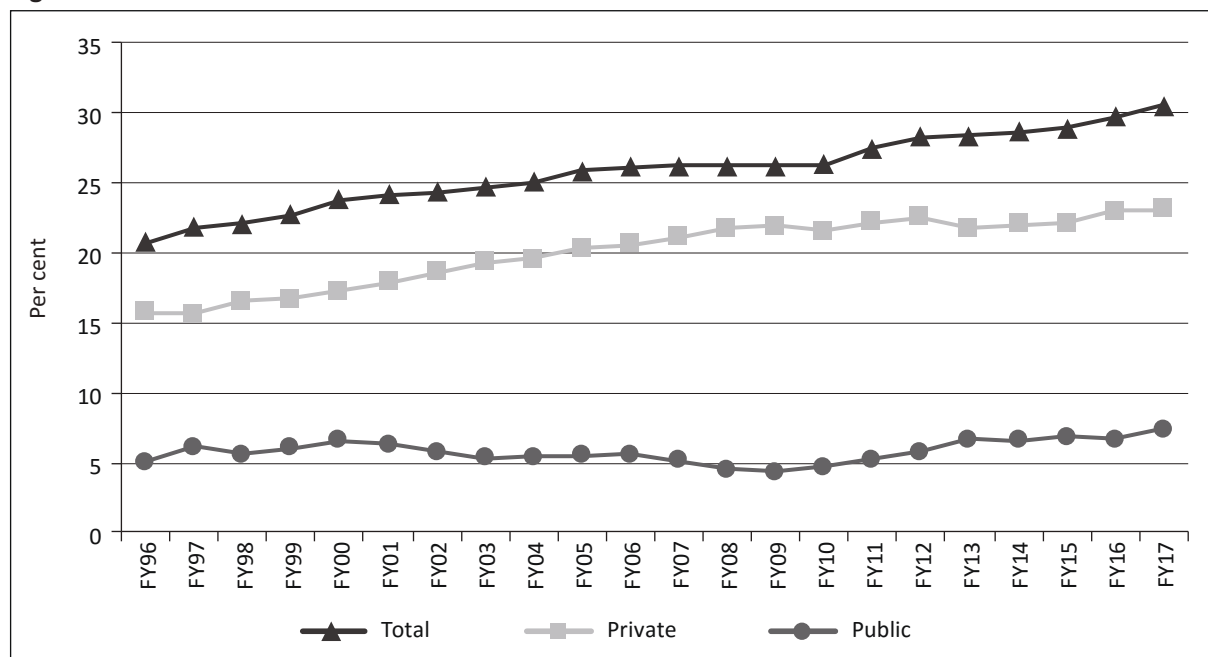
<sup>7</sup>See, for example, Khan et al. (forthcoming).

<sup>8</sup>Adopted for the period FY2015-16—FY2019-20.

growth rate is more likely to be around 7 per cent<sup>9</sup>; in fact, the hard statistics are that the long-term average GDP growth rate has been 5.7 per cent during FY1993-94—FY2016-17, and has reached, according to the Bangladesh Bureau of Statistics (BBS), to 7.3 per cent in FY2016-17. Any further planned growth would have to be intrinsically linked to the growth of private sector investment—GDP ratio, which has remained stagnant at around 22 per cent (FY2015-16). In a milieu of macroeconomic stability and reasonably high savings ratio, excess liquidity in the banks and financial institutions, and the lack of perceptible growth in private sector investment are the causes of major concerns. According to the Planning Commission, a planned growth rate of 8 per cent would require the investment—GDP ratio to increase to 32.5 per cent (or more, assuming that the existing incremental capital—output ratios (ICORs) remain the same).<sup>10</sup>

The above warrants a critical role of public investment, which has been gradually increasing in the recent years, from less than 5 per cent in FY2007-08 to around 7.5 per cent in FY2016-17 (Figure 3).

**Figure 3: Investment as Share of GDP**



Source: Author’s calculations from the Bangladesh Bureau of Statistics (BBS) data.

During the past few years, the government has increased its public investment programmes, not only to enhance overall investment—GDP ratio, but also to crowd in private investment through intensifying the development of physical (roads, ports, information technology (IT), communications) and social (skills, education, health) infrastructures. It is argued that, private investment is not only held back by inadequacies of the monetary and financial sectors, but also various other constraints that can be addressed through increased public investment.<sup>11</sup> Numerous factors are forwarded to explain the recent slowdown in the pace of private investment, such as infrastructure bottlenecks, energy crisis, skilled manpower and high bank-lending rates. Analysts are equally concerned with other broader issues of institutional weaknesses and poor governance, especially corruption, policy instability and inefficient government bureaucracy.<sup>12</sup>

<sup>9</sup>For various growth projections for Bangladesh, see IMF (2017), ADB (2017) and World Bank (2017a).

<sup>10</sup>For alternative growth—investment scenarios for Bangladesh, see Mujeri (2014).

<sup>11</sup>These figures and the issue of political instability are reported in MoF (2014).

<sup>12</sup>See, for example, WEF (2017).



Second, a critical challenge that the macroeconomic regime in Bangladesh faces, is how to maintain and/or sustain price stability while maintaining a sustained high growth momentum, and accommodating its commitment to inclusive growth. It has been noted above that, various reforms (especially financial reforms, fiscal restraints) and various developments, whether policy-induced and/or owing to fortuitous circumstances, have so far helped maintain such a balance. Figure 8 (in Section 4) shows that, Bangladesh has been attaining a growth rate of 6 per cent and above during the past decade, with the inflation rate ranging from 6 to 8 per cent. However, current GDP forecasts of 7–8 per cent or more, as perceived by the Bangladesh Planning Commission, will require a review of how a faster growth of aggregate demand and its implications for the economy's fiscal, current accounts and the exchange rate, will be accommodated.

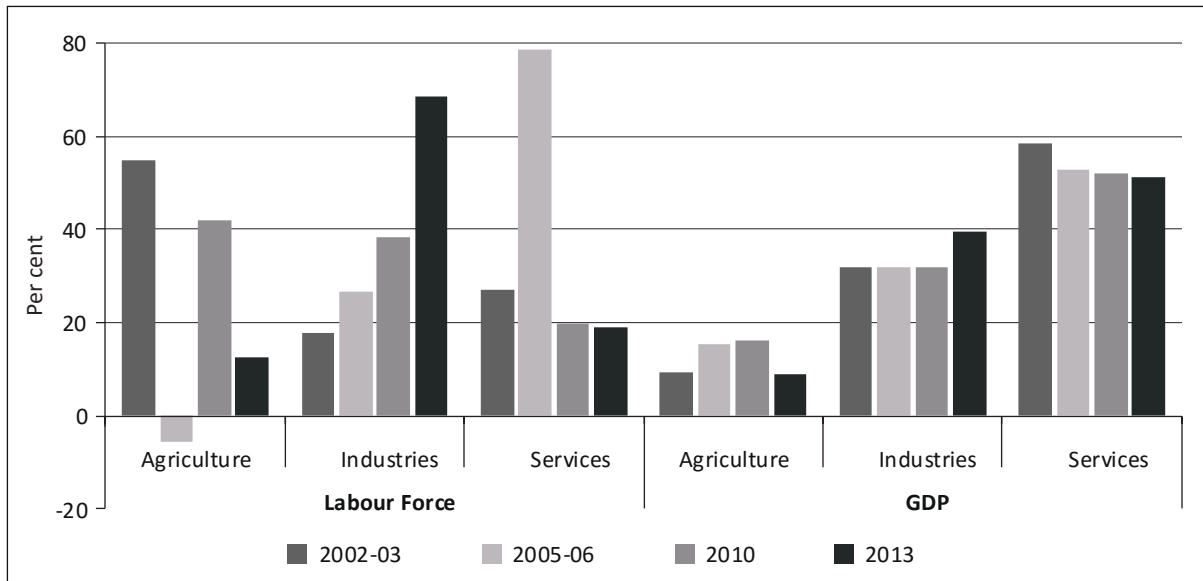
Third, a large proportion of the labour force in Bangladesh are the working poor and/or vulnerable. These include particularly those in self-employment, own-account workers, unpaid family helpers and casual day-workers (Islam, 2014a). Despite major achievements in the reduction of poverty, the incidence of extreme poor as well as the absolute number of people under poverty remain unacceptably high. Further, addressing the disconcerting rise in inequality and introducing measures to enhance the living standards of the bulk of the population—will constitute a major development challenge. In order to pursue the central pledge of 'Leave No One Behind' in the 2030 Agenda, and to ameliorate the conditions of the bulk of these vulnerable groups and millions of others who constitute the socially excluded, Bangladesh has embarked on the challenges of inclusive growth strategy, the centre-piece of which would lie in achieving the goal of full, productive, remunerative employment (SDG 8) (UN, 2015). Macroeconomic policy would need to embody an employment strategy, and an overall pattern of growth, that is 'inequality-averse' (Khan, 2015), as had been the experience of the East Asian countries in the early periods of their growth.

Fourth, in order to attain a sustained growth towards a middle-income country, Bangladesh would need to undergo substantial structural transformation that would be commensurate with the foundations of growth associated with a higher-income economy. Such a transformation is observed not just in terms of sectoral changes in GDP, but also in terms of the shifts in the sectoral shares in total employment. In particular, this is associated with tangible increases in the modern sector's share in total employment. The latter characterises rising labour productivity in the economy, with labour force shifting away from low-productivity agriculture to high-productivity manufacturing, and the modern services sectors.<sup>13</sup> Although employed workforce in agriculture is declining, and manufacturing employment is growing, the changes are slow. Despite the fact that the agriculture sector's share in GDP has fallen sharply, the share of employed workforce in agriculture has changed little over 1995–2013. Similarly, another yardstick for a movement toward structural change is the gradual increase in the share of employment in manufacturing, which too has remained comparatively low. It may be noted that, a relatively higher level of growth in employment in the industries sector in most periods (between 4 to 8 per cent), compared to that in agriculture ((-) 0.1 to 4 per cent) and services sectors (between 1 to 5 per cent), have contributed to mild changes in the structure of employment in the economy. More importantly, the incremental contribution of employment by the industries sector has gradually increased over time—from only 17.9 per cent in 2002-03 to 68.3 per cent in 2013 (Figure 4). In fact, this incremental contribution of the industries sector was much higher than what it contributed to GDP during the same period. Nevertheless, these changes in sectoral employment trends are inadequate to characterise a structural transformation.

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<sup>13</sup>This signifies a characterisation of an economy moving towards the Lewisian turning point. For further reflections on this, see Islam (2014b).

Figure 4: Incremental Contribution of Employment and GDP by Broad Economic Sectors



Source: Author's estimations from BBS (2004, 2008, 2011, 2015).

Among the several other indicators of structural change is the growth of formal sector employment, of which, the wages-and-salaried workers constitute an important proportion. Again, the progress is observed to be unsatisfactory.<sup>14</sup>

In order to boost productivity and structural transformation, measures would need to be put in place to upgrade skills and education, and infuse higher technology and innovation. Thus, productive employment generation would need to be associated with the growth of jobs in higher productivity sectors, and other conditions that facilitate labour movements between sectors, as well as between regions. While macroeconomic stability is seen as necessary for high and sustainable rates of growth, it does not, by itself, ensure high rates of economic growth, or a pattern of growth that would deliver higher employment and income.

In Bangladesh, the pattern of growth generated through the macroeconomic stance has been short on 'inclusion' and job generation. There are no indications suggesting that growth has been associated with progressive distributional change, which could have had a better outcome in terms of poverty reduction, as well as in reducing the incidence of vulnerable populations. The macroeconomic framework needs a closer review to foster a truly inclusive growth in Bangladesh. It will need to accommodate policies that would generate jobs, for example, through incorporating a productive, remunerative employment strategy.<sup>15</sup> It will also have to undertake budgetary and public investment measures (provision of public goods and income entitlements) to address the millions of unprotected and vulnerable populations. The following sections provide critical insights on the current practices of macroeconomic policy, and argue that, a more flexible use of the macroeconomic instruments would be necessary to address the objectives of price stability and inclusive growth. Given the scope of the study, only some salient features are highlighted, chiefly with regard to monetary and fiscal policy instruments.

<sup>14</sup>See Khan et al. (forthcoming).

<sup>15</sup>In point of fact, there does not exist a clearly articulated and comprehensive employment strategy in Bangladesh.

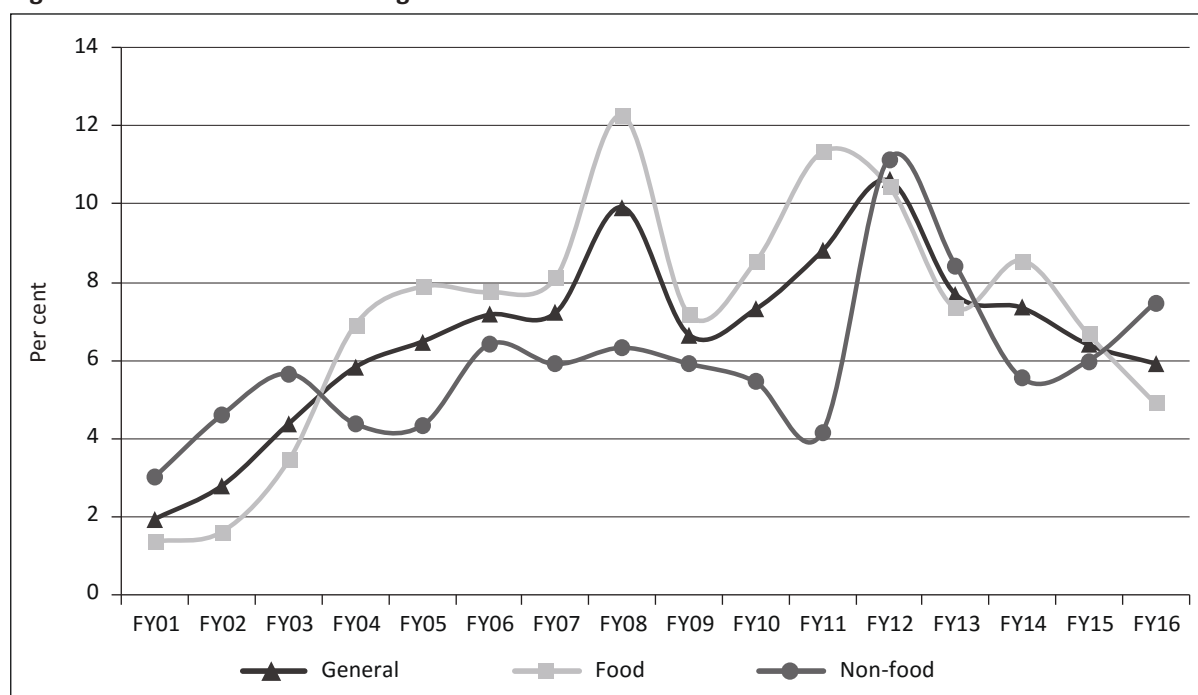
#### 4. MONETARY POLICY, PRICE STABILITY AND INCLUSIVE GROWTH<sup>16</sup>

Maintaining price stability is a predominant and critical objective of Bangladesh’s macroeconomic policy framework. However, while adjusting to targets within the broad fiscal and monetary goals that have provided stability to the economy, Bangladesh has refrained from the conservative stance of ‘inflation targeting’ (Hammond, 2012), which has been widely adopted both in the developed and developing countries.<sup>17</sup> In fact, the Monetary Policy Statement (MPS), aligning with the overall macroeconomic objectives of the economy, states that, it will “continue to focus on achieving its inflation target while providing sufficient space in its monetary program for lending to activities which support broad-based investment and inclusive growth objectives” (Bangladesh Bank, 2014, 12).

The MPS is predominantly focused on price stability, and is relatively muted on how the monetary policy framework could better accommodate and contribute to investment and inclusion. The price stability challenge in Bangladesh, as in other developing countries, is complex; and requires a careful review of what constitutes a realistic short-run inflation target, how low it should be, and whether it is calibrated through potential estimates of inflation—growth trade-offs. It is equally important to trace the multiple causes of inflation, and the varied policy instruments that are traditionally applied to contain inflation. There are a very few empirical studies of inflation—growth trade-offs in Bangladesh, let alone a continuous monitoring of such trade-offs.<sup>18</sup> As noted in Figure 5, inflation in Bangladesh has tended to show a steady decline since FY2011-12, to reach an annual average of 5.9 per cent in FY2015-16.

In fact, except for an odd year or two, Bangladesh hardly had double-digit inflation over this entire period. As is evident from Figure 5, the volatility in inflation rates comes from factors affecting both non-

**Figure 5: Trend of Inflation in Bangladesh**



Source: Author’s compilations from the Bangladesh Bureau of Statistics (BBS) data.

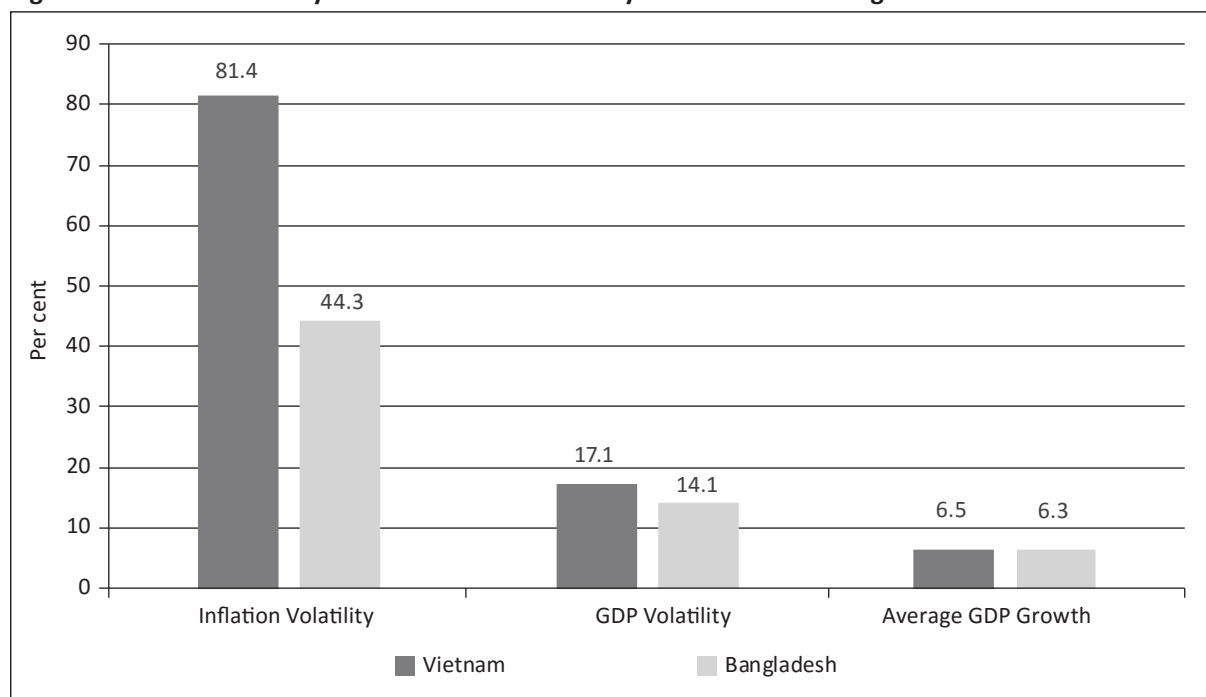
<sup>16</sup>For further details on the issues of price stability, growth and inclusion in Bangladesh, see Muqtada (2015).

<sup>17</sup>Conservative proponents of inflation targeting propose an inflation rate of 3 per cent or less.

<sup>18</sup>See Farashuddin (2008); Younus (2012); Anwar and Islam (2013). These tend to suggest trade-offs at around 7–8 per cent inflation rates, except Biswas et al. (2016), where the threshold is estimated at 6.25 per cent. Sample size, the period concerned and methodological differences account for these variations.

food prices (e.g. commodity) and food prices, which contribute a large share to headline inflation. Food price inflation in Bangladesh occurs owing to various factors—supply disruptions due to floods, and other natural disasters (as happened pervasively in 2017), price distortions by market intermediaries, and a rise in food import prices, among others. Clearly, controlling inflation in Bangladesh requires various other interventions to complement the monetary instruments. Long-term public investments and other measures would be needed to address structural factors and food price volatility. One may note that, over the last two decades, the rate of inflation in Bangladesh has fluctuated, and the level of fluctuation which was much higher in the 1990s decelerated in the 2000s. The volatility in the inflation rate was 44.3 per cent during 1996—2014 (Figure 6). A comparison of Bangladesh and Vietnam shows that, though inflation volatility in Vietnam was much higher, i.e. 81.4 per cent than Bangladesh, GDP growth volatility and average GDP growth was almost similar for both the countries. Hence, volatility of inflation in Bangladesh has not been a major concern during the past two decades.

**Figure 6: Inflation Volatility and GDP Growth Volatility in Vietnam and Bangladesh: 1996—2014**



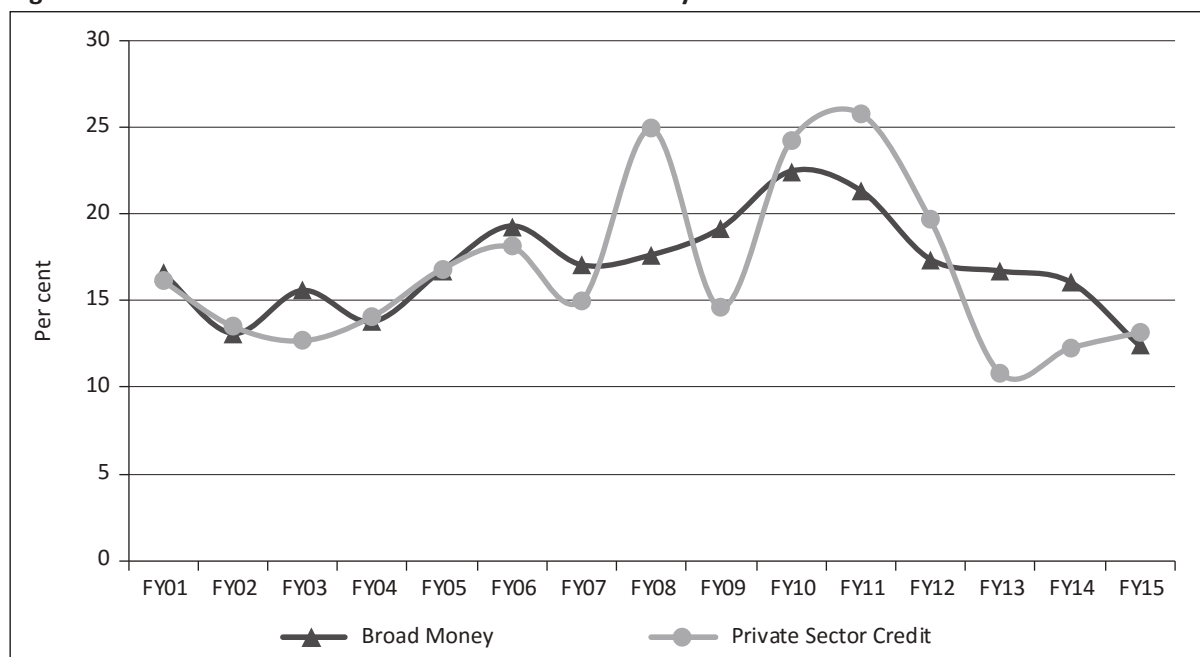
**Source:** Author's calculations from the World Development Indicator (WDI) database, The World Bank. Available from: <https://databank.worldbank.org/data/home.aspx> [Accessed: 3 February 2018].

Regarding the role of the monetary policy to control price levels, it appears that the instruments at disposal are often not adequate to respond to inflationary tendencies (Muqtada, 2015). The Bank rate (viz. the policy rate) has been held constant almost since FY2003-04 (Bangladesh Bank uses the repo rate as a proxy policy rate); instead, it addresses price stability largely through the credit/deposit channel, often by maintaining a closely monitored relationship between broad money (M2) and reserve money (RM).<sup>19</sup> The use of control over money aggregates (credit channel) provides a pseudo-control over the credit flow to the private sector (Figure 7). There are, however, several other factors that would explain constraints to the flow of credit to the private sector, including those that explain investment constraints in general.

The credit channel does have its limitations, and can frequently miss the inflation targets. On the other hand, the policy rate channel, widely in vogue where money and financial market are well developed, cannot be fully applied since the 'transmission mechanisms' are very weak, and financial infrastructure

<sup>19</sup>This implies a careful calibration of inflation rate tracking and potential output growth, weighted by a money demand multiplier; this is often a sum up of projected inflation, GDP growth, plus a multiplier factor.

**Figure 7: Growth of Private Sector Credit and Broad Money**

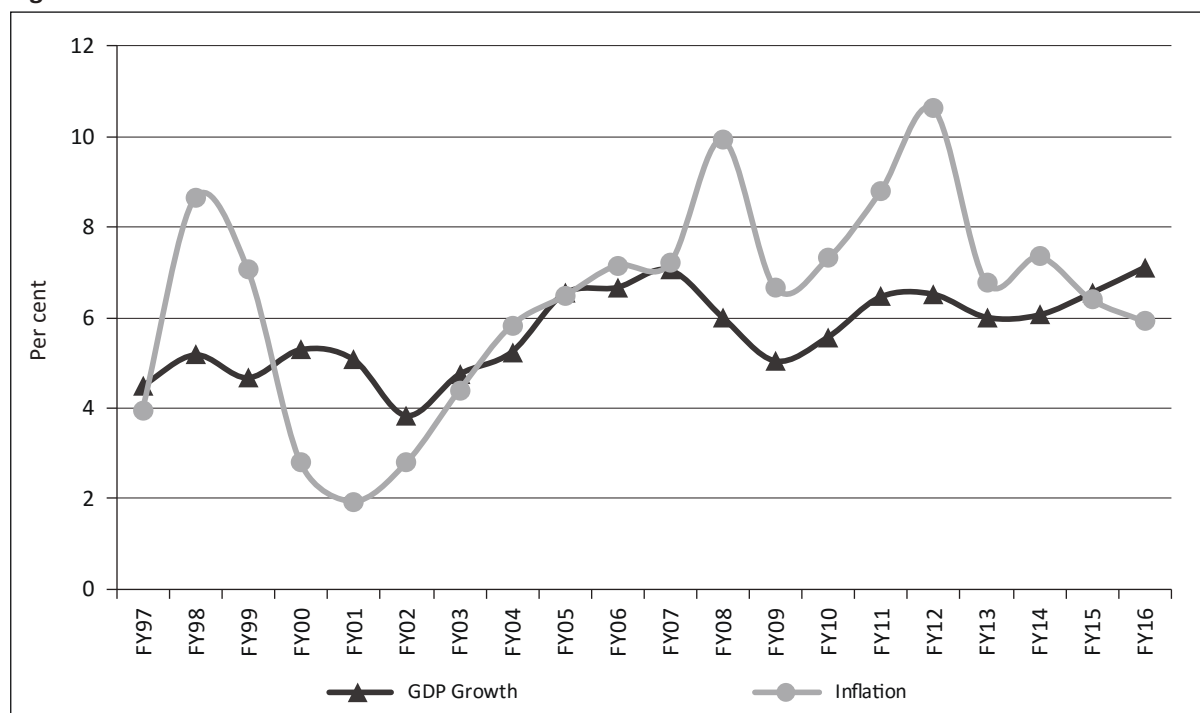


Source: Author’s calculations from the Bangladesh Bank data.

is underdeveloped. The ongoing reforms for greater market competition in the sector are likely to place increasing responsibility on the Bank’s ‘policy rate’, the effectiveness of which will depend on, among others, a much greater financial deepening, strengthening of credit and debit markets and interbank transactions and integration—all within an efficient regulatory and accountable framework.

As noted earlier, the overall trend relationship between GDP growth and inflation over the past two decades has been relatively stable, i.e. growth has not been overly threatened by the observed fluctuations in the price levels, nor is inflation seen as among the major constraints to investment (Figure 8).

**Figure 8: GDP Growth and Inflation**



Source: Author’s compilations from the Bangladesh Bureau of Statistics (BBS) data.

In fact, Figure 8 does show a positive relationship between growth and a mild inflation over a prolonged period. It does not, however, shed light on how much lower the inflation rate should be, and most importantly, how to attain that level without affecting output levels.

Nevertheless, there remains an apprehension regarding the efficiency of the existing monetary and financial system, in their ability to control inflation and exchange rate stability in the future, particularly when the economy is poised for a higher growth pathway, and one which may require greater external interaction. There are various other potential threats to price stability that can trigger inflation uncertainties. There are several such possibilities. Foremost among these, is the potential fiscal dominance. Bangladesh at its current and projected pace of growth, would require much higher public expenditure to meet various infrastructural and social needs (Mansur, 2014). Should revenue growth fail to finance such expenditure, an increased borrowing, especially from the banking sector, is likely to cause price instability.<sup>20</sup> A second potential is the exchange rate volatility. During the recent past, the real effective exchange rate (REER) has been stable. Although in principle, Bangladesh maintains a market-based, free-floating exchange rate regime, Bangladesh Bank intervenes occasionally to buy/sell foreign currency to smoothen volatility and to support international competitiveness of Bangladesh exports. In a growing economy, much will depend, *ceteris paribus*, on the growth of export capacity to meet the import surge, and the future steadiness of remittance flows. Third, risks can equally come from non-price factors affecting inflation (supply shocks) or non-economic factors (e.g. political instability).

During the recent past, some of the above risks have surfaced, but have not threatened inflation to any appreciable degree. During the first half of FY2017-18, import spending surged, with several fold increase in spending on food imports, as well as on fuel, machinery and infrastructural mega projects, which adversely affected current account deficit and the exchange rate. Further, the fairly bold economic growth rates that policymakers in Bangladesh are projecting over the medium-term (7FYP) and beyond, would require careful articulation of policies to avoid trade-offs between growth and inflation.

With inflation rates being within a comfortable band over the past several years, it would be critical to review how the monetary policy could influence savings and investment, and hence, aggregate demand. Since savings appear to be relatively more responsive to income growth than policy rates<sup>21</sup>, the more significant constraint would lie with investment growth. Private investment has been nearly stagnant for a prolonged period, with a slight increase in the two recent years. One has to see how far this is due to the recent declining trend in lending rates. The lending rate, which stood at 10.4 per cent in FY2015-16 (Figure 9), needs to come down further.<sup>22</sup>

In order to build confidence among the investors, Bangladesh has been undertaking various banking and financial sector reforms, with the expectation of enhancing greater competition in the sector, and to strengthen the regulatory framework. These have led to some specific positive developments. However, many failings and anomalies still remain, which are reflected in the persistently unacceptable non-performing loans (NPLs), capital adequacy ratios (CARs). A careful strategy is needed to bring about a further reduction in—high NPLs, excess liquidity, high interest rate spreads, and the huge proportion of classified loans, especially in the state-owned commercial banks (SCBs). For instance, as

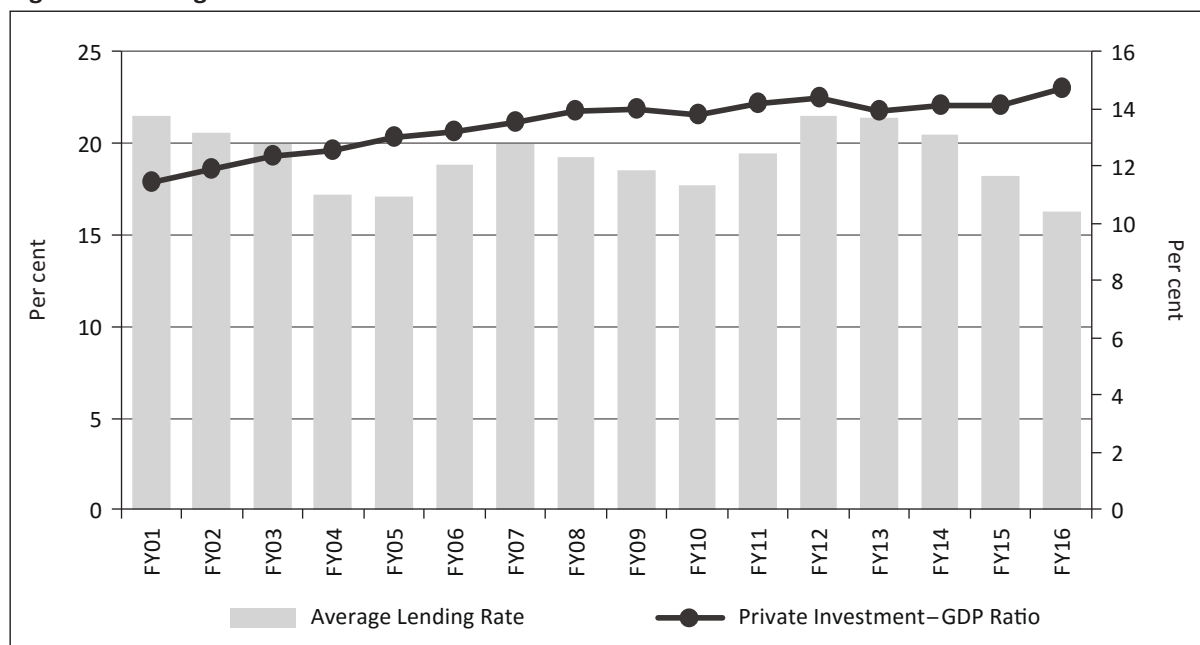
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<sup>20</sup> Bangladesh has, in the recent past, been meeting its borrowing needs increasingly through national savings certificates (NSCs). See Section 6.2 on the relative importance of the sources of public borrowing in Bangladesh.

<sup>21</sup> See Farashuddin (2008).

<sup>22</sup> Bangladesh Bank has recently issued instructions to commercial banks to place a cap on deposit and lending rates.

Figure 9: Lending Rate and Private Investment—GDP Ratio



Source: Author's compilations from the Bangladesh Bureau of Statistics (BBS) and Bangladesh Bank data.

Note: Average lending rate is shown in the right vertical axis.

Table 1: Selected Indicators of the Banking Sector in Bangladesh

(in Per cent)

Bank Type	FY2005			FY2015		
	CAR	Gross NPL Ratio	Interest Rate Spread (Overall)	CAR	Gross NPL Ratio	Interest Rate Spread (Overall)
State-owned banks	-0.84	24.37	5.14	4.88	21.89	3.65
Foreign banks	24.62	1.54	7.93	24.14	5.67	7.72
Private banks	9.45	7.76	5.25	11.84	8.25	5.12
All banks	7.08	15.79	5.31	10.27	9.67	4.87

Source: Author's compilations from the Bangladesh Bank data.

Table 1 shows, despite Bangladesh Bank's attempt to reinforce compliance with Basel II framework<sup>23</sup>, there is a huge variation in CARs and the NPLs amongst the various groups of commercial banks. The comparatively better performance in these indicators by the foreign banks is allowing them, in the current milieu, to maintain a higher interest rate spread. The interest rate spread has declined somewhat, but is still high, and is often attributed to loan defaults (and scams), but also to alleged 'collusive, oligopolistic fixing of lending rates.'<sup>24</sup> Some of these factors are linked to political and vested interests and serious governance deficits, which negate the initiatives to bring financial institutions towards best-practice standards.<sup>25</sup> Currently, the turmoil in the banking and financial sector, unless quickly brought under control, could potentially increase exposure to investment risks.

Based on the findings above, the monetary policy of Bangladesh, under the current trends in price stability and low inflation volatility, is well-positioned to focus on its other mandate, i.e. facilitating

<sup>23</sup>Since the introduction of the Basel II framework in 2009, there has been greater accountability and risk resilience capacity in the sector; but there is still need for closer enforcement to curb loan defaults and government interferences that impairs the risk management culture. Capital adequacy is still below BASEL III requirements for some banks, and the prospects of full BASEL III implementation by 2019 seem bleak.

<sup>24</sup>See Islam (2012).

<sup>25</sup>See Habib et al. (2017); in the recent past the financial and banking sector has been jolted by a series of scams and fraudulent practices.



investment and inclusive growth, with a focus on employment. There are sufficient reasons to argue in favour of pursuing, albeit with caution, an expansionary policy, in a milieu of substantial slack in the labour market that would tend to boost aggregate demand and job generation. Apart from the regulatory and other measures to further curb lending rates (which is being subverted by many non-economic forces), and bring in greater investor confidence, there is a need to mobilise resources (domestic savings), and to introduce various other incentive measures to boost private investment, e.g. credit flows to the private sector<sup>26</sup>, and incentives to broad-base the distribution of credit.

## 5. FINANCIAL SECTOR DEVELOPMENT AND FINANCIAL INCLUSION

A strong financial system and an appropriate financial infrastructure are essential to sustain price stability, encourage savings and investment, and foster growth and job creation. In the past two decades, despite the drawbacks as mentioned, the financial sector has managed to cope with the needs of a growing economy, such as through mobilisation of savings and credit growth to the private sector. Similarly, one observes a substantial growth in M2, which is higher than many countries with similar per capita GDP. Table 2 provides a trend picture of the key indicators of financial sector deepening in Bangladesh.

**Table 2: Growth of Financial Sector Deepening Indicators**

(in Per cent)

Indicator	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17
M2	16.7	19.3	17.1	17.6	19.2	22.4	21.3	17.4	16.7	16.1	12.4	16.3	10.9
Private sector credit	16.8	18.1	15.0	24.9	14.6	24.2	25.8	19.7	10.8	12.3	13.2	16.8	15.7
Domestic credit	17.4	19.9	14.4	21.0	16.1	17.8	27.5	19.5	11.0	11.6	10.0	14.2	11.2

Source: Author's calculations from the Bangladesh Bank data.

While the pace of financial sector deepening has to be stepped up for financial resource mobilisation and credit utilisation by the private sector, there are several other issues that the financial system needs to address in order to promote growth and social inclusion. The financial system is rather fragmented and consists of formal and informal entities, the latter being outside the regulatory framework. The formal sector financial system includes the banks, the non-bank financial institutions, the insurance companies, and extends to the regulation of the money and capital markets. There are a few so called semi-formal financial institutions, such as the Palli Karma-Sahayak Foundation (PKSF), Grameen Bank and the cooperatives.

The formal sector which also includes a large number of licensed microfinance institutions (MFIs), has a rather skewed credit distribution structure. With excess liquidity in most banks, there is too much credit chasing a few large clients, and credit is concentrated in a few selected sectors, e.g. RMG and textiles, and in the corporate sector. A significant dimension in the development of the financial structures toward greater inclusion and participation would be the broadening of the lending base, and diversification of credit allocation. Within the formal financial structure, the MFIs play an important role in the extension of microcredit to the poor and underserved. It may be noted that, Bangladesh has played a pioneering role in advancing the role of microcredit-lending and the processes of financial inclusion.<sup>27</sup>

<sup>26</sup>See MPS of January—June, 2018 (Bangladesh Bank, 2018), which has put restraints on private sector credit growth.

<sup>27</sup>Grameen Bank, BRAC and Proshika in Bangladesh, have been globally recognised as prominent and effective initiatives of financial inclusion, that support poorer people, through access to resources/opportunities and financial choices, to strengthen their efforts for a better livelihood, and enhance individual capabilities. These models have been replicated in several other developing countries of the world.



**Table 3: Microfinance Sector of Bangladesh**

Particular	June 2010	June 2011	June 2012	June 2013	June 2014	June 2015	June 2016
Number of licensed NGO-MFIs	516	576	590	649	742 (cancelled 45)	753 (cancelled 56)	758 (cancelled 78)
Number of clients (million)	25.3	26.1	24.6	24.6	25.1	26.0	27.8
Total borrowers (million)	19.2	20.7	19.3	19.3	19.4	20.4	23.3
Amount of outstanding loans (billion BDT)	145.0	173.8	211.3	257.0	282.2	352.4	459.4
Amount of savings (billion BDT)	51.4	63.3	75.3	94.0	107.0	135.4	171.2

Source: Microcredit Regulatory Authority (2010–2016).

Note: NGO: Non-government organisation; BDT: Bangladeshi Taka.

While these financial inclusion institutions and initiatives have played a significant role in Bangladesh, especially during the peak of poverty incidence of the 1970s and 1980s, there has been criticism in the recent years on their performance (Table 3) as well as on the growing disconnect, between ‘social inclusion’ objectives and interests of the lending institutions. Nevertheless, the MFIs have spread and deepened the concept of financial inclusion.

Financial inclusion is currently being vigorously pursued in Bangladesh—not only to alleviate poverty, but also to extend credit and financial freedom to the poor and vulnerable, especially under the existing credit market imperfections. Apart from the MFIs that exist within the Microcredit Regulatory Authority (MRA) framework, there are numerous other informal microcredit institutions and lending entities, whose operations are designed to address the needs of the vulnerable and those who are usually excluded from access to formal sector credit.

The renewed financial inclusion drive, under the supervision of the Bangladesh Bank and conducted both through the existing formal banking network as well as through new forms of micro-lending and mobile lending, is poised to attain several objectives: (i) financial institutions can be a significant contributor to the objective of inclusive growth (by extending credit and financial services to the underserved populations and regions of the country); (ii) financial institutions are likely to develop and deepen the financial sector by strengthening and extending institutions to non-traditional sectors and regions, especially in the rural areas; (iii) these institutions, especially through ‘directed’ lending to agricultural production, would tend to ease supply constraints, which would support measures to curb food inflation and sustain price stability. In the above scenario, the financial inclusion initiatives intend to go beyond the simple social profitability context of MFIs, and are defined as being under supervision of official authorities.<sup>28</sup> The intended objectives are to ensure greater access to finance for the underserved population that would invest in productive activities and diversification, and help to extend the structures of financial services that would potentially allow greater mobilisation of savings. Among the more recent financial inclusion initiatives, the following are noteworthy:

- Agriculture sector credit policy, including ‘directed lending’ by encouraging all commercial banks to extend lending to the sector with subsidies support from Bangladesh Bank’s refinancing schemes;

<sup>28</sup>For example, banks and financial institutions are supervised by the Bangladesh Bank; MFIs are supervised by the MRA; so on and so forth.

- A credit programme for share-croppers, enabling more than half a million of this vulnerable group, to receive credit through a special finance facility;
- ‘Ten Taka account’ for farmers, which is a novel initiative to facilitate the opening of bank accounts for hitherto unbanked poor farmers, wage labourers and other vulnerable groups (with as small a deposit as 10 Taka), and which can be used by the accountholders as savings and payments medium, as well as to receive various input subsidies and social safety net payments from the government;
- Stepped up lending to small and medium enterprises (SMEs), by the commercial banks and financial institutions, through ‘refinancing’ incentives, especially to support small businesses, women entrepreneurs and backward regions;
- Mobile banking, which under a surge in demand for mobile financial services, has led to the extension of mobile banking licenses to several banks, e.g. BRAC Bank’s subsidiary, bKash. These are rapidly expanding their services throughout the country (Table 4).

The above financial inclusion initiatives, through greater reach and depth, are likely to strengthen the foundations of the banking and the financial system as a whole, within a common framework of prudential regulations.

**Table 4: Comparative Summary of Mobile Financial Services**

Description	June 2013	June 2014	June 2015	June 2016	June 2017
Number of banks in the services	18	20	20	18	17
Number of agents	99582	414170	538170	604418	758570
Number of registered clients (lakh)	66	167	286	362	537
Number of active accounts (lakh)	26	67	122	133	274
Number of total transactions	17603660	44015721	96159303	124530380	181932951
Total transaction amount (crore BDT)	4206	8523	12970	23151	30009
Number of daily average transactions	586786	1467191	3205310	4151013	6064432
Average daily transaction amount (crore BDT)	140	284	432	772	1000

Source: Author’s compilations from the Bangladesh Bank data.

Unlike the microcredit campaign of the MFIs, the current financial inclusion initiatives are likely to impart impulses to the growth of productivity and structural changes, through its multipronged credit advances to productive sectors and economic diversification.

Financial inclusion, in Bangladesh, is emerging as a crucial cornerstone of inclusive growth. It has the potential—not only to reach the most vulnerable and poor in the financial system, but also to engage them in productive activities, and thereby helping them to ‘work’ out of poverty.<sup>29</sup> There are studies to suggest that financial inclusion also helps in an economy’s effort to reduce inequality.<sup>30</sup> The financial inclusion initiatives, as observed above, have been increasingly supporting the expansion of financial services to the poor and vulnerable, largely in the rural areas.

Despite the expanded operations of the financial systems to enable greater access to credit and financial services, a large proportion of the population still do not have access to credit. According to a 2014 survey of the Institute of Microfinance (InM), while microcredit finance market plays a significant role

<sup>29</sup>“Inclusive finance—safe savings, appropriately designed loans for poor and low-income households and for micro-, small- and medium-sized enterprises, and appropriate insurance and payments services—can help people help themselves to increase incomes, acquire capital, manage risk and work their way out of poverty” (UN, 2006, 7).

<sup>30</sup>See, for example, Beck and Demirgüç-Kunt (2008).

in providing credit and financial services, there is still a nationally representative 46 per cent, who do not have access to credit (Akter, 2016). While the formal financial structure purports to foster growth, structural diversification and job creation, and thus contributes to inclusion, the formal institutions would also need to step up the development of an inclusive financial system. Such a system needs to be thoroughly reviewed and alternatives explored, on how the formal financial system could extend and interact services that are being enabled by financial institutions and other non-formal credit institutions. This would then reinforce a widened lending base, further expand access to credit and other financial services (such as deposit and savings, insurance and payments), to less banked regions, groups (women, marginal farmers), and serve to pursue the SDG 2030 Agenda.

There are other considerations too. With too many banks competing for too few sectors/clients in urban areas, the ‘rural connect’ is emerging as a significant avenue to diversify their lending portfolios. The critical issues for normal banking would relate to how to minimise operational and credit risks, and reduce delivery costs. In this regard, the private commercial banks (PCBs), are engaged in evolving strategies that would advance the rural connect to extend normal banking approaches—particularly to support the smaller businesses and the missing-middle, and thereby address the existing credit market imperfections.

Further approaches, strategies and credit lines need to evolve to widen and integrate financial segments, both in urban and rural areas, and formal and informal. Currently, there is a majority of bank branches in rural areas, but this accounts for a small fraction of total advances.<sup>31</sup> Initiatives, mentioned above would help to reduce such imbalances in lending portfolios and credit allocation, and extend support to inclusive growth. Further, the rapid introduction of digital technology in the banking system, such as mobile banking, e-banking, modernisation of payment systems, regulations, guidelines and supervision—are likely to bring about greater transparency and accountability, and a reduction in the costs of delivery of financial services. It would be interesting to see how the government, in a broader monetary policy framework, develops appropriate institutional and regulatory framework to provide new intermediation initiatives between bank profitability and financial inclusion.

## **6. FISCAL POLICY, EMPLOYMENT AND SOCIAL INCLUSION**

### **6.1 Bangladesh’s Fiscal Position: Issues and Reflections**

Balancing the budget and keeping deficit low as a principle, is always a critical consideration in maintaining price stability. Severe and unsustainable government debts can often lead to monetary policy interventions, raise interest rates, and cause market uncertainties. On the one hand, such a ‘fiscal dominance’ situation is as undesirable as extreme forms of fiscal consolidation; on the other, a country may resort to this order to return rapidly to low fiscal deficits.<sup>32</sup> Fiscal deficit and overall debt—GDP ratio, of course, vary in size from country to country, and the burden of fiscal responsibility<sup>33</sup> would depend on how well an individual country copes with its debt sustainability. In this context, it may be noted that, there are combinations of policy choices and policy instruments that can be used in attaining fiscal balances, but which can have different secondary outcomes.

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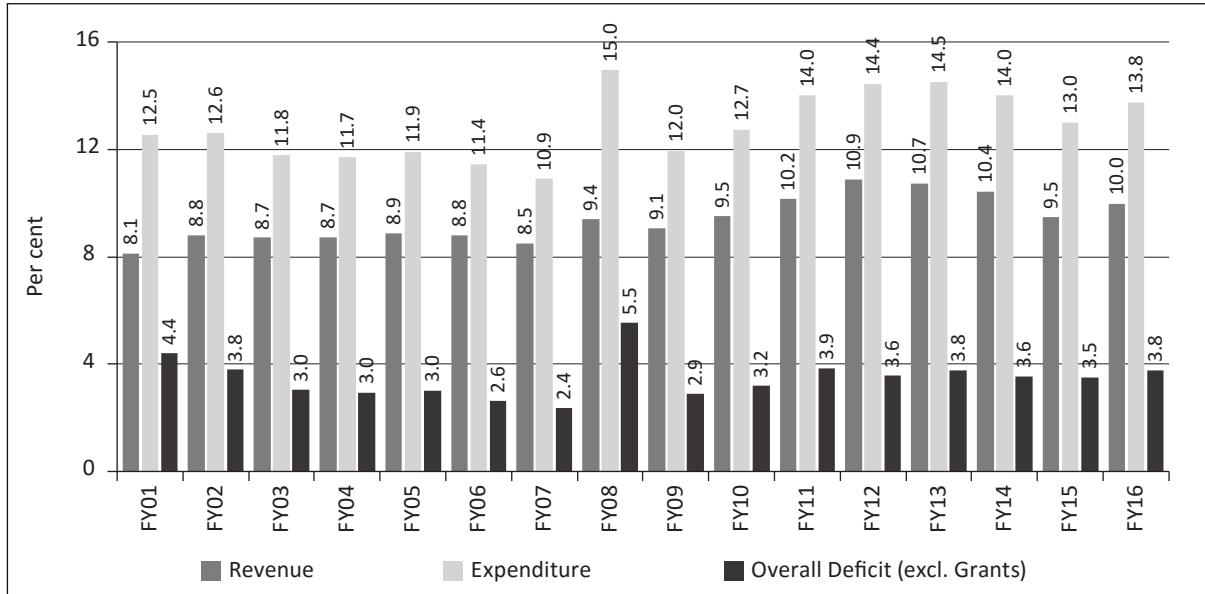
<sup>31</sup>See Chowdhury and Islam (2012).

<sup>32</sup>The debate on fiscal consolidation has ruled over much of the past two decades, especially in the European Union (EU), and intensified, as debt—GDP ratio continued to increase in a milieu of slow growth and rising unemployment.

<sup>33</sup>In this regard, one may note that, a large number of countries, both in developed and developing countries, have adopted ‘fiscal rules’ with specified numerical thresholds related to revenues, expenditures, budget balance and debts. The rules are often statutory, and some countries have established Fiscal Responsibility Councils to monitor compliance with statutes. It is interesting to review the Consultation IV Reports of the International Monetary Fund (IMF) for these countries. See IMF (2017).

Bangladesh is not among the 96 countries where the fiscal rules are currently in vogue.<sup>34</sup> Instead, the country has been establishing its fiscal and public spending accountability through various processes such as greater transparencies and better oversight in the public expenditure reviews and budget formulation.<sup>35</sup> Given that Bangladesh has maintained a relatively low budget deficit for a prolonged period, Bangladesh has not yet confronted the urgency of introducing fiscal rules and related statutory compulsions. Since FY2000-01, the deficit has hardly crossed 4 per cent, except in FY2007-08, when the economy resorted to selected stimulus measures to cope with the impact of the global financial crisis (GFC)<sup>36</sup> (Figure 10).

**Figure 10: Key Components of Fiscal Framework as Share of GDP**



Source: Author's calculations from the Ministry of Finance (MoF) data.

In a more recent year, i.e. FY2016-17, the deficit as share of GDP has once again risen to 5 per cent. In spite of an increase of 1.2 per cent in revenue—GDP ratio from the previous year, the deficit has increased due to enhanced current expenditure (of 2.4 per cent during the same period), largely on increases in pay and allowances, and in subsidies.<sup>37</sup> Such year-on-year fluctuation in fiscal deficit are not a cause of alarm, unless there is a trend in rise in price and/or debt—GDP ratio, which is stable and well below the widely accepted standard of 40 per cent. Further, the foreign reserves (currently equivalent to more than six months of imports) and a current account surplus provide a comfortable cushion.

Nevertheless, Bangladesh's fiscal situation is in some ways at a crossroads: it has a controlled fiscal deficit position, but in a low revenue expenditure equilibrium. Fiscal deficit is deemed to be low and stable, thereby supporting the overall macroeconomic stability of the economy. On the other hand, as Bangladesh moves towards its desired middle-income status by 2021, such a 'comfortable' status quo of revenue and expenditure levels is unlikely to cope with the surge of development needs, especially with an anticipated demand for substantial infrastructure and imports. A commonly observed binding constraint facing Bangladesh, is its relatively low tax-base, and consequently a low revenue—GDP ratio that restricts the scope for expansionary expenditure policies. Besides, there are also several

<sup>34</sup> Varied fiscal rules exist in India, Pakistan and Sri Lanka, see IMF (2017).

<sup>35</sup> See World Bank (2015).

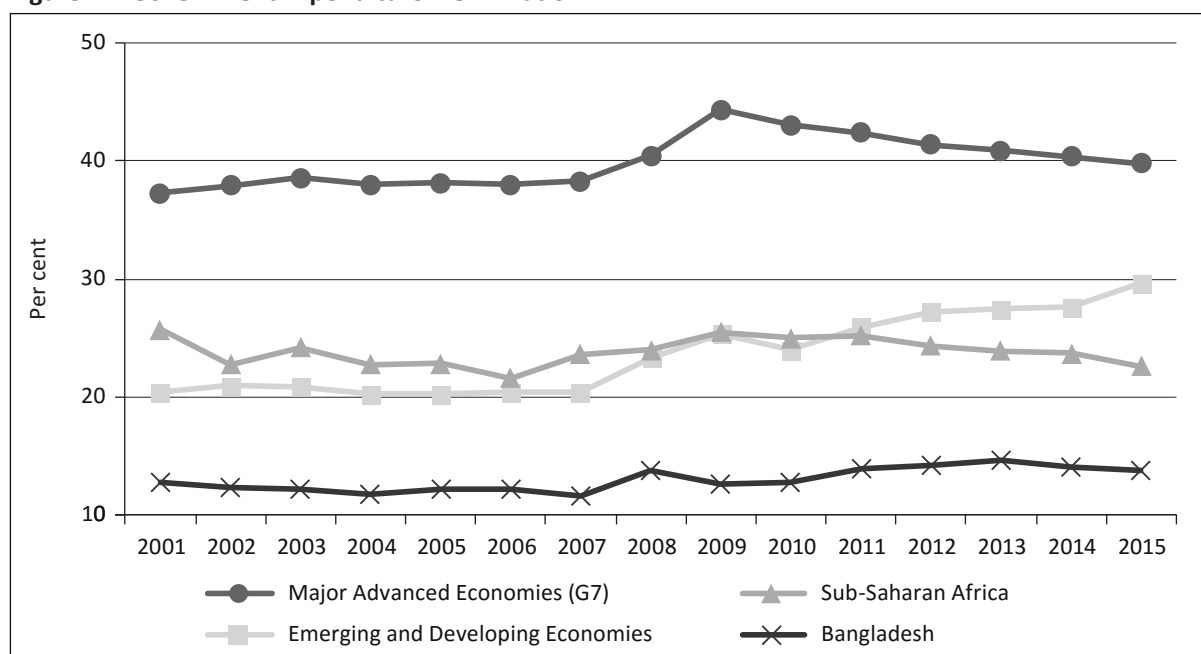
<sup>36</sup> See, for instance, Rahman et al. (2010) for a brief account of the impact of the crisis in Bangladesh, and some of the stimulus measures undertaken by the government.

<sup>37</sup> See World Bank (2017b).

sticky expenditures, e.g. wages, salaries and interest payments of the government that constitute a substantial part of the budget. It is likely that the burden of a continued consolidation or conservative fiscal regime, will be borne through restraints in social and capital expenditures.

Structural transformation and its association with shifts to higher income status, is not only manifest in changing sectoral shares of value-added and employment, but also in several other indicators. One such is the transformation in budget structures, especially in public expenditure patterns. The latter, as per cent of GDP, are above 40 per cent in major advanced economies and nearly 30 per cent in emerging economies, compared to about 13 per cent (FY2014-15) in Bangladesh. Even Sub-Saharan African countries, on an average, have an expenditure—GDP ratio of more than 20 per cent (Figure 11).

**Figure 11: Government Expenditure—GDP Ratio**



Source: Author's calculations from the International Monetary Fund (IMF) data.

Note: G7: Group of Seven.

## 6.2 Seeking an Expansion in Fiscal Space

In order to move towards the envisioned middle-income country status, and subsequently to become a UMIE by 2030, as well as to enhance social inclusion, in line with its commitment to achieve the SDGs, Bangladesh would require inter alia, an expanded fiscal space and budget flexibility:

- Since a prime objective of the fiscal policy is to ensure the stability of an economy, it is necessary to create a fiscal space to cushion impacts of cyclical downturns on aggregate demand.
- The substantial growth of GDP and incomes over the past two decades, and even higher projected growth, would put a high demand on infrastructure and public goods and services.<sup>38</sup>
- Towards social inclusion, a fiscal space and a proactive budget is required to pursue a strategic and robust public investment and expenditure policy to address market failures. These are also needed to support a range of employment-intensive sectors, various employment interventions (e.g. self-employment through microcredit lending), social safety net programmes (SSNPs) to support the massive proportion of vulnerable people in the rural areas, and other active labour market policies (ALMPs) to enhance skills and employability of the workforce. There is vigorous contention, from

<sup>38</sup>See, for example, Mansur (2014).

academics and policy researchers, that a more proactive fiscal policy would be necessary to yield better employment outcomes.<sup>39</sup>

Although a greater fiscal space is desirable for a dedicated strategy of inclusive growth, many of the basic social inclusion programmes can be accorded priority even without necessarily seeking big expansions in the budget. Such measure, according to Keynesians, may be necessary when an economy has to address high levels of unemployment and/or collapse in household incomes through fiscal stimulus, as Bangladesh resorted to in the aftermath of the GFC, during 2008-2009.

A fiscal space is as much about raising revenues and budget reallocations as shifting policy choices. Conservative macroeconomic reforms not only severely restrict fiscal deficits and the budget size, but also in many ways, influence the pattern of expenditures, both of which may adversely affect job growth and social welfare. The affected sectors in a restrictive framework are usually agriculture and social services, the very sectors that should provide the impetus and the human capital required for an inclusive growth. An overemphasis on fiscal deficits and a disregard for aligning fiscal instruments to the structural and social imperatives of the economy can lead to missing the potential influence of built-in tools of fiscal policy. In Bangladesh, which has a relatively strong fiscal position, and commitment to inclusive growth and structural diversification, the implications of pursuing a so-called 'credible' fiscal regime needs to be revisited.<sup>40</sup>

In view of the above, what are the likely fiscal options for Bangladesh's agenda for future inclusive growth, employment and structural transformation? While there is generally a growing consensus on, and advocacy of, the need for greater fiscal space and structural reforms, there is scarcely any review or assessment of: (i) the extent of the fiscal space that is needed; (ii) how such a space has to be created; (iii) an identification of the priority areas for which the fiscal space is required; or (iv) the nature of the structural reforms that would support future development, inclusion and employment goals. This would warrant a full review of the country's fiscal stance vis-à-vis its commitment to attaining the UMIE status, as well as the 2030 Agenda.

The current government planning towards increasing fiscal space and public spending, appears predominantly dependent on better administration and efficiency of the existing revenue expenditure system. It appears that, should the de facto fiscal rules remain strictly conservative as present, a fiscal space would largely come through higher growth (and hence, revenues) and/or revenue expenditure reforms; of course, through more concerted measures of revenue collection—e.g. widening tax-base, curbing tax evasion and enhancing administrative capacity, among others. It is beyond the scope of the present study to assess the growth of the various components of revenue sources that would create a higher revenue—GDP ratio, or their differential impacts on various income-groups. Nevertheless, based on current data and policy analysis, a few points are in order on seeking an expanded fiscal space.

First, the paradox, as stated earlier, of low debt levels coexisting with relatively low revenue expenditure levels would need to be firmly addressed, largely through raising revenue earnings. While there have been increasing contributions from income tax and value added tax (VAT) during the past decade and a half, the overall increase in revenue from these two sources, as per cent of GDP, is still very low, i.e. around 3.5 per cent and 4.2 per cent respectively (FY2014-15) (Ahmed, 2015). As observed earlier, revenue—GDP ratio in Bangladesh (around 11 per cent, see Figure 10) is still below that of its South Asian counterparts, along with many other developing countries with similar per capita income. The average revenue—GDP ratio for UMIE, which Bangladesh is expecting to attain by 2030, is 21.4 per

<sup>39</sup>Among many others, see Krugman (2005); Chowdhury and Islam (2012); on Bangladesh, see (CPD, 2017a; 2017b).

<sup>40</sup>See IMF (2017) on the exhortations for improving budget practices in Bangladesh.



cent (10.4 per cent in FY2013-14). Recently, there have been a number of measures and a major drive to boost revenue mobilisation. The National Board of Revenue (NBR) expects to raise its revenue earnings both through better coverage of the tax net, as well as through continuous reforms and consolidation of both the income tax and VAT systems.<sup>41</sup> The two sources are projected to account for about two-thirds of the incremental rise in revenue growth (FY2017-18). Nevertheless, both the sources have the potential to produce much greater yields, subject to further reforms and better tax administration. In terms of income tax and VAT yields, Bangladesh ranks among the lowest in South Asia (World Bank, 2012).

Second, the revenue raising process, and the instruments and legislations to do so, have differential impacts on efficiency and equity. Although tax revenues have, since FY2000-01, increased at appreciable rates (though from a low base), there are several studies that suggest that the current returns are far lower than the potential/predicted values.<sup>42</sup> There are many well-known factors that account for this. Effectively, there are the structural factors (large proportion of agriculture and informal sector population that characterise the small tax base), with less than 1 per cent of the country's population contributing to tax revenues.<sup>43</sup> The economy, and incomes of various groups have grown, but the tax base has not grown concomitantly. Moreover, there are many sources of income, especially held by the rich, on which taxes are low or exempted, while there are other concealed sources (e.g. widespread black money) that are often a root cause of corruption and rent-seeking. The corporate sector is relentlessly influencing the government to reduce corporate tax rates, to appropriate exemptions and subsidies, and to recapitalise bankrupt banks with taxpayers' money. On the other hand, the poorer and the salaried middle-income classes, who are likely to be disproportionately burdened with income taxes and VAT, do not have a similar lobby. The NBR has been attempting several reforms to raise revenues, but has been persistently falling short of attaining targets set for each budget year. Such reforms must remain sensitive to the impact and burden these may have on the poorer sections of the tax brackets.

Third, much more needs to be accomplished on establishing a far more efficient tax administration, and enforcement of reforms that enhance efficiency and transparency. Many of these issues are often an outcome of poor governance—which is characterised by deliberate leakages, lack of administrative capacity for tax collection, and fairly widespread rents earned through collusion and complicity. The current tax system accommodates exemptions and subsidies to various industries and/or groups (such as to the RMG and other export-oriented industries). While many of these could be worthy and can stand on merit for various considerations, these can equally lead to arbitrariness and biases. Legislations, policies and enforcement must be articulated to reflect transparency, uniformity and equity.

Fourth, while revenue mobilisation remains the key instrument in creating greater fiscal space, there are some elements on the expenditure side, whose relevance could be reviewed periodically, without political or administrative prejudices, and downsized if priorities were to shift. Such periodic reviews could release resources through switching expenditure priorities. Nevertheless, for several reasons cited above, total public expenditure in Bangladesh will need to expand to match the imperatives of higher growth, infrastructure development and social inclusion initiatives, e.g. the National Social Security System (NSSS). In this context, a serious lacuna lies with budget implementation itself, which has consistently fallen below targets, as has been observed with the Annual Development Programmes (ADPs); this occurs despite downward revision of expenditure targets caused inevitably by revenue shortfalls. The size of budget has been increasing in every successive year, while the rate

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<sup>41</sup>Over the past several years, there has been a consistent shortfall of revenue earnings from the government's projected targets (CPD, 2017b).

<sup>42</sup>Also see, for example, CPD (2017b) and Ahmed (2015).

<sup>43</sup>There is reportedly a recent rise in the number of taxpayers, from about 1.5 million to 3.3 million.

**Table 5: Budget Implementation in Bangladesh: A Comparative Picture***(in Per cent)*

Component	2015				2016			
	India	Vietnam	Uganda	Bangladesh	India	Vietnam	Uganda	Bangladesh
Revenue mobilisation	92.6	101.8	99.7	78.7	104.7	102.4	98.1	83.0
Development expenditure	80.5	104.2	87.2	73.0	155.8	102.4	83.0	74.7
Total expenditure	92.7	101.1	89.3	78.8	100.7	101.8	90.3	79.4

Source: CPD (2017b).

of implementation has fallen constantly below targets. Table 5 compares Bangladesh's performance in terms of various budget implementation components.

Fifth, the other common options in creating a fiscal space besides via additional resource mobilisation and switching expenditure priorities, are official development assistances (ODA) and public borrowings (all these sources together are often encapsulated as the 'fiscal diamond'). These options, which are available in different measure to the individual country, have their own costs and benefits, and need to be cautiously exercised.<sup>44</sup> The present study has reviewed the first two options above. ODAs have been low in general, and although foreign borrowing has recently started increasing, its relative share in total borrowing has declined. Foreign borrowing currently constitutes about 16 per cent of total debt financing.

Public investment (currently at 7.5 per cent) will need to complement a flailing private investment to reach the 8 per cent growth target of the 7FYP, to achieve the proposed high growth path to UMIE by 2030, as well as to realise multiple SDGs. This would likely imply higher public borrowing. Table 6 points to some features of financing the budget deficit in Bangladesh: share of domestic borrowing has gone up to 82.2 per cent in FY2014-15 from 72.4 per cent in FY2009-10; of this, the non-bank borrowing constitutes nearly 73 per cent of total domestic borrowing. In Bangladesh, public borrowing especially from the banks and financial institutions, has remained fairly restrained. As was observed

**Table 6: Financing of Budget Deficit***(Crore Taka)*

Source of Financing	FY2010	Share in FY2010 (%)	FY2015	Share in FY2015 (%)	Average Annual Growth FY2010—FY2015 (%)
Foreign borrowing (net)	6036	27.6	9179	17.8	8.7
Foreign borrowing	11004	50.3	13789	26.8	
Amortisation	-4968	22.7	-4610	8.9	
Domestic borrowing	15819	72.4	42366	82.2	21.8
Borrowing from banking system (net)	-2092	9.6	4893	9.5	
<i>Long-term debt (net)</i>	5769	26.4	11898	23.1	15.6
<i>Short-term debt (net)</i>	-7861	36.0	-7005	13.6	
Non-bank borrowing (net)	17912	82.0	37473	72.7	15.9
<i>National savings schemes (net)</i>	11699	53.5	28686	55.7	19.6
<i>Others</i>	6213	28.4	8787	17.0	7.2
<b>Total financing</b>	<b>21855</b>	<b>100.0</b>	<b>51545</b>	<b>100.0</b>	<b>18.7</b>

Source: Author's calculations based on MoF (2011; 2016).

<sup>44</sup>See Harasty et al. (forthcoming).



earlier, banking contributes approximately a third of domestic financing, the rest accruing largely from sale of government's NSCs. The recent increase of domestic financing of deficit via sale of high-interest-bearing NSCs, has given rise to various concerns<sup>45</sup>, especially that it could potentially threaten the interest and liquidity position of the economy. Bangladesh will need to reassess the growth of borrowing, domestic or foreign, through bank or non-bank sources, and recalibrate its deficits and debt sustainability.

It is not certain, whether the pace at which such a fiscal space will be augmented, could match the speed of expenditure and financing needs of a rapidly growing economy (IMF, 2017). In case higher public borrowing becomes necessary, much will depend on how these resources are raised, and how far these can be switched to capital expenditure, after accommodating rising current account expenditures.<sup>46</sup> Other options are being explored by Bangladesh to raise capital funds such as the sovereign wealth fund<sup>47</sup>, to accelerate structural transformation and aggregate demand. Since inflation and debts/deficits have been relatively low and stable over the past two decades, a measured fiscal expansion could be accommodated without exerting excessive pressure on the current debt discipline.<sup>48</sup>

### 6.3 A Budget for Social Inclusion

A progress towards social inclusion does not happen automatically via trickle down. A country's budget is among the key instruments that can lead and encourage such a progress. The present study does not make any attempt to design such a budget; rather, it indicates broad directions and priorities of an inclusionary budget. The budget is an outcome of multiple policy choices that effectively define an individual country's fiscal and public policy stance. The priorities in these choices and the programme measures that are adopted, would determine the size and composition of the budget. There exist powerful advocacies on the role of fiscal policy and empirical observations on the multiple ways, by which fiscal measures can influence employment and social inclusion outcomes. For instance, various fiscal measures can be further strengthened for: growth support, especially when there is underspending from non-government sectors (e.g. through increases in public investment), to generate growth and jobs; redistributive support (e.g. special employment schemes<sup>49</sup>); wage/employment subsidies; SSNPs and other allocations for supporting ALMPs via automatic stabilisers and discretionary fiscal measures); public provisions (e.g. on health, education and skills development).

The relationship between fiscal policy, growth, employment and inclusion is, however, more complex than the discussion above suggests. The impact of the changes in the size and composition of each of the fiscal elements, viz. fiscal expenditures, revenues, fiscal deficit and its financing, would have varying consequences for employment and access to opportunities and public provisions. Thus, it is necessary to review closely the factors that determine the size and composition of the budget in Bangladesh.

The need for a fiscal space, and measures to enhance it, would require closer scrutiny of not only the revenue—expenditure programme, but also greater efforts in linking budget allocations to priorities of inclusive growth. Table 7 shows the sectoral allocations and budget priorities in Bangladesh.

The table shows the current sectoral priorities, where defence and public order and safety together capture more budget resources (11.6 per cent) than either physical or social infrastructure expenditures.

<sup>45</sup>For example, the IMF (2017) estimates that the costs of budget borrowing has increased by between a quarter to half per cent of GDP.

<sup>46</sup>Krugman (2005).

<sup>47</sup>See previous discussion; also Ahmed (2015) and IMF (2017).

<sup>48</sup>It may be pertinent to recall the Keynesian contention that, if financed by borrowing, an increase in autonomous government expenditure—whether investment or consumption—would cause output to expand through a multiplier process, particularly when there are unemployed resources.

<sup>49</sup>See Bhaduri (2005), for a persuasive case of integrating employment-based programmes in budget planning.

**Table 7: Sectoral Allocation of National Budget in Bangladesh***(in Per cent)*

Sector	FY2005	FY2010	FY2015
Public services	26.0	32.8	32.8
Local government and rural development	8.6	7.7	7.1
Defence services	6.8	6.2	6.6
Public order and safety	4.5	5.6	5.0
Education and technology	13.7	12.7	13.1
Health	6.5	6.1	4.5
Social security and welfare	4.9	8.1	6.2
Housing	1.1	1.1	0.8
Recreation, culture and religious affairs	1.2	0.8	0.8
Fuel and energy	7.6	3.8	4.6
Agriculture	7.1	7.9	7.6
Industrial and economic services	1.0	0.8	1.2
Transport and communication	10.9	6.6	9.8
Total expenditure	100.0	100.0	100.0

Source: Author's calculations from MoF (n.d.a).

Note: The totals may not add to 100, due to rounding of errors.

Sectoral allocations are likely to change with shift in priorities. Existing allocation structure may not be consistent with the priorities of inclusive growth. This would require articulation in budget planning and design of the 'social inclusion' expenditure framework.

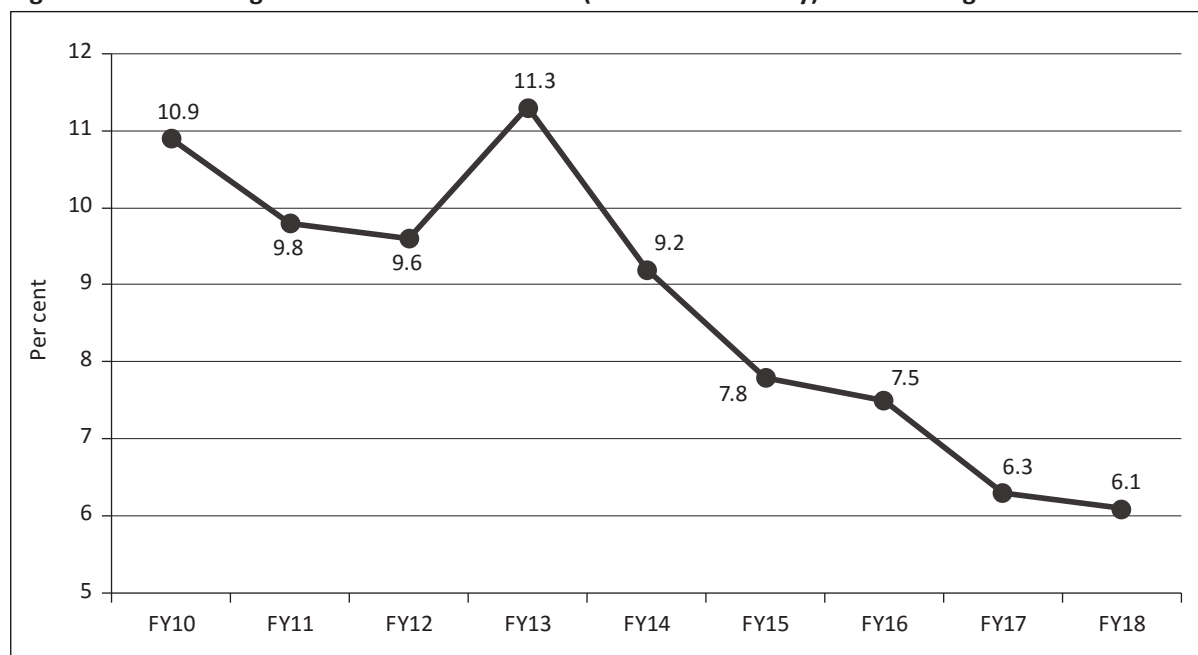
Foremost, sectoral expenditure prioritisation is significant. In particular, as mentioned previously, support to boosting job generation would be a crucial fiscal prerogative. Allocations to employment-friendly sectors are one such consideration. Among the many ways that fiscal instruments in Bangladesh have been used to promote inclusive growth, mention must be made of some sectoral measures; for example, those introduced to promote labour-intensive, export-oriented industrialisation (see Box 1).

#### **Box 1: Labour-intensive, Export-oriented Industrialisation: Fiscal Interventions**

The fiscal policy measures have a direct and immediate impact on promoting manufacturing growth. Successive governments took proactive fiscal policies under the broader economic liberalisation initiatives in order to induce the growth of the labour-intensive manufacturing sector. The main objective of the policies were to promote export-oriented industries by removing the anti-export bias in the economy. These policies had significant implications on growth and employment in Bangladesh. The policies included: duty-free access to imported inputs; reduction in tariff levels and number of tariff rates; streamlining and simplification of import procedures; provision for financial assistance on traditional exports; tax rebates on export earnings and concessionary duties on imported capital; accelerated depreciation allowance and excise fund refund on domestic raw materials and inputs; proportionate income tax rebates of at least 30 per cent on export earnings. Among the relevant policies undertaken since 2000, the following may be noted.

During FY2004-05, government took bold tariff measures for promoting the country's textiles sector as the backward linkage industries of the garments sector. It proposed reductions in the existing rates of duty on most of the raw materials and essential machinery and spares needed by this industry. Considering the importance of textiles industry as a backward linkage industry of RMG sector, which was under tremendous pressure at the advent of the Multi-Fibre Arrangement (MFA) phase out, the government proposed to reduce the income tax for the sector.

A comparison between FY2009-10 and FY2014-15 shows that there has been a perceptible increase in defence, whereas allocations in health, rural development, social development and welfare, and agriculture have declined (Table 7). In particular, a secular decline in allocations to agriculture (Figure 12) is a matter of concern. In fact, allocation to agriculture is now lower than that in the defence

**Figure 12: Share of Agriculture and Allied Sectors (other than Subsidy) in Total Budget**

Source: Author's compilations from budget documents (various years), Ministry of Finance (MoF), Government of Bangladesh (GoB).

Note: Revised budget figure used for FY2016-17; Budget figure used for FY2017-18.

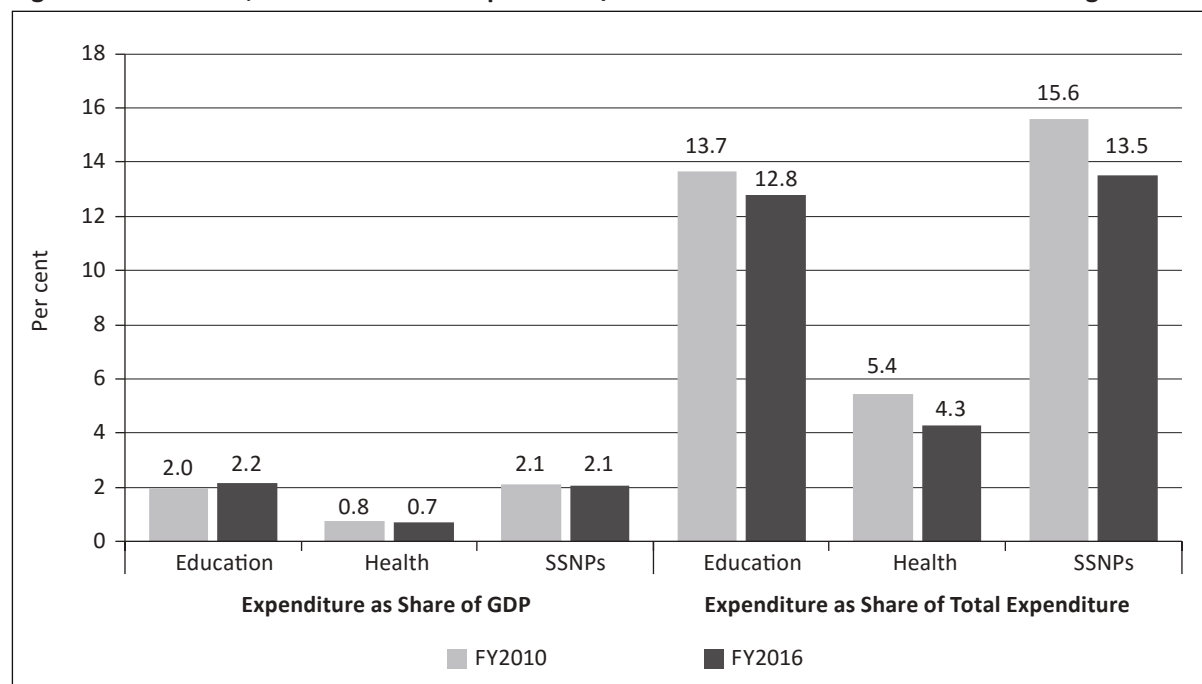
sector (in FY2016-17). Major allocations are needed in agriculture in order to raise technology, skills and input levels, which will ultimately contribute in the much-needed productivity enhancement of the sector. This would potentially raise the incomes of the vast majority of the households through both agricultural activities, as well as rural non-farm enterprises. Boosting jobs, wages/incomes and productivity in the agriculture sector through purposive fiscal interventions, is likely to be a significant impulse towards reducing poverty and inequality.

While sectoral allocations and fiscal incentives would need to be continuously reviewed to ensure higher potential growth, job generation and structural transformation—the budget on social sectors too, would need a reassessment to move ‘beyond a status quo budget.’<sup>50</sup> Figure 13 provides a context of such a review.

Expenditure as a percentage of GDP on education and health has been increasing in recent years, but their pace of increase is slower than planned increase for the respective years of the 7FYP. One may note that, while the 7FYP has a planned increase in the two sectors, the real per capita expenditure is tangibly lower than the nominal increase (CPD, 2017a). In fact, allocation to health has remained significantly lower than 1 per cent of GDP throughout the past several years, which is unlikely to pace up the much-needed public provisions on health, and the development of a national health system. The core programme of the sector, Health, Population and Nutrition Sector Development Programme (HPNSDP) 2011—2016, which had several targets under 40 indicators to be achieved by the terminal year, is far behind target.<sup>51</sup> Similarly, allocation for SSNPs, which is a crucial element in the gradual consolidation of the NSSS of the government, is a mere 2 per cent of GDP, much lower than that are observed in many Asian countries. While allocations to education and health have marginally increased, one has to note that, this increase in per capita terms (given the massive population base that needs coverage) can be paltry (Mahmud, 2002). In other words, the simple average per capita allocations do not reflect to what extent actual benefits impact at the household level (Mahmud,

<sup>50</sup>See CPD (2017a).

<sup>51</sup>Compare this to allocation to defence, which has been more than 1 per cent of GDP throughout the past decade.

**Figure 13: Education, Health and SSNP Expenditure/Allocation as Share of GDP and Total Budget**

Source: CPD (2017b).

2002). Despite high priority pledged to job generation, education, social protection and other social sectors, budgetary allocations and follow-up measures do not reflect the commitments convincingly.<sup>52</sup>

#### 6.4 Thinking Alternately

A budget for inclusive growth would need to go beyond simply social spending, and include an appropriate and accountable expenditure framework (perhaps in the same manner as the government is planning to achieve the SDG targets) that addresses various goals of inclusive growth. There are of course, many indicators and goals where the progress may be less perceptible, e.g. the reduction of income inequality, which has been increasing persistently over the past decade. Some of the social spending towards health, education, pensions and other transfers is intended to provide some palliatives, but would require vigorous initiatives to create more and better income-earning opportunities for the ‘bottom deciles’ of the population.

Analysts quite rightly point out that the expansion of efforts to mobilise resources, especially revenues, would be the ‘cornerstone’ of any pro-poor fiscal strategy.<sup>53</sup> In other words, a greater fiscal space has to be generated to address pro-poor programmes and targets. In the 7FYP, the government has, for the first time, recognised the need for a specific review of these issues to create fiscal space to address aspects of social inclusion, and has incorporated some budget reform measures (taking a combination of the revenue raising and reallocations route), especially to address an important component of inclusive growth, viz. the continuously rising inequality in the economy. The reforms include measures to increase allocations to education, health, social protection, and more importantly, to rural infrastructure. These allocations would help support programmes, if designed and implemented well, to increase jobs and income opportunities, especially in the rural areas. These would also significantly contribute to productivity and growth. The reallocations would come about from resources raised from ambitious targets of personal income taxes (additional 2.5 per cent of GDP), VAT (additional 1.8 per

<sup>52</sup>For instance with respect to budgets in Bangladesh, it appears, allocations for six ministries concerning social welfare and security, have gone through a generally declining trend, both as percentage of GDP and of total budget (CPD, 2017b).

<sup>53</sup>See, for example, Mahmud et al. (2008); also IMF (2017).

**Table 8: Reducing Income Inequality—Fiscal Proposals in 7FYP***(Per cent of GDP)*

Reform Measure	Base Year Values FY2015	Increase Over 5 Years	End-Year Values FY2020
Increase spending on education	2.2	0.8	3.0
Increase spending on health	0.8	0.4	1.2
Increase spending on social protection	2.0	0.3	2.3
Increase spending on rural infrastructure	2.0	1.0	3.0
<b>Total increase in social spending</b>	<b>2.5</b>		
<b>Financed by</b>			
Cutback on energy subsidy	2.0	-1.0	1.0
Increase in personal income tax	1.0	2.5	3.5
Increase in VAT	4.2	1.8	6.0
Increase in local government revenues	0.2	0.5	0.7
<b>Total financing</b>	<b>5.8</b>		

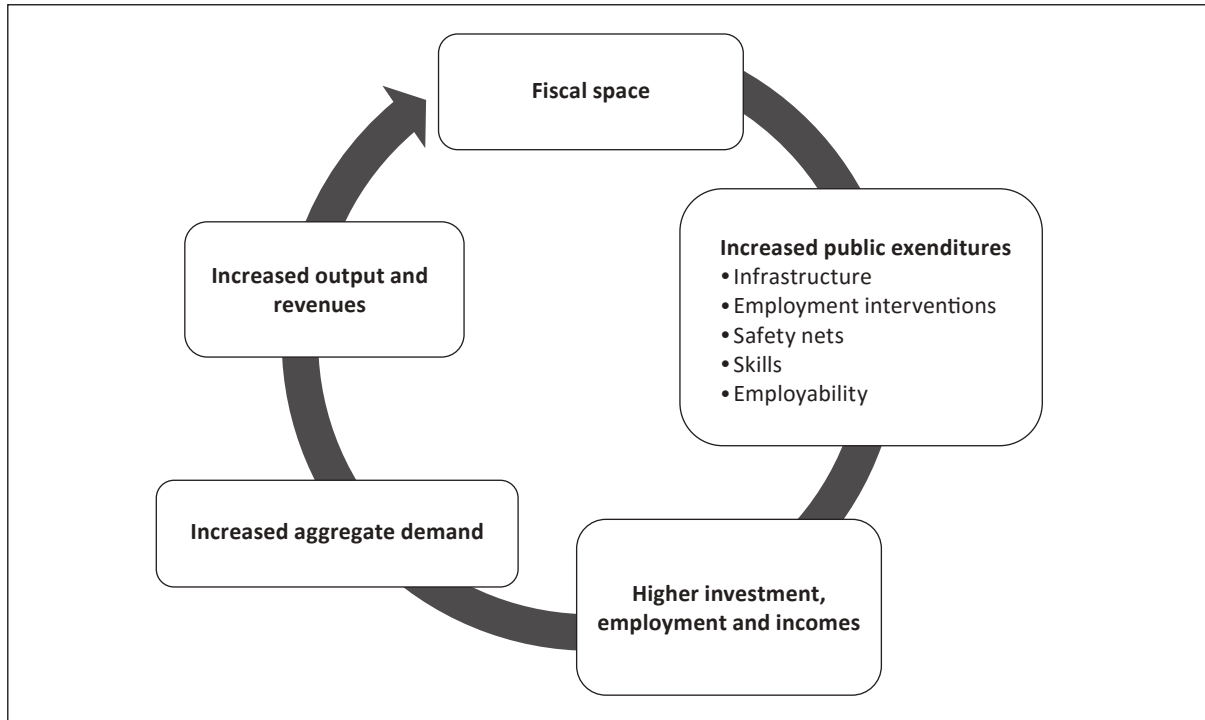
Source: Author's calculations from the Seventh Five Year Plan (7FYP) data.

cent of GDP), local government revenues, and further, from a 1 per cent reduction in energy subsidies (Table 8). Much will depend on whether these efforts to raise revenues and reprioritise expenditures can be duly accomplished. A study on an analysis of the annual budget for FY2017-18 (CPD, 2017a) shows that the revised budget FY2016-17 has already downsized both the revenue (from 12.4 per cent to 11.2 per cent) and expenditure (from 17.4 per cent to 16.2 per cent) targets by 1.2 per cent (CPD, 2017a). These will have implications for deficits, and how it will affect the ADPs, as well as the need for foreign financing. Further analysis and policy efforts are required to explore such expenditure switching, as mentioned in the 7FYP, to address priorities and concerns of inclusionary and equitable growth. As mentioned above, a fiscal space is essentially an exercise in policy choices. While raising additional resources will remain a distinct advantage, there are a number of empirical studies which show that such choices can be pursued significantly through budgetary reallocations on priorities.<sup>54</sup>

In Bangladesh, the focus appears to be on raising revenues and restraining fiscal expenditure in an accounting bind. There is hardly an assessment of the possibilities of mobilisation of resources on a broader front, such as through impacts on the real economy. One such effect can be through enhancing jobs and wages to create a greater fiscal space (Diagram 1). The prudent use of fiscal space can itself create further fiscal space. The spending on physical and social infrastructures (e.g. skills) are part of the structural reforms that would help boost private sector investment. The expansion of output and employment that is likely to be induced, can potentially trigger a virtuous cycle of higher fiscal space (via higher taxes and private consumption) and further rounds of structural reforms.

<sup>54</sup>Hoy and Sumner (2016), for example, carries out a detailed simulation exercise to show how large reductions in poverty (at different threshold levels) can be realised simply through reducing allocations on defence spending and subsidies to fossil fuels. The authors refer to these as 'public bads'. They also advocate a prudent taxing of the rich, to generate additional fiscal space.

**Diagram 1: Generating Fiscal Space through Real Economy Effects**



**Source:** Author’s perception.

**Note:** In order to pursue ‘inclusive growth’ and the SDGs, especially in the milieu of renewed vow to pursue the goal of full employment and decent work (SDG 8), public expenditures and public investment will need to be hugely stepped up. This would require, as argued above, to move out of the current low revenue—expenditure syndrome, though, as necessary, a targetted and well-calibrated fiscal expansion that would significantly boost the real economy through higher investment, employment and incomes.

## 7. EXTERNAL STABILITY, GROWTH AND JOBS

While external stability is crucial to sustaining domestic price stability, it is equally significant in promoting export competitiveness, export diversification and employment generation. The latter are strongly related to, and are important considerations in, the trade and industrialisation policy of Bangladesh. This section highlights the significance of external stability, within the macroeconomic policy framework, for promoting growth, export competitiveness and employment.

Along with achieving reasonable stability in inflation rates and budget deficits, Bangladesh has also experienced external stability during the past decade. It has had a current account surplus and a stable REER for most of the post-GFC period. A steady REER has been maintained to allow a conducive support to the growth of RMG exports, which account for the bulk of the country’s export earnings. Normally, a steady and competitive REER would, as observed in many countries, support trade expansion, employment and export diversification (Epstein, 2007). In Bangladesh, there has been a rapid rise in the RMG industry, which has also led to a significant growth of manufacturing employment. However, there has been far too little export diversification.

During FY2015-16, there have been a few adverse developments that have created an aberration in external stability. Owing to various factors, export earnings from RMG have shown a declining growth; remittances equivalent to about 27 per cent of foreign exchange earnings appear to have stalled, and been in declining trend; imports (of both food and non-food items) have surged.<sup>55</sup> This has been reflected in the recent depreciating value of the Bangladeshi Taka (BDT) against the United States

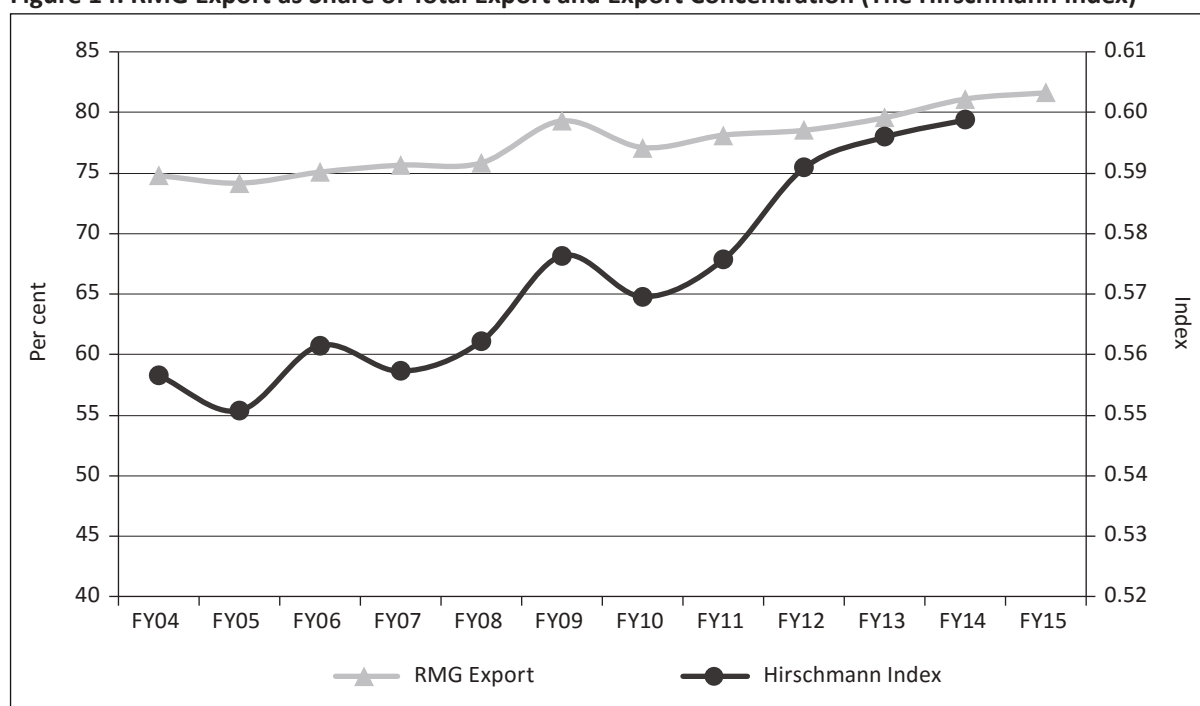
<sup>55</sup>In particular, imports of food (especially rice), fuel and construction materials have risen significantly during the recent past.

Dollar (USD), as well as other global currencies, which if unchecked, can potentially contribute to higher inflation.

Although the above challenges to stability may not be considered unusual in an economy which is growing, and which also faces frequent internal shocks (such as significant losses to agriculture/rural sector due to floods in 2016), these point to the need for a rethink of the long-term foundations of such stability and its interlinkages with domestic investment and structural transformation. Short-term measures, such as the Bangladesh Bank’s frequent interventions in the exchange market (under its ‘managed’ free-floating regime) may not always be adequate in smoothing exchange rate volatility and sustaining a steady REER. Much will depend on the extent of, and exposure to, risks that could potentially lead to major disruptions and a longer period of instability.

There are several potential challenges and risks. The present study points to one significant among these, i.e. the overwhelming dependence on RMG as the dominant source of export earnings. In fact, as Figure 14 shows, RMG exports constitute more than four-fifths of export earnings, and its share has been continuously increasing.

**Figure 14: RMG Export as Share of Total Export and Export Concentration (The Hirschmann Index)**



**Source:** Author’s calculations based on data from the Export Promotion Bureau (EPB), Bangladesh (available from: <http://epb.portal.gov.bd/site/files/51916ae6-a9a3-462e-a6bd-9ef074d835af/> - [accessed: 27 December 2017]); and Trade Map database, International Trade Centre (ITC) (available from: <https://www.trademap.org/Index.aspx> [accessed: 27 December 2017]).

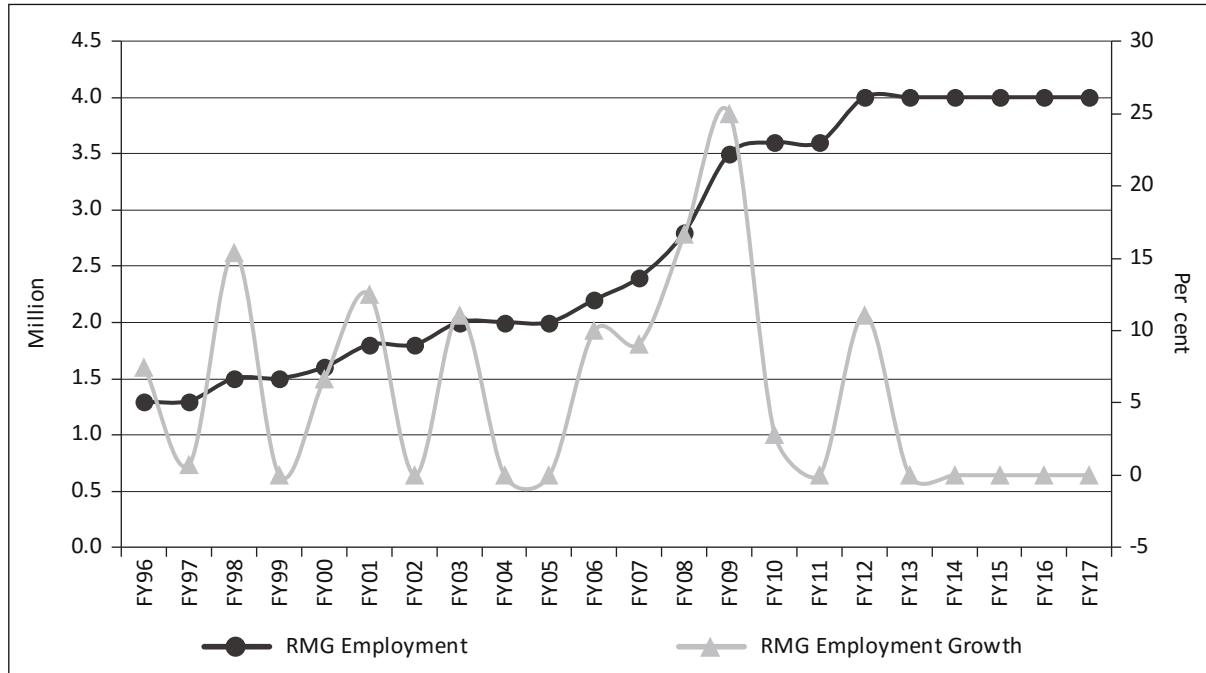
**Note:** Hirschmann Index is shown in the right vertical axis.

Its growth bodes well both for growth, jobs and capacity to import; but this also implies a sharply growing export concentration, as shown in the trend in Hirschmann Index in Figure 14. While according to the government and the Bangladesh Garment Manufacturers and Exporters Association (BGMEA), RMG is likely to maintain a growth momentum (13 per cent on an average during the 7FYP period), there are several issues that can affect such optimism:

- (i) With per capita GDP increasing at more than 5 per cent, real wages in the RMG sector are likely to rise, and erode the low labour cost factor as the dominant consideration in future growth projections of the sector. There is already a perceptible tendency towards use of labour-saving



Figure 15: Total Growth of Employment in RMG Sector



Source: Bangladesh Garment Manufacturers and Exporters Association (BGMEA).

Note: Growth of RMG employment is shown in the right vertical axis.

technologies by many RMG enterprises, to enhance productivity and reduce hiring costs. It may be noted that, the rate of registered employment growth has been falling distinctly during the past few years (Figure 15).

- (ii) Since the Rana Plaza tragedy, in which 1,132 RMG workers lost their lives, the industry as a whole has fiercely come under the global scanner, compelling firms to implement various compliance measures related to building and worker safety, and to broader working conditions, including rights at work.<sup>56</sup> These compliances, which are significant in promoting decent work, are likely to enhance costs considerably. These have started to affect the smaller firms in particular.
- (iii) Several other factors such as the pace of global demand for RMGs, and increasing competition from other countries (e.g. Cambodia, Vietnam, Ethiopia, India) to gain a greater share of the export market, can potentially slow down the growth of RMG exports from Bangladesh; and this could further reduce the growth and job-generating prospects of the sector.

The success in the rapid growth of the RMG sector over the past several decades, encouraged and supported by various policies and incentives, have also created a near-complete dependence on the sector for the economy’s export earnings. Several experts have emphasised that policy attention and incentives given to the sector have been highly biased, and have not been equally extended to other potential labour-intensive export-oriented industries.<sup>57</sup> Sustainability of the trade and external balance in the long-run, would thus, require a more diversified export structure. Currently, Bangladesh economy’s export capacity to cope with ever-growing import demands simply through the narrow RMG export base, would remain shaky and untenable. The backward-forward linkages to the RMG industry that could broad-base industrial growth and job creation—have been limited.

As stated earlier, there are several other factors that can ease the challenges to external stability. Among these is the role of remittances and foreign direct investments (FDIs). Remittances which are

<sup>56</sup>See European Commission (2017).

<sup>57</sup>There still remains anti-export biases and protection, which are restraining export potential of several industries. See Khan (2015); Ahmed (2015).



currently about 37 per cent of export earnings, have grown significantly over the past decade, and have helped to build up the foreign exchange reserves of the Bangladesh Bank. However, remittance earnings have been declining during the recent past. There are several factors beyond the scope of this study—that can cause uncertainties in sustaining a rising trend in remittances.

Further, FDIs, though rising, have not been as forthcoming into Bangladesh, as in some neighbouring countries, e.g. Cambodia or Vietnam. Although labour costs are still relatively low and attractive in Bangladesh, there have been less than satisfactory FDIs into the labour-intensive industries and other potential export sectors (for example, leather and leather-related industries received only 1.1 per cent of total net FDI in 2016, while this share was 3.3 per cent in 2017), nor has price and REER stability led to any substantial improvement in domestic investment. In other words, price stability and trade liberalisation measures have not been able to increase investment sufficiently. Such measures would need to be backed up by various structural measures. Bangladesh's competitiveness ranking has been improving recently (Table 9), having moved up from 106 to 99 in the Global Competitiveness Index. However, its position was lower than Sri Lanka (85); and considerably lower than India (40) or Vietnam (55).

**Table 9: Global Competitiveness Index Ranking of Selected Countries**

Country	2016-17 (Out of 138 Economies)	2017-18 (Out of 137 Economies)
Bangladesh	106	99
Cambodia	89	94
India	39	40
Nepal	98	88
Pakistan	122	115
Sri Lanka	71	85
Vietnam	60	55

Source: Author's compilations from WEF (2017).

There are thus several issues that have to be considered in developing a more resilient external stability. While in general, there has been a stable REER, which is necessary for the growth of exports and employment, this has not been sufficient to help diversification of exports in Bangladesh. Recent uncertainties with regard to remittances and RMG exports warrant that vigil needs to be exercised to cushion against possible shocks to REER. On a different development, in the recent past, access has been given to foreign borrowing by private firms on a limited scale, apparently to enhance private sector credit growth, as well as to put downward pressure on domestic rates. The effects of this move would need to be monitored very closely, in relation to how the borrowing firms perform, and how exchange rate fluctuations could affect repayments and a drawdown on foreign reserves. It would be naïve to ignore that Bangladesh will continue to face global shocks and uncertainties, for which the exchange rate regime exercises prudence over the management of its foreign reserves.<sup>58</sup>

Further, with regard to stimulating domestic investment and raising FDI, greater competitiveness would be necessary, which will be determined as much by a stable REER and low labour costs as raising labour productivity. The latter would depend on a host of factors, including easing of investment and infrastructure constraints, and a major attention to restructuring the low skills profile of the workforce for a highly competitive external market. In order to foster structural transformation and job creation, macroeconomic and structural reforms would need to be supportive of, and consistent with, an integrated strategy of industrial and trade diversification.

<sup>58</sup>The government has stalled its decision to give effect to the proposal to create a 'sovereign wealth fund', which would have had part of its foreign reserves directed to infrastructure development. While infrastructure development is critical to creating a basis for structural transformation, the use of the limited reserves would be risky unless the export-capacity-to-import is greatly stepped up.

## **8. CONCLUSIONS**

The broad objective of macroeconomic policy is to contribute to economic growth and social well-being in an equitable and sustainable manner. Bangladesh is committed to achieve the goals of the 2030 Agenda, which embody the pursuit of an equitable society through an inclusive growth strategy. A macroeconomic policy would need to spearhead such a strategy. In doing so, the study has argued that the overriding challenge of macroeconomic policy in Bangladesh would precisely be in giving effect to the dual mandate of achieving macroeconomic stability and inclusive growth, as mentioned in the MPS. At the risk of repetition, the first steps towards designing a macroeconomic policy framework for an inclusive growth would require, *inter alia*, a rethinking of a macroeconomic policy framework that goes beyond attaining ‘intermediate variables’ of stability, and focuses robustly on growth, employment and income (Stiglitz et al., 2006; Bhaduri, 2005). The challenges identified are—high and sustained growth and structural transformation to reach the UMIE status by 2031, reduction in continuously rising inequality, measures to deal with weak employment performance, addressing unacceptably high incidence of vulnerable population, among others. This would require strategic planning, including a more aggressive fiscal and monetary stance.

The present paper has reviewed the usual macroeconomic policy instruments, and their current practices in Bangladesh. Regarding monetary policy, it has been observed that Bangladesh has maintained a comfortable stretch of price stability, and inflation has been relatively low. Monetary instruments which have an imprecise control over inflation targets, have been complemented by low budget and current account deficits to help sustain low inflation.

One must note that, it would be difficult to get on to the much-anticipated higher growth path of achieving UMIE under the parameters that currently define existing stability conditions. This would involve, as the International Monetary Fund (IMF) suggests, ‘upgrading’ of macroeconomic practices to cope with various challenges. In the monetary sector, one such practice is the use of the market-determined ‘policy rate’. Despite various reforms undertaken to strengthen the banking and financial markets, the ‘policy rate’ (as understood in a developed money/financial market), cannot be applied since the ‘transmission mechanisms’ are very weak, and financial infrastructure is underdeveloped. This will require greater financial deepening, strengthening of credit and debit markets, and interbank transactions and integration.

Given the recent trends in price stability, the monetary policy needs to adjust its ‘inflation only’ priority, and focus equally forcefully on its employment/inclusive growth mandate. This would entail stimulations and incentives to enhance domestic savings and investment, and boost aggregate demand. Private investment in Bangladesh is relatively low compared to its Asian comparators who have achieved higher growth and structural transformation. Financial markets are not only weak, but also fraught with anomalies, unacceptably high loan defaults and outright scams, especially in the PCBs and SCBs, which have shaken investors’ confidence. This requires firm action to institute an efficient regulatory and accountable framework.

Financial sector deepening needs to factor in an inclusive financial structure, whereby access to credit markets can be extended to unbanked and underbanked population and regions, the ‘rural connect’ in particular. This would also help ease credit market imperfections and the skewed credit distribution, as currently exist. The financial inclusion initiatives would need to step up within a strategic policy and regulatory framework. Such opportunities and access to credit for the disadvantaged poor, the small farms and enterprises, if appropriately designed and expanded through a comprehensive MPS and regulations, can by itself be an important redistributive measure, which could reduce the transfers and fiscal burdens.

However, macroeconomic policies cannot, on their own, deliver desired employment and inclusion outcomes in the economy. Productive employment generation and state welfare are contingent on an integrated set of policies that would include various sectoral, labour market and institutional measures, which have to be incorporated in a dedicated budget. The present study has underscored the need for budget prioritisation, especially in a relatively low revenue—GDP ratio scenario, in order to yield greater fiscal space, and identified measures to pursue the government’s stated goals of growth and equality. The paper also underscores the need for a measured fiscal expansion, to step up public investment to complement the slow growth in private investment, as well as to meet the needs of UMIE growth-path through structural reforms and infrastructure development.

Fiscal policy is not only about financing development, but also a political statement of the government regarding its stance on the economic and social well-being of the people. Public policy and public expenditure will be critical for a more focused social inclusion, i.e. a budget for social inclusion through a closer review of priorities in both revenue and expenditure portfolios.

Closely linked to the above is the imperative of maintaining external stability. This is of paramount importance in not only maintaining low inflation, but also in enhancing competitiveness. Maintaining a steady REER is crucial to supporting employment through growth and diversification of exports.

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