Bangladesh Development Update

October 2016

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BANGLADESH DEVELOPMENT UPDATE

Sustained Development Progress

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Preface

The objective of this report is to update the Government of Bangladesh, think tanks and researchers, the general public as well as the Bank's senior management on the state of the economy, outlook, risks, progress on structural policy reforms and key challenges the economy is currently facing. The coverage includes developments in the real sector focusing on growth, inflation, and poverty; external sector developments focusing on the balance of payments, foreign exchange reserves and the exchange rate; fiscal developments focusing on revenue mobilization, public expenditures, and deficit financing; financial sector developments focusing on credit and interest rates; and monetary developments focusing on reserve money and broad money growth trends. This update also focuses on introducing carbon taxation in Bangladesh.

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Abbreviations and Acronyms

ADB	Asian Development Bank
ADP	Annual Development Plan
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BERC	Bangladesh Energy Regulatory Commission
BHEL	Bharat Heavy Electricals Limited
BIFPCL	Bangladesh-India Friendship Power Ltd. Company
BPC	Bangladesh Petroleum Corporation
BSTI	Bangladesh Standards and Testing Institution
CD	Customs Duty
CNG	Compressed Natural Gas
COP21	Conference of the Parties in Paris in 2015
DMRTD	Dhaka Mass Rapid Transit Development Project
DNCC	Dhaka North City Corporation
DSE	Dhaka Stock Exchange
EBA	Everything But Arms
ECNEC	Executive Committee of the National Economic Council
EEBL	Excelerate Energy Bangladesh Limited
EMDEs	Emerging Market Developing Economies
EPB	Export Promotion Bureau
EU	European Union
FAO	Food and Agriculture Organization
FBCCI	Federation of Bangladesh Chamber of Commerce and Industries
FDI	Foreign Direct Investment
FY	Fiscal Year
GBP	British Pound
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GNI	Gross National Income
GSM	Global System for Mobile communication

ICP	International Comparison Program
ICT	Information And Communications Technology
IMED	Implementation Monitoring Evaluation Division
INDC	Intended Nationally Determined Contributions
IPL	International Poverty Line
ISO	independent system operator
KSA	Kingdom of Saudi Arabia
LIBOR	London Interbank Offered Rate
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LPI	Logistics Performance Index
LPL	Lower Poverty Line
MDGs	Millennium Development Goals
MPS	Monetary Policy Statement
MW	Megawatts
MH	Million Hectares
MMT	Million Metric Tons
MSTPP	Moitri Super Thermal Power Project
MUSCCFPP	MW Ultra-Super Critical Coal-Fired Power Project
MW	Megawatts
NBR	National Board of Revenue
NDC	Nationally Determined Contribution
NER	Nominal Exchange Rate
NPL	Nonperforming Loan
NPR	Nominal Protection Rate
PBRL	Padma Bridge Rail Link

PD	Project Director	T-Bill	Treasury bill
PMB	Padma Multipurpose Bridge	TFP	Total Factor Productivity
PPF	Project Preparatory Fund	Tk	Taka
PPP	Purchasing Power Parity	TPP	Trans-Pacific Partnership
RD	Regulatory Duty	UAE	United Arab Emirates
RMG	Ready-Made Garments	UK	United Kingdom
RNPP	Nuclear Power Plant	USA	United States of America
ROA	Return on Assets	USD	United States Dollar
SCBs	State Owned Commercial Banks	USDA	United States Department of Agriculture
SD	Supplementary Duty	VAT	Value Added Tax
SDG	Sustainable Development Goals	WDI	World Development Indicators
SR	Saudi Riyal	WTO	World Trade Organization

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Executive Summary

This update introduces Bangladesh's new poverty numbers at $1.90 per capita per day in 2011 purchasing power parity (PPP) prices, followed by an account of recent economic development, the outlook, risks, and policy responses. The revised poverty rates are significantly lower, but follow the same downward historical trend seen when using the 2005 international extreme poverty line. Bangladesh can bring its extreme poverty rate down to nearly zero by 2030 either by accelerating GDP growth to 9 percent per year, or by maintaining its recent growth rate while taking steps to make growth more inclusive. Bangladesh is on track to sustaining its recent 6 plus percent growth in the near and medium-term, driven by exports and strong domestic demand. Security, financial and trade shocks are the main risks. The policy challenges are to boost productivity and private investment by reforming business regulations, addressing infrastructure and energy deficits and increasing the efficiency of financial intermediation. A special policy focus in this report is on introducing carbon taxation.

Poverty and Shared Prosperity

Based on the international extreme poverty line of $1.90 per person, per day, and the 2011 Purchasing Power Parity (PPP) conversion factors, the World Bank has revised the entire series of estimated poverty rates from 1991 to 2010 for Bangladesh.

The international extreme poverty line was updated in 2015 to reflect new price data, and while most countries reported updated statistics at that time, the World Bank did not apply the 2011 PPP for Bangladesh; rather it took extra steps to assess that the 2011 PPP accurately reflected the prices of goods for people in the country.

- The World Bank estimates the proportion of people living below an international extreme poverty line primarily to monitor global and regional poverty, to allow for comparisons between countries, and to track progress toward global goals to end extreme poverty set by the World Bank, the United Nations, and others. National poverty rates are the most appropriate for underpinning dialogue or targeting programs to reach the poorest in a country.

- *The number of poor in Bangladesh is much lower, but the historical trend is the same.* The extreme poverty rate at $1.90 (2011 PPPs) was 18.5 percent in 2010, which corresponds to around 28 million poor in that year, the latest year for which a household survey is available for Bangladesh. In contrast, the international extreme poverty rate measured at the old line of $1.25 per day (at 2005 PPPs) was 43.3 percent, which corresponds to an estimated 65.6 million extreme poor. Regardless of the line used, however, the declining trend of extreme poverty shows strong progress over the last 25 years.

- *The purchasing power of the Taka was much stronger than previously estimated.* The 2011 PPP conversion factor suggests that the Bangladesh taka's purchasing power relative to the US dollar in 2011 was much stronger than what the 2005 PPP conversion factor suggested (adjusted for inflation). As a result, Bangladesh's GDP and poverty statistics based on the 2011 PPPs show that Bangladesh is better off in USD terms than previously thought.

- *The international extreme poverty rates at $1.90 per day are more closely aligned with those of other countries in South Asia, as well as with Bangladesh's national lower poverty line.* According to the new estimate, Bangladesh is slightly better off than countries at a similar level of income, and the revised estimate is much more comparable to other countries in South Asia. Also, the international extreme poverty line is now much closer to the Bangladesh government's Lower Poverty Line.

Bangladesh fared reasonably well on sharing prosperity.

The poorest 40 percent of the population not only saw positive per capita consumption growth, but this grew 0.43 percentage points higher than the per capita consumption growth of the total population during 2005-10. Using this indicator, called the Shared Prosperity Premium, Bangladesh outperformed a number of countries in the South Asia Region (including India, Bhutan and Pakistan), but fell behind neighbors in East Asia such as China, Vietnam and Cambodia, where the income of the poorest people grew even faster than the average.

Ending extreme poverty in Bangladesh by 2030 will require faster growth that is far more inclusive.

If Bangladesh maintains the average real per capita growth and the pace of poverty reduction observed between 2005 and 2010, the extreme poverty rate in 2030 would fall to six percent. The average real GDP growth needed to achieve an extreme poverty rate of three percent by 2030 is around nine percent per year. If economic growth benefits more people, particularly the poor, sustaining the growth rate of recent years may be enough to get Bangladesh to three percent or less by 2030.

Recent Economic Developments

The economic growth rate was better than most

- GDP growth in FY16, provisionally estimated at 7.05 percent by the Bangladesh Bureau of Statistics, has been healthy despite slowing private investment and remittances.

developing countries, but not high enough to meet Bangladesh's 8 percent growth aspiration.

- Growth in agriculture is estimated to have been a decent 2.6 percent in FY16, driven by growth in non-crop agriculture. Rice production has stagnated, but minor food crops, livestock products and fish production have grown remarkably. Industrial growth is estimated at 10.1 percent in FY16, driven by growth in large and medium scale manufacturing and construction. Growth in the services sector increased from 5.8 percent in FY15 to 6.7 percent in FY16, largely reflecting an increase in estimated value added in public administration, education and health due to public sector wage increases.

- Exports have rebounded, driven by Ready-Made Garments (RMG) exports to the United States and the European Union. Although non-RMG exports growth also increased, the overall export basket remains predominantly RMG based. Remittances declined in FY16, driven entirely by a decline of inflows from Gulf Cooperation Council (GCC) countries, despite a significant increase in the number of Bangladeshi workers abroad. Progress on ease of doing business has been slow. Inadequate infrastructure, financial intermediation, bureaucratic inertia, and corruption continue to hinder domestic as well as foreign investment.

Inflation has slowed, benefitting from soft global commodity prices, but remains high relative to global rates and compared with competitors.

- Overall, the rate of inflation decreased to 5.9 percent in FY16 from 6.4 percent in FY15, the lowest rate in the last twelve years. Food inflation slowed from 6.7 percent in FY15 to 4.9 percent in FY16 due to a fall in international commodity prices and good rice harvests. Non-food inflation accelerated by 1.5 percentage points, from 6 percent in FY15 to 7.5 percent in FY16, mainly due to an increase in pay for government employees, hikes in electricity and gas tariffs, and a rise in the flow of credit to the private sector.

- After narrowing for several years, the urban-rural inflation difference widened in FY16. The impact of the increase in public sector wages, as well as rise in electricity and gas prices was greater in urban than rural areas.

The large surplus in the current and financial account has persisted, leading to further reserve accumulation and appreciation pressure on the nominal exchange rate.

- The current $31 billion level of reserves is equivalent to over 8.2 months of imports. Management of foreign exchange reserves is becoming increasingly challenging. Elevated reserves provide a comfortable cushion underpinning the exchange rate and foreign trade, but they can also lead to inflationary pressures, asset bubbles, and pressure for sterilization. The government needs to stimulate domestic investment, allow greater exchange rate flexibility, and, given a continued, steady surplus in the capital account, consider liberalizing the capital account. The latter would need to be gradual and cautious.

- Interventions by Bangladesh Bank (BB) kept the taka in check against the US dollar, but the real exchange rate has appreciated. The taka appreciated against the euro, pound-sterling, Indian and Pakistan rupees, and Chinese yuan in the 12 months ending August 2016. Combined with a large inflation differential with these countries, this has led to an 8.8 percent real appreciation of the taka from January 2015 to May 2016, thus challenging the competitiveness of Bangladeshi exports in global markets.

Monetary and fiscal policies have

- Interest rates have maintained their downward trend, but the financial sector continues to be plagued by falling profitability, rising NPLs and capital

remained prudent overall, but several outstanding structural issues need to be addressed.

inadequacy, particularly in state owned commercial banks. Large loan restructurings have so far failed to produce the intended results. Trading in the stock exchanges has stagnated.

- An accommodative monetary policy stance has been maintained overall, with some easing of the policy rates in the last half of FY16. This led to a large deviation of growth in reserve money (the monetary policy operating instrument) from the monetary program target. Excess liquidity continued to swell despite some pick up in the demand for credit in the private sector.

- A large revenue shortfall relative to the original budget led to an increase in the overall budget deficit, despite the usual undershooting of the Annual Development Plan (ADP) expenditure target. Domestic financing of the fiscal deficit nearly doubled, with excessive reliance on costly non-bank sources. Consequently, fiscal space has shrunk, despite a stable debt to GDP ratio.

Structural Reforms

Progress on structural reforms has been uneven.

- Positive developments include the setting of a new mechanism to review interest rates paid on savings instruments and their use in financing the budget as well as the approval in principle of a new power bill that enables the establishment of an independent system operator in a more coordinated manner.

- However, the implementation of the new VAT and Supplementary Duty Act 2012 has again been pushed back to July 2017.

Near- and Medium-Term Outlook

The near term outlook for Bangladesh is stable, driven by exports and strong domestic demand, and supported by prudent macroeconomic policies, continued improvements in infrastructure, and structural reforms.

- Real GDP is projected to grow at 6.8 percent in FY17, reflecting relatively weaker private consumption growth (5 percent) and government consumption growth (10.4 percent) relative to the preliminary estimates for FY16. Two critical road projects have recently been completed, which, if managed well, will contribute significantly to reducing travel time and transport costs, boosting productivity and trade.

- The overall fiscal framework underpinning the FY17 Budget is prudent, with sustainable deficit and debt levels and an improved composition of spending. However, the revenue targets are aspirational, while the size of the ADP is large in relation to the government's ability to spend and implement. The monetary policy stance for FY17 is not ambitious enough to reduce the inflation rate in line with competing countries.

Challenges

Risks to the outlook are predominantly domestic and weighted to the downside.

- Domestic risks to growth and the fiscal position include setbacks in implementing reforms affecting the allocation of labor, land and capital, such as the removal of impediments to increasing productivity. Security, financial and trade shocks are also key risks. In addition to focusing global attention on how prone Bangladesh is to terrorism, the materialization of security risks could jeopardize the steady economic progress of recent years. Continued weakness in the state-owned banks could undermine growth prospects and affect fiscal sustainability, as would further delays in launching the new Value Added Tax (VAT).

- External risks include weaker-than-expected global trade and an unexpected tightening of global financing conditions. The medium-term impact of Brexit, will likely center on trade, as the UK represents the third largest export destination for Bangladesh after the United States and Germany. The depreciation of the pound as well as the euro risks eroding the competitiveness of Bangladeshi exports to these markets. With currencies having stabilized at this weaker level, it is unlikely that both of these currencies will go back to their pre-Brexit levels in the medium term. If the ongoing fiscal consolidation in GCC countries is sharper than expected, remittance flows could slow sharply.

Policy Responses

The challenge is to boost productivity and private investment by reforming business regulations, mitigating infrastructure and energy deficiencies, and enhancing the efficiency of financial intermediation.

- Room for expansionary macroeconomic policies is limited because of structural constraints on the supply side.

- Greater investment in infrastructure, productivity enhancing technology, and human capital, combined with reforms to enhance financial intermediation efficiency, could lay the foundation for stronger growth. In addition, addressing energy bottlenecks remains critical for sustaining Bangladesh's long term growth.

- Finally, Bangladesh needs to address areas of fiscal vulnerability. Carbon taxes could be very positive for Bangladesh. Given the potential benefits, and their ability to help mitigate risk, Bangladesh should consider implementing a carbon tax and continue its path toward being a global leader in environmentally sustainable development.

A. Trends in Poverty and Shared Prosperity

This section reports Bangladesh's poverty reduction results using the international extreme poverty line of $1.90 per person per day and progress in promoting growth among the poorest 40 percent of its citizens. The World Bank did not report poverty numbers at the $1.90 international extreme poverty line for Bangladesh in October 2015, when the updated line was adopted globally, but chose instead to do additional research to ensure that the 2011 Purchasing Power Parity (PPP) exchange rates were an accurate reflection of the prices of goods in Bangladesh. The revised series of poverty rates are found to be significantly lower, such that the divergence between the number of extreme poor based on the national Lower Poverty Line (LPL) and the international extreme poverty line has nearly disappeared. Bangladesh can end extreme poverty by 2030 either by accelerating GDP growth to 9 percent per year or by taking steps to make existing growth more inclusive.

Global monitoring of extreme poverty has been measured by the proportion of people living below an international poverty line. In October 2015,[1] the international poverty line was updated from $1.25 a day at 2005 PPPs to $1.90 a day at 2011 PPPs for most countries. Bangladesh was one of five countries which retained the $1.25 poverty line to calculate international extreme poverty rates, as the switch to the $1.90 line resulted in a significant change in the estimated poverty rate, warranting further analysis. For the 2016 update of the global poverty monitoring, after a detailed assessment of the data and methodology, the World Bank, in collaboration with the Bangladesh Bureau of Statistics and the Asian Development Bank, recommended that poverty for Bangladesh be estimated using the updated international extreme poverty line of $1.90 per day at 2011 Purchasing Power Parities (PPP). Accordingly, the entire series of extreme poverty numbers from 1980 to 2013 has been revised, ensuring comparability between various rounds.[2]

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1 A Global Count of the Extreme Poor in 2012: Data Issues, Methodology and Initial Results by Ferreira, et al, Policy Research Working Paper 7432, World Bank, October 2015.

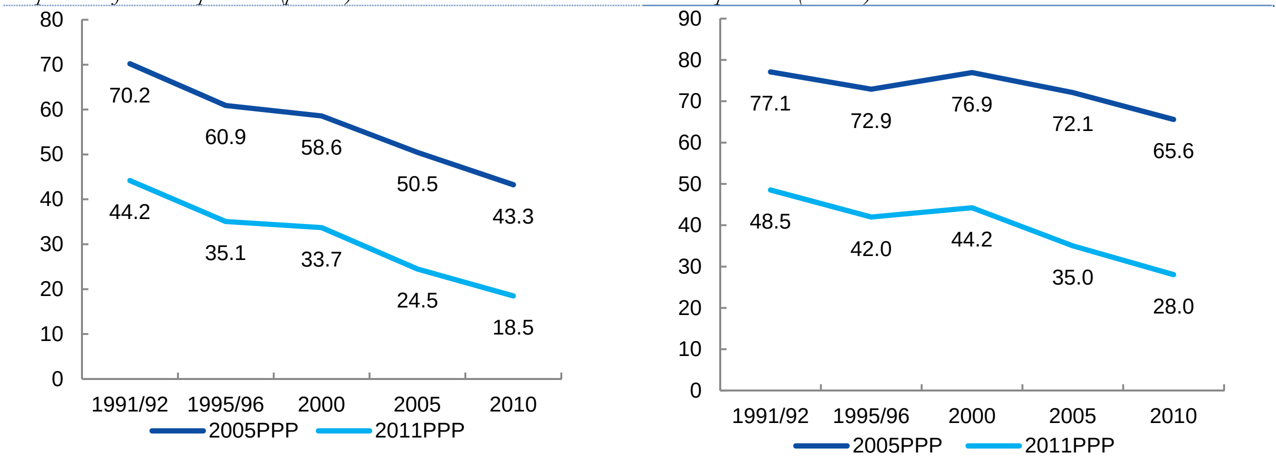
2 Note that the World Bank estimates the proportion of people living below an international poverty line primarily to monitor global and regional poverty. National

The number of extreme poor is found to be much lower, but the historical trend of the international extreme poverty rates based on the 2011 PPP is consistent with that of the 2005 PPP.

Based on the updated international extreme poverty line of $1.90 per day (2011 PPP), the poverty rate was 18.5 percent in 2010, the most recent year for which a household survey is available for Bangladesh, which corresponds to an estimated 28 million extreme poor (Figure 1, Panel B). In contrast, the extreme poverty rate at the now-retired line of $1.25 per day (2005 PPP) was 43.3 percent, or around of 65.6 million people living in extreme poverty (Figure 1, Panel A). Although the estimated extreme poverty rate was significantly lower with the adoption of the 2011 PPP, the trend over time shows a very stable pattern of progress irrespective of which threshold is used. Figure 1 shows that if the 2005 PPP and $1.25 line are used, the extreme poverty rate declined from 70.2 percent to 43.3 percent between 1991/92 and 2010, while if the 2011 PPP and $1.90 line are used, the extreme poverty rate declined from 44.2 percent to 18.5 percent during the same period.

Figure 1: Proportion of people living on less than $1.90 per day and population of the poor

Proportion of Poor Population (percent) *Poor Population (million)*



Source: World Development Indicators (June, 2016) and PovcalNet.

There is much better convergence between the international extreme poverty line and the Bangladesh government's Lower Poverty Line (LPL).

Both lines attempt to capture the rate and breadth of extreme poverty. The international extreme poverty line of $1.90, measured in taka, is almost identical to the population weighted average of the official LPLs (Table 1).[3] Since the methodology is different, the numbers are not directly comparable, but the difference in extreme poverty headcount rates based on the international extreme poverty between and the official LPL in 2010 has declined from 25.8 percentage points to only less than 1 percentage point.

poverty rates are the most appropriate for underpinning dialogue or targeting programs to reach the poorest in a country.

[3] LPLs differ across areas to reflect price differences but the international extreme poverty index ignores spatial price differences. This is a reason why the poverty rate measured at the LPLs is slightly lower than that of $1.90 even if the average of LPLs is slightly higher than the $1.90 poverty line.

Table 1: Comparison of poverty lines for 2010 in Bangladeshi taka and poverty rates

Type	Poverty line (taka in 2010 prices, monthly)	Poverty headcount rate (%)
$1.25 in 2005 PPP	1801	43.3
$1.90 in 2011 PPP	1297	18.5
LPLs	1305*	17.5

Source: Authors' estimations based on World Development Indicators and the Bangladesh Poverty Assessment, World Bank (2013)

Note*: Population weighted average of LPLs

Table 1 also explains why poverty rates measured at the $1.90 poverty line are much lower than those of the $1.25 poverty line although the nominal international poverty line is higher.

The $1.25 poverty line is measured in 2005 prices while the $1.90 poverty line is measured in 2011 prices. As shown in Table 1, if both poverty lines are evaluated in 2010 prices, the $1.25 poverty line and the $1.90 poverty line correspond to monthly values of Bangladeshi taka 1801 and 1297, respectively. In other words, $1.90 in 2011 is valued much less in Bangladesh than $1.25 in 2005. Why did this happen?

The new 2011 PPP revealed that the purchasing power of the taka was much stronger than previously estimated.

The PPP exchange rate of Bangladeshi taka relative to US dollar in 2011 is Tk 24.8 per dollar according to the 2011 PPP, but Tk 52.4 per $ according to the 2005 PPP.[4] In other words, the new 2011 PPP indicates that the purchasing power of Bangladeshi taka in 2011 relative to US dollar was more than twice as strong as the 2005 PPP implied. Consequently, the poverty line in Bangladeshi taka still declines significantly after switching to the 2011 PPPs. As a result of this large increase in the purchasing power of Bangladeshi taka, Bangladesh's GDP and other statistics based on the 2011 PPP show that Bangladesh is wealthier in USD terms than previously thought.

The differences between the 2005 and 2011 PPP were not caused by price data but primarily due to methodological improvements.

Each time PPPs are updated, some methodological improvements are made. The 2011 PPPs were no exception. The 2011 International Comparison Program (ICP), which produced the 2011 PPPs, improved the methodology for linking Bangladeshi and US prices compared with estimates made in 2005. The joint World Bank Group, Asian Development Bank and Bangladesh Bureau of Statistics study found that price data collected for the 2005 and 2011 PPPs are of good quality and consistent with other price data collected in the same time period, such as Consumer Price Indices.[5] The methodological improvement in linking Bangladesh prices to US prices results in the significantly higher purchasing power of the taka relative to the US dollar using the 2011 PPP.

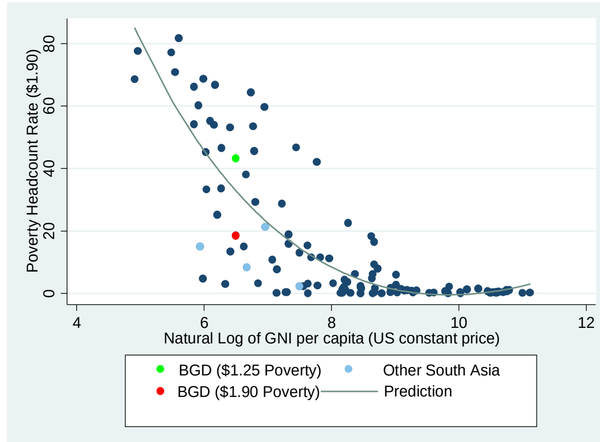
4 Basic Need Price Index (BNPI), rather than CPI, was used for inflation adjustments. BNPI is a price index that refers to inflation rates estimated from the official upper poverty lines.

5 Capilit, E., Y. Dikhanov, E. B. Prydz, H. Uematsu, and N. Yoshida. (2016). "Selection of PPPs for estimating the extreme poverty index in Bangladesh for global poverty monitoring." Mimeo.

Bangladesh's new extreme poverty rates based on the 2011 PPP are much more comparable with other countries in South Asia than the previous estimates.

Compared with other countries at a similar income level, Bangladesh's extreme poverty rate using the $1.90 (2011 PPP) international poverty line was lower than the global average (represented by the solid line in Figure 2). The updated extreme poverty rate is much more aligned with the poverty rates of other countries in the region (represented in blue dots in Figure 2).

Figure 2: Comparisons of poverty rates with other countries



Source: Capilit et al. (2016)

Ending extreme poverty by 2030 will require faster growth with greater inclusion.

The World Bank's overarching goal is to end extreme poverty by 2030 - a goal that now has the full weight of the international community behind it as part of Sustainable Development Goal (SDG) 1.[6] What would it take for Bangladesh to reduce its extreme poverty to 3 percent or less by 2030, if not eradicate it altogether?

To estimate the required growth rate, the growth elasticity was estimated for a five year period (2005 to 2010 or 2000 to 2005)[7]. Starting from a projected 13.8 percent extreme poverty rate in 2015, the poverty rate is projected for 2020, 2025 and 2030 using expected growth elasticities. If the growth elasticity remains unchanged from what was observed between 2005 and 2010, then Bangladesh needs an annual GDP per capita growth rate of 7.5 percent (Table 2), which corresponds to a total GDP growth rate of around 9 percent. This will be challenging. However, if Bangladesh could share growth more widely, at levels seen from 2000-2005, then maintaining the current rate of GDP per capita growth may suffice. Thus, growth that is more inclusive will be critical for Bangladesh to end extreme poverty by 2030.

6 The World Bank's goal of ending extreme poverty is similar but slightly different to the first Sustainable Development Goal in terms of measurement. The World Bank aims to reduce the extreme poverty index to 3 percent globally by 2030. The World Bank goal does not try to reduce the extreme poverty index in all countries to zero. So, for instance, if a country cannot reduce its poverty rate to below 3 percent, the global target might still be achieved.

7 The growth elasticity is the percentage change in poverty that results from a 1 percent change in growth.

Table 2: Growth Rate Needed to End Extreme Poverty

Scenario	Growth rate per capita GDP (%)	Poverty to Growth elasticity	Poverty rate in 2030 (%)
Trends between 2000 and 2005	3.3	-1.54	5.33
Trends between 2005 and 2010	4.8	-0.92	5.98
Faster growth only	7.5	-0.92	2.96
More inclusive growth	4.8	-1.54	2.88

Bangladesh fared reasonably well on sharing prosperity.

Shared prosperity is measured as the growth in per capita income or consumption of the bottom 40 percent of the population compared with the growth in per capita income or consumption of the total population in every country. The larger the per capita consumption growth rate among the bottom 40 compared to the national growth rate, the more quickly economic progress is shared with the poorer segments of society. Building on this concept, the Shared Prosperity Premium is estimated as the difference in the growth in per capita consumption of the poorest 40 percent in a country to the growth in per capita consumption of the total population. If the premium is positive, the poorest are doing better than the country as a whole, and if the premium is negative, then the poorest are staying behind.

Consumption per capita of the bottom 40 percent grew by 1.77 percent per annum during 2005-2010, while consumption per capita of the total population grew by 1.34 percent per annum. Therefore, Bangladesh had a shared prosperity premium of 0.43 percentage points during 2005-10, outperforming near neighbors like India, Bhutan, and Sri Lanka, whilst falling behind East Asian countries such as China, Vietnam and Cambodia, where consumption of the poorest citizens grew much faster than the national average.

B. Recent Economic Developments

Bangladesh is on track to sustaining the recent 6 plus percent growth in the near and medium-term, driven by exports and strong domestic demand. However, private investment rate has been stagnating and remittances have been declining. Headline inflation has declined but core inflation has increased. Official foreign exchange reserves has crossed the $31 billion mark, equivalent to 8.2 months of imports of goods and non-factor services. Although taka-dollar exchange rate has been stable, the real effective exchange rate has appreciated significantly because of large differential between inflation rates in Bangladesh and its trading partners. Interest rates have declined, but the banking system remained flush with excess liquidity. Fiscal deficit undershot the budget target in FY16 and the composition of domestic financing continued to shift towards costlier sources. Monetary policy remained accommodative. The near and medium terms outlook is stable, but the inflation target is not ambitious enough. Security, financial and trade shocks are the main risks. The policy challenges are to boost productivity and private investment by reforming business regulations, mitigating infrastructure and energy deficits and increasing the efficiency of financial intermediation. A special policy focus in this report is on introducing carbon taxation to build on Bangladesh's commitment to contribute towards climate change.

GDP growth in FY16, provisionally estimated at 7.05 percent by the Bangladesh Bureau of Statistics (BBS), has been healthy despite slowing private investment and weak remittances. On the demand side, growth came from increases in government consumption and investment expenditures, while on the supply side it came largely from increased growth in services (Table 3). These reflected increases in public sector wages. The growth windfall from such increases cannot be sustained.

The magnitude of the provisional growth estimate (Table 3) is debatable in the context of the growth assessments based on available and relevant high frequency indicators.[8] However, there is little doubt that growth has exceeded 6 percent which, by current international standard, is commendable performance.

8 The World Bank, Bangladesh Development Update, April 2016.

Table 3: GDP Growth

	FY11	FY12	FY13	FY14	FY15	FY16
GDP Growth	6.5	6.5	6.0	6.1	6.6	7.1
Growth of Production Sectors (%)						
Industry	9.02	9.44	9.64	8.16	9.67	10.10
o/w Manufacturing	10.01	9.96	10.31	8.77	10.31	10.30
Services	6.22	6.58	5.51	5.62	5.80	6.70
Agriculture	4.46	3.01	2.46	4.37	3.33	2.60
Growth of Expenditure Components (%)						
Private consumption	6.49	4.11	5.13	4.01	5.82	5.26
Government consumption	6.74	3.08	5.79	7.89	8.75	10.71
Private Investment	7.95	9.50	1.74	9.34	6.02	5.53
Government Investment	17.06	15.16	20.22	11.64	10.86	19.87
Exports, goods & services	29.34	12.53	2.45	3.20	-2.83	-0.32
Imports, goods & services	29.15	10.52	1.22	1.17	3.20	-8.90

Source: Bangladesh Bureau of Statistics (BBS), Growths are in constant term, National Account 2005-06

Agriculture.

Growth in agriculture is estimated to have been a decent 2.6 percent in FY16, driven by growth in non-crop agriculture. Rice production has stagnated, but minor food crops, livestock products and fish production have grown remarkably.

Rice production maintained at the same level as last year.

The government's food grains (rice and wheat) production target for FY16 was 36.4 million metric tons (mmt), of which targets for aman, aus, boro and wheat were 13.6 mmt, 2.5 mmt, 19 mmt, and 1.4 mmt, respectively. The target was about 1 percent higher than the actual production in FY16 (36 mmt). Aman and aus production has been estimated by the BBS at 13.19 mmt and 2.29 mmt, which are just about the same as last year (Table 4). The wheat production estimate has been finalized at 1.4 mmt for FY16, which too is almost the same as the previous year's actual production. The 19.1 mmt target of boro production may not have been achieved as cultivation declined with many farmers switching to other crops such as potato, wheat and maize. Farmers grew boro paddy on 4.7 million hectares (mh) of land during the current harvesting season, lower than last season's 4.8 mh. Taking the reduced boro acreage into consideration, the US Department of Agriculture (USDA) projects Bangladesh's total boro production at 18.6 mmt in FY16, down from 19.2 mmt in FY15. Thus, the total food grain production in FY16 is likely to have been lower than the target and also slightly lower than last year's actual production.

Increased productivity in rice needed to sustain self-sufficiency.

The crop sector has played a critically important role in ensuring food security and creating jobs. Notwithstanding a severe and increasing farmland constraint, Bangladesh has achieved near self-sufficiency in rice production through a considerable increase in cropping intensity and technological progress. Cropping intensity increased from 177 percent in FY05 to 190 percent in FY13. During this period rice production rose by about 40 percent, while production of other crops also experienced a rise. The increasing costs of irrigation and agricultural labor coupled with higher returns from alternative crops are now discouraging farmers from remaining engaged in rice cultivation. This is evident from the slow growth of rice production since FY11 (Table 4). In fact, total rice and wheat production growth (4.4 percent) fell short of population growth (6.2 percent) during FY11-16. Sustaining productivity increases in rice cultivation is likely to become more challenging in the future than it has been in the past. Boro rice, the main driver of crop productivity in Bangladesh in the past, is nearing the frontier of existing technological potential. Expansion of farm land is not an option. Excessive use of chemical fertilizers for growing more agricultural products continues to pose a serious threat to land fertility, public health and biodiversity. The most significant challenge facing agriculture is the overuse, degradation, and change in quality of critical natural resources, including land and water.[9] Assuming no immediate advancement in technology, further increase of rice cultivation may happen only through expansion of modern varieties in aman and aus while maintaining the existing level of Boro production. Climate variability has added to uncertainties faced by farmers in cultivating aus and aman rice. In addition, excessive use of water for irrigation is causing groundwater table to fall further, which is making irrigation more costly.

Table 4: Rice and Wheat Production

(Lac metric ton)

	FY11	FY12	FY13	FY14	FY15	FY16 (P)	FY11-16 (Growth)
Aus	21.3	23.3	21.6	23.3	23.3	22.9	7.3
Aman	127.9	128.0	129.0	130.2	131.9	131.9	3.1
Boro	186.2	187.6	187.8	190.1	191.9	191.9	3.1
Wheat	9.7	10.0	12.6	13.0	13.5	13.5	38.6
Total production (rice and wheat)	345.1	348.8	350.9	356.6	360.6	360.2	4.4
Total rice and wheat imports	57.0	21.1	18.9	29.9	52.6	*40.81	-28.5
Rice and wheat production growth (%)		3.9	1.1	0.6	1.6	1.1	-0.1
Population growth (%)	1.2	1.2	1.2	1.2	1.2	1.2	6.2

Source: Bangladesh Bureau of Statistics (BBS);

(p) denotes provisional estimates
*July-May for FY16

Fish production has grown at a healthy pace.

The fisheries and animal farming (livestock and poultry) sub-sectors accounted for about 5.31 percent of the GDP in FY16, of which the fish sector contributed around 3.23 percent and the animal farming sector contributed 2 percent. Nearly 17.1 million people are involved in fish production, while animal farming has created job opportunities for around 6.5 million people. For around a decade or so, fish production in the country has been increasing to keep up with the growing demand at home and abroad. Bangladesh's annual demand for fish is about 4.1 million tons while production in FY16 was around 3.85 million tons.[10] It produced 3.7 million tons and 3.5 million tons of fish in FY15 and FY14, respectively. Yet, the country has a deficit of 0.25 million tons, which could be met by by ensuring proper utilization of water bodies as well as using latest technologies.

9 The World Bank, Rural Growth Dynamics, 2016.

10 According to the Department of Fisheries (DoF) and the Bangladesh Shrimp and Fish Foundation (BSFF).

Poultry production continues to thrive.

The country's poultry industry has achieved self-sufficiency in meeting local demand for meat and eggs. The industry is now producing 1,500 mt of poultry meat per day against the target of 1,400 mt. It also produces 16 million eggs per day against a demand of 15 million eggs, and almost 10 million pieces of chicken every week against the weekly demand for nearly 9 million pieces. As a result, the industry now has an exportable surplus. Although Bangladesh could not yet export poultry due to the inability to maintain international standards, the poultry industry is in a new phase of development. An increasing number of poultry farms are tilting towards integrated farming to market chicken meat and eggs. This trend will not only lead to greater competition among the industry operators to ensure safe and hygienic poultry products, but also make it more difficult for smaller operators to compete. Increased integration in the industry will benefit consumers through competitive prices.

Industry.

Industrial growth is estimated at 10.1 percent in FY16, driven by growth in large and medium scale manufacturing and construction.

Double digit manufacturing growth sustained.

The manufacturing sub-sector grew by 10.3 percent in FY16, the same as last year. Large and medium scale industries grew by 11.01 percent in FY16, compared to 10.7 percent in FY15. Small scale manufacturing industries grew by 7.02 percent in FY16, compared to 8.54 percent in FY15. Industrial activity suffered due to supply disruptions and weaker consumer confidence than in FY15. Overall imports for the industrial sector grew about 6.5 percent in dollar terms, mainly due to import of capital machinery which grew by 14.1 percent. Power plants, Padma Bridge construction, flyovers and balancing, modernization, rehabilitation and expansion of industrial units, garments and textiles in particular, spurred capital machinery imports. Political stability and a decline in prices of capital machinery in international markets appears to have encouraged entrepreneurs to get into new ventures or expand their existing businesses.

Recovery underway in construction.

The construction sub-sector performed better in FY16, growing at 8.9 percent compared to 8.6 percent the previous year. Real estate, renting and business activities have also performed better, expanding by 4.5 percent in FY16 compared to 4.4 percent in FY15. In spite of the tremendous potential of the construction and real estate sector, various factors adversely affected its development: land value distortions, absence of secondary property markets, limited asset securitization and sale of mortgages, and weak backward linkage industries such as cement, ceramic, and brick manufacturing industries. The real estate business recently recovered due to property price corrections, falling interest rates on home loans and sustained political stability. The number of unsold ready apartments has now declined to 8,000 from 22,000 a couple of years back. The recent decline in lending rates is expected to further boost apartment sales. However, the terror attack in Gulshan has dampened the prospect of a faster revival. The construction sector now accounts for about 8.9 percent of GDP, employing around 3 million people, and accounting for 5.1 percent of the employed labor force in 2015.[11]

The power supply situation improved but the demand for

As of June 30, 2016, total actual generation during day peak hours was 7,800 megawatts (mw) per hour and during evening peak hours it was 9,036 mw. The demand was 8,408 mw. The maximum generation in 2016 so far has been 8,890 mw on September 8, 2016, and it was also the maximum generation in BPDB's history.

[11] BBS, Quarterly Labor Force Survey, Bangladesh, July-September 2015.

power has been increasing as well.

Electricity generation has remained below capacity because of gas shortages and plant shut downs for maintenance. The number of plants in operation increased slightly from a year ago, as has the peak demand. An increase in peak generation nearly kept up with the rise in peak demand. Total generation increased significantly from a year ago, but load-shedding still continued.

Services.

Growth in the services sector increased from 5.8 percent in FY15 to 6.7 percent in FY16, largely reflecting an increase in the estimated value added in public administration, education and health due to public sector wage increases.

Notable among the well-performing sub-sectors in FY16 were public administration and defense, and education where growth reflected the implementation of large public sector wage increases (Table 5). Proxy indicators such as trade financing, bank advances to the transport and communication sector, and cargo handled through Chittagong port suggest robust activities in the services sector generally. Although the service sector has been rapidly rising in Bangladesh, it continues to be dominated by traditional activities. As in the past, traditional services comprising wholesale and retail trade, hotels and restaurants, real estate, transport, personal services, and public administration, predominate. There is no runaway, dynamic sector as evident from the near constancy of sub-sector shares within the service sector (Table 5). Since service industries tend to be labor-intensive, encouraging dynamic services activity is critical from the employment perspective. Bangladesh's future growth will depend increasingly on raising productivity in the service sector.

Table 5: Components of Service Sector (% of Total Service)

	FY12	FY13	FY14	FY15	FY16
Wholesale and Retail Trade	24.5	24.1	23.9	23.7	23.0
Hotel and Restaurants	1.7	1.8	1.8	1.8	1.8
Transport, Storage and Communication	20.1	19.4	18.6	18.4	18.2
Financial Intermediations	6.5	6.6	6.7	6.8	6.7
Real Estate, Renting and Business Activities	12.3	12.3	12.7	13.0	13.2
Public Administration and Defense	6.0	5.9	6.2	6.2	7.5
Education	4.5	4.4	4.5	4.6	4.8
Health and Social Works	3.6	3.7	3.7	3.7	3.7
Community, Social and Personal Services	20.9	21.7	21.7	21.7	20.9
Service Sector	100.0	100.0	100.0	100.0	100.0

Source: Bangladesh Bureau of Statistics (BBS)

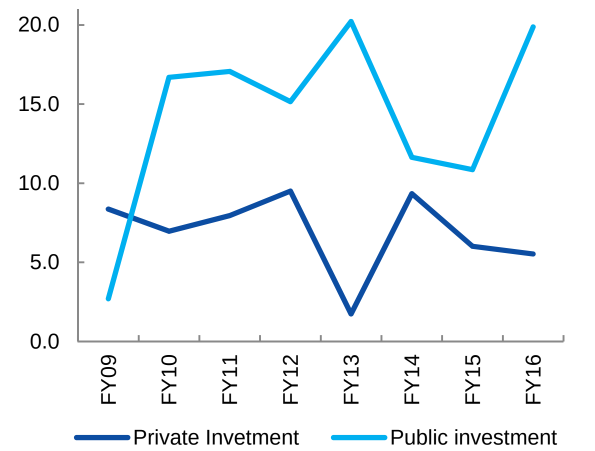
Investment.

Progress in easing the binding constraints on investment has been slow. Inadequate infrastructure, financial intermediation, bureaucratic inertia, and corruption continue to hinder domestic as well as foreign investment. The lack of effective alternative dispute resolution mechanisms and slow judicial processes impede the enforcement of contracts and the resolution of business disputes. There was significant political stability since March 2015, but recent terror attacks have raised concerns about a short-term, adverse impact on business and investment.

Private investment as a percentage of GDP declined to a three-year low of 21.78 percent in FY16, despite macroeconomic stability.

However, a significant rise in public investment led to an increase in total investment in relation to GDP from 28.9 percent in FY15 to 29.4 percent in FY16 (Figure 3). The increase in public investment is attributable to the government's expenditure on infrastructure projects. However, these do not necessarily translate into infrastructure assets one for one because of leakage and inefficiency in the public investment process. As a result of falling private investment, the gap between the actual and the projected figures of private investment rate[12] is widening. Private investment is clearly not savings constrained. Capital flight from Bangladesh peaked in FY13. With a friendlier investment environment, the recent gap between projected and actual private investment rate could have been narrowed.

Figure 3: Private and Public Investment Growth Rates
(percent)

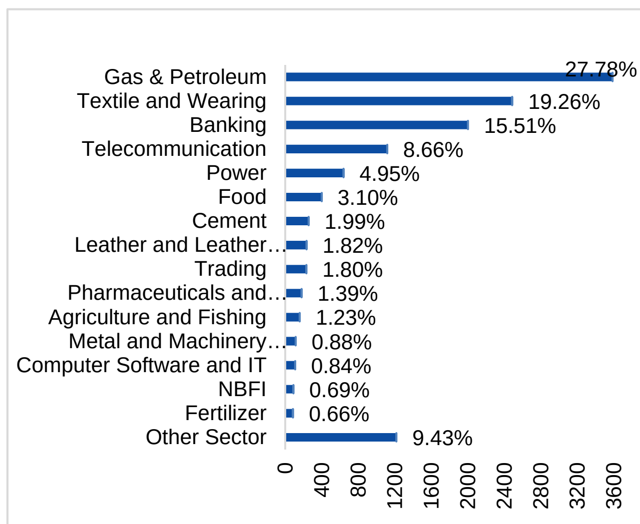


Source: Bangladesh Bureau of Statistics

Although still small in relation to GDP, FDI has increased of late.

Unlike domestic private investment, FDI increased significantly from $1.8 billion in FY15 to $2 billion in FY16. FDI inflows in Bangladesh were directed mainly to manufacturing, trade and commerce related activities (Figure 4). After sluggish growth in earlier years, a significant jump in FDI inflows in power, gas and petroleum sectors in 2015 was a positive signal to the gas-starved energy sector. Textiles, power, gas and petroleum, banking and telecommunications account for 70 percent of FDI. More than 50 percent of recent FDI are actually reinvestments by existing companies. This is a positive sign since it is indicative of their earning sufficient revenue to run their business, and the growing confidence of foreign firms to continue doing business in Bangladesh. On the other hand, a deceleration in the contribution of equity capital in the total share of FDI

Figure 4: Stock of FDI by Sector (end of December, 2015)



Source: *Bangladesh Bank*
**Bar indicates US$ million)*

12 According to the 7th Five Year Plan.

inflows is indicative of the continuing lack of enthusiasm on the part of new investors to invest in Bangladesh.

There is some evidence that perceptions about the business environment may be improving.

During February-April, 2016, the Center for Policy Dialogue conducted an entrepreneurs' survey on perceptions relating to the Bangladesh economy.[13] Overall, they found improved perceptions about the business environment in 2016 compared to 2015, as "about 37.1 percent of all respondents indicated positive changes in business environment in 2016; 33.3 percent mentioned the opposite." The positive changes in perceptions related to demand for firms' products. About 52.8 percent of all respondents were optimistic about demand for their product in 2016, compared with 39.6 percent in 2015. A boom in retail sales during last Ramadan in the run up to Eid validated these perceptions.[14] A majority of the business executives (67.7 percent) felt that the planned establishment of Special Economic Zones will provide necessary infrastructure support to new investment. This is indicative of the private sector's readiness to commit resources for investment in a conducive environment.

Table 6: Selected Doing Business Indicators

	Time to start business (days)	Dealing with Construction Permits (days)	Getting Electricity (days)	Registering Property (days)	Total tax rate (%)	Enforcing contracts (days)
Bangladesh (Dhaka)	19.5	278	404	244	34	1,442
India (Mumbai)	26	147	47	46.5	61	1,420
Sri Lanka	9	115	100	51	55	1,318
Pakistan (Karachi)	18	276	215	208	33	1,096
Nepal	17	86	70	5	30	910
Thailand	25	103	37	6	30	440
South Korea	4	28	18	5.5	33	290

Source: Doing Business Report, 2017

Structural impediments continue to bite.

Private investors are discouraged from investing in Bangladesh because of infrastructure deficits, scarcity and high prices of land, corruption, political uncertainty and, of late, concerns about security. Severe scarcity of gas and electricity is making the process of getting utility connections for new businesses difficult. Currently, approximately 2,000 new businesses are waiting to get electricity connections. The demonstration effect of such delays on new investment is bound to be negative. The cost of investment has increased as a result of scarce and high priced land for industrial purposes. This is preventing many large companies from investing. The most recent evidence from *Doing Business* indicators provides very little comfort. Bangladesh remains well behind countries such as India, Sri Lanka, Pakistan, Nepal, Thailand and South Korea on getting electricity, dealing with construction permits, registering property and enforcing contracts (Table 6). On corruption, Bangladesh ranks 2nd worst in South Asia and the 13th worst in the world.[15] This discourages domestic as well as foreign investment since corruption increases the costs and uncertainties of doing business. The political turmoil of FY14 and FY15 in the country adversely affected the investors' confidence and the recent terrorist attacks have delayed the restoration of investor confidence back to normal levels. Bangladesh runs the risk of losing both domestic and foreign investor interest if the fear of more such attacks in the future is not assuaged. The government

13 CPD, State of Bangladesh Economy, May 2016.
14 Prothom Alo, July 5, 2016.
15 Global Corruption Perception Index 2015.

needs to provide a positive message about the security of the lives and property of the foreign as well as domestic investors.

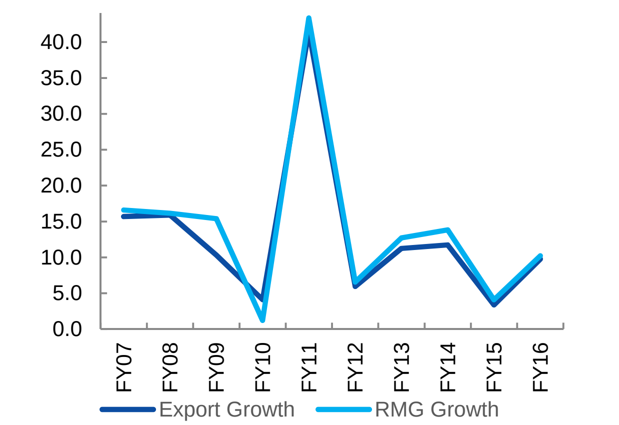
Exports

Exports have rebounded, driven by RMG exports to the United States and the European Union. Although non-RMG exports growth also picked up, the overall export basket remains predominantly RMG based.

Garments and traditional markets remain at the core of exports.

Export earnings grew by 9.8 percent (in nominal dollar terms) in FY16, after a disappointing performance in FY15 when growth was only 3.4 percent. In real terms, as per preliminary estimates by the BBS, export earnings declined by 0.3 percent.[16]

Figure 5: Exports and RMG growth:
y-o-y (percent)



Source: Export Promotion Bureau

Export growth was led by the RMG sector which grew at 10.2 percent, while the non-RMG sector grew by 7.8 percent (Figure 5). There were moderate declines in growth of jute goods (-1.4 percent) and frozen foods (-5.4 percent). Leather goods and tea witnessed sharp declines of -30.1 percent and -30.4 percent, respectively. The contractions in these exports were offset by the growth in woven garments (12.8 percent) and knitwear (7.5 percent). Note, however, that exports relative to GDP have declined from 18 percent in FY12 to 15.1 percent in FY16. In an export-driven economy like Bangladesh this is a trend in the wrong direction.

Exports to the United States, which remains the single largest destination for Bangladeshi exports, grew by 7.6 percent. This was accompanied by a 9.7 percent expansion of exports to the European Union (EU). Within the EU itself, exports grew by 18.9 percent in the UK. The growth in these markets was led by the strong performance of the RMG sector. This allowed exports to exceed the US$ 33.5 billion target by 2.2 percent.

The export rebound was driven by RMG volume growth.

Within the traditional RMG markets such as the USA and EU, growth was entirely volume driven. In the USA, apparel import volumes grew by 11.9 percent[17] whereas apparel import values grew by 7.4 percent.[18] This indicates that Bangladeshi products have still not been able to move up the RMG value chain. In FY15, the significant depreciation of the Euro against the USD took away most of the effect of a strong volume growth on the dollar value of RMG exports.

16 This is hard to reconcile with data on export volume growth.
17 http://otexa.trade.gov/msrcty/a5380.htm
18 http://otexa.trade.gov/msrcty/v5380.htm

Little progress has been made towards product diversification.

RMG exports accounted for nearly 82 percent of the total export value in FY16, a 2 percentage point increase from FY15. However, there has been progress in the performance of the RMG sector in non-traditional markets. Japan, which is one of the largest non-traditional export markets, witnessed a 19 percent increase causing overall exports to Japan to break the US$1 billion mark for the first time. Additionally, RMG exports have also increased by 19 percent in Australia, 12 percent in China, 16 percent in Russia and 31 percent in India. During 2015 (calendar year), Bangladesh also increased its global market share for RMG products to 5.9 percent.[19] During the same period Bangladesh's competitors such as Vietnam, Turkey and India also increased their market share. The impressive performance in a non-traditional market such as Japan can be attributed to the relaxed Generalized System of Preference granted by Japan for Bangladeshi knitwear products. This policy change coupled with the earlier duty waiver on apparel items from Bangladesh has helped to facilitate export growth. Bangladesh was also successful in securing duty free access for its RMG products in markets such as China and India. While RMG growth was led demand from traditional markets, the impressive performance in the non-traditional markets played an important role in boosting exports above target in Bangladesh.

Imports declined.

As reported in the provisional national accounts estimates for FY16, an 8.9 percent decline in imports in real terms resulted in a 47 percent drop in the absolute value of (negative) net exports, thus more than offsetting the impact of a real decline in exports on GDP growth. Decline in imports of food grain and fertilizer contributed to the real decline in total imports. Note that growth in households' real consumption expenditure fell from 5.8 percent in FY15 to 5.3 percent in FY16. Also, growth in real private investments fell from 6 percent in FY15 to 5.5 percent in FY16. These may have contributed to softening the demand for imports.

Remittances.

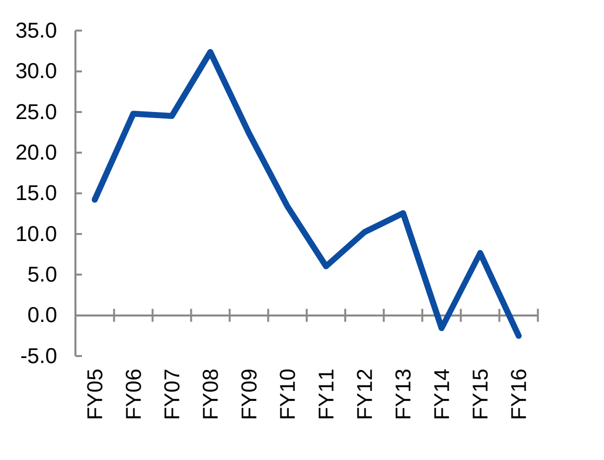
Remittances fell in FY16, driven entirely by declines from GCC countries, despite a significant increase in the number of Bangladeshi workers abroad.

Remittances declined in FY16.

Despite significant outflow of migrant workers in both FY15 and FY16. Remittance inflows to Bangladesh declined by 2.5 percent in FY16 relative to its level in FY15 and 15.3 percent decline in July-August 2016 relative to July-August 2015 (Figure 6). The decline in FY16 was almost entirely accounted for by a decline in remittances from the Kingdom of Saudi Arabia (KSA), United Arab Emirates (UAE), and Kuwait. Globally remittance inflows to developing economies in 2015 increased by a mere 0.4 percent relative to 2014 – the weakest

Figure 6: Remittance Growth

(percent)



Source: Bangladesh Bank

[19] https://www.wto.org/english/res_e/statis_e/wts2016_e/WTO_Chapter_09_tables.pdf

since 2008. Other regional countries in the region also experienced slow or negative growth in remittances in the recent past.

In theory, remittances can decline because of a combination of the following: a decline in the stock of migrant workers abroad, lower earnings per capita, a reduced propensity to save, and a weaker propensity to remit out of what migrants are saving. Detailed data to quantify the contribution of each of the factors noted above is not available.

The number of Bangladeshi workers abroad has increased steadily in recent years.

In FY16, the number of migrant workers abroad increased by 7.6 percent, the highest in the last 7 years. The annual number of migrants going abroad reached 0.68 million in FY16; 48 percent higher than the number going abroad in FY15. About 71.3 percent migrants went to GCC countries in FY16. Saudi Arabia accounted for the highest incremental share, while a significant number also went to Oman, Qatar and Malaysia. Migration to Singapore has been steady. Female migration has also surged, and the number of female migrants exceeded 100,000 in FY16 for the first time since FY92.

Average earnings may have declined.

Because of increased unemployment and/or decreased wages of illegal migrants in GCC countries in particular as the authorities have been tightening enforcement of regulation against illegal migrants. There is anecdotal evidence that the real income of migrants is waning in GCC countries, as prices for staple goods and public services have increased.[20] The unemployment rate among Saudi citizens is 11.5 percent, but relatively few have lost jobs because of legal complexities in firing Saudis. Hence, the weight of layoffs has fallen on foreign workers.[21] Saudi construction firms have been hard hit due to lower oil prices that have curbed and in some cases delayed government spending on major infrastructure projects. Oil exporting countries in the Middle-East have lost $390-500 billion in revenue due to the fall in oil prices since last year.[22] The number of construction contracts shrank by about 65 percent in the second quarter this year relative to the same period the previous year. Saudi Arabia, the biggest economy in the GCC, depends predominantly on oil exports for its revenues.[23] Lavish bonuses, overtime payments and other benefits have been slashed.

The propensity to save and remit may have declined.

With increased unemployment, lower wages, or a higher cost of living, the propensity to save may have decreased among migrants because of ratchet effects on consumption. According to media reports, with a monthly pay of Saudi Riyal (SR) 1200, a migrant worker could manage a decent living for SR300 two years back. The same living standard now costs SR700. Conventionally, if income falls,

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[20] According to a Daily Star report (August 11, 2016), foreign workers' annual iqama (residency permits) renewal fees increased to 2400 Saudi Riyals from 700. Many companies are passing the fees on to the migrants. As part of efforts to offset the impact of oil price shock on revenues, Saudi authorities increased oil prices in the domestic market.

[21] Saudis tighten their belts for Eid in age of austerity, The Daily Star, September 6, 2016.

[22] IMF, World Economic Outlook, April 2016. "Fiscal and current account deficits deteriorated sharply in oil-exporting countries in 2015, as oil-related government revenues and export receipts plummeted. This trend has been accompanied in some countries by receding public foreign assets and other indicators of rising fiscal vulnerability". See World Bank, Global Economic Prospects 2016.

[23] Oil exports accounted for 72 percent of total revenue of the Saudi government in 2015, reports AP.

consumption should fall proportionally, but this does not necessarily happen because consumption habits are hard to change. Certain consumption habits are formed at high income levels that are not completely abandoned when income falls. This effect is particularly strong when the income decline is perceived to be temporary. The propensity to remit may also have been adversely affected by the decline in interest rates. The deposit rate fell from 7.26 percent in January 2015 to 5.67 percent in May 2016. The interest rate on national savings certificates was reduced by 2 percentage points in May 2015.

Inflation.

Inflation has slowed, benefitting from soft global commodity prices, but remains high relative to global inflation and inflation in comparator countries.

Overall inflation decelerated to 5.9 percent in FY16.

Compared with 6.4 percent in FY15, its lowest in the last twelve years. The slowing was driven largely by a deceleration in food inflation (Figure 7). The fall in global food and commodity prices, satisfactory food grain production, a stable nominal taka-dollar rate, and restrained monetary growth contributed to the lowering of the inflation rate. The annual average food inflation rate decreased from 6.7 percent in FY15 to 4.9 percent in June 2016, while the non-food inflation rate increased from 6 percent to 7.5 percent during the same period. Core inflation, excluding food and fuel, is accelerating.[24]

Food inflation decelerated due to the fall in international commodity prices and good rice harvests.

According to Food Price Watch, the average Global Food Price Index[25] declined by 15 percent in FY16 compared to FY15. Low international food prices contained the cost of imported food items. Declines in the price of rice at the retail level also contributed to lower food price inflation. During Jan-Mar of 2016, the average retail price of coarse rice was Tk 26-27 per kg and wheat was Tk 32-33 per kg, which were respectively 16 percent and 9 percent lower compared to the same period of previous year. The monthly average price of coarse rice in Dhaka dipped to as low as Tk 26.4 per kg in May 2016, compared with Tk 31.1 per kg in May 2015.

Non-food inflation increased by 1.5 percentage points.

From 6 percent in FY15 to 7.5 percent in FY16, mainly due to a rise in the new pay scale for government employees, hikes in electricity and gas tariffs, and a rise in the flow of credit to the private sector. The decomposition of non-food inflation shows that average inflation accelerated in clothing, footwear, rent, lighting, household equipment, transport, communication, and medical care.

The urban-rural inflation differential widened.

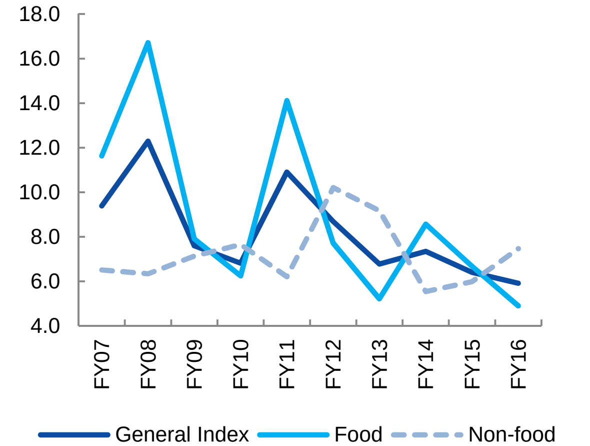
Average inflation in rural areas slowed to 5.3 percent in FY16 from 6.2 percent in FY15, but inflation in urban areas picked-up to 7.1 percent from 6.8 percent due to an increase in non-food inflation from 6.2 percent to 7.8 percent (Figure 8). The rise in urban non-food inflation largely reflected increases in rents and household furniture and appliance prices. The gap between urban and rural areas increased further to 1.9 percentage points in FY16, compared with 0.6 percentage points in FY15. The food inflation gap increased to 2.3 percent in FY16 from 0.9 percent in FY15. The gap for non-food inflation widened to 0.5 percent percentage point in FY16 from 0.4 percent in FY15, mostly driven by rent, fuel and lighting.

24 Bangladesh Bank, Monetary Policy Statement, July-December 2016.

25 The FAO Food Price Index is a measure of the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices, weighted with the average export shares of each of the groups.

Figure 7: Inflation

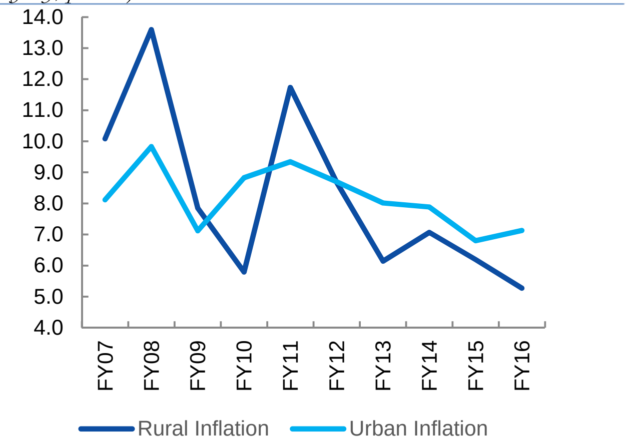
(y-o-y, percent)



Source: Bangladesh Bureau of Statistics

Figure 8: Rural and Urban Inflation

(y-o-y, percent)



Source: Bangladesh Bureau of Statistics

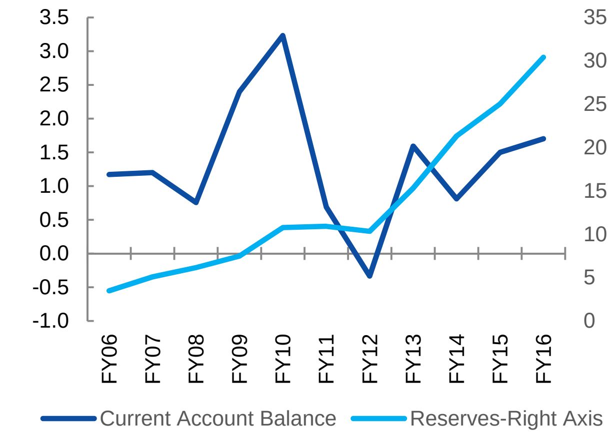
External balance. *Notwithstanding the decline in remittances, the persistence of a large surplus in the current and financial accounts has led to further reserve accumulation and appreciation pressure on the nominal exchange rate. BB interventions kept the latter in check against the US dollar, but the real exchange rate has appreciated significantly.*

Comfortable external balance. The overall external balance recorded a surplus of over $5 billion (Table 7) and the level of foreign exchange reserves exceeded the $30 billion mark at the end of FY16 (Figure 9). The current account surplus increased from $2.8 billion in FY15 to $3.7 billion in FY16 due to an 8.9 percent expansion of exports and a somewhat subdued 5.5 percent growth of imports. A combined $670 million decline in the services and income account deficits helped offset the impact of a $453 million decline in remittances on the overall current account surplus. A $2.1 billion surplus in the financial and capital accounts complemented the surplus in the current account. Increase in aid disbursements, foreign direct investments (FDI), and decline in the size of "errors & omissions" helped sustain surplus in the financial, although the size the surplus declined relative to last year because of a large increase in outflows on account of trade credit and other short-term loans (Table 7).

The real exchange rate appreciated further (Figure 10). The Nominal Exchange Rate (NER) of the taka against the US$ has varied within a narrow band between Tk 77.80 and Tk 78.4 throughout FY16. This is largely due to large scale USD purchases by the BB to prevent any nominal appreciation of the taka in order to maintain export competitiveness in the global market. However, the value of the taka against other major currencies has been volatile. The taka appreciated against the euro, pound-sterling, Indian and Pakistan rupees, and Chinese yuan in the 12 months ending August 2016 (Table 8). This, combined with a large inflation differential with these countries, has led to an 8.8 percent real appreciation of the taka from January 2015 to May 2016, thus challenging the competitiveness of Bangladeshi exports in these markets. Furthermore, with the nominal appreciation of the US dollar against major global currencies including the euro and pound-sterling, the appreciation of the Bangladesh currency in real terms against these currencies is even more pronounced. The one big exception is the Japanese yen against which the taka depreciated by nearly 23 percent during this period, helping overcome the 5.6 percentage point inflation differential between Bangladesh and Japan, and increasing the competitiveness of Bangladeshi exports in the Japanese market.

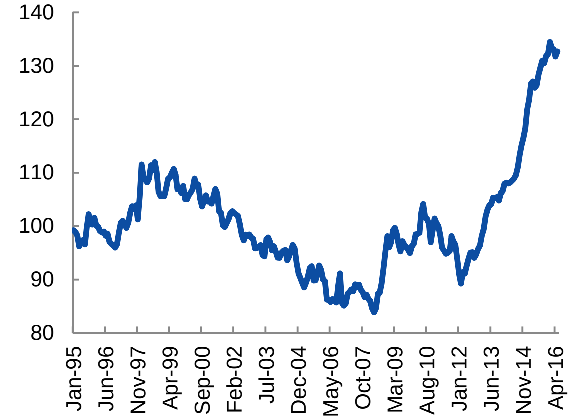
Figure 9: Current Account Balance

(percent of GDP) *Reserve (USD in Billion)*



Source: Bangladesh Bureau of Statistics and Bangladesh Bank

Figure 10: Real Effective Exchange Rate



Source: International Monetary Fund (IMF)

Table 7: Selected Balance of Payments Indicators

Items	FY12	FY13	FY14	FY15	FY16
	US$ million				
Trade balance	-9320	-7009	-6794	-6965	-6274
Merchandise export f.o.b. (inc. EPZ)	23989	26567	29777	30697	33441
Merchandise import f.o.b.(inc. EPZ)	-33309	-33576	-36571	-37662	-39715
Services (net)	-3001	-3162	-4099	-3186	-2793
Income (net)	-1549	-2369	-2635	-2869	-2582
Workers' remittance	12734	14338	14116	15170	14717
Current Account Balance	-151	-634	-41	105	29
Capital account (net)	482	629	645	496	478
Financial account	1436	2863	2686	1925	1610
o/w Foreign direct investment (net)	1191	1726	1432	1830	2001
MLT loans (excludes suppliers credit)	1539	2085	2277	2472	2904
Other short term loans (net)	-54	-141	738	-87	314
Trade Credit (net)	-56	-78	36	638	-16
Errors and omissions	-977	-752	750	-923	-758
Overall Balance	494	5128	5483	4373	5036

Source: Bangladesh Bank

The aggressive pursuit of nominal exchange rate stability of the taka against USD is not without risk.

Foreign exchange reserves grew by 21.6 percent in FY16. This in turn has caused a substantial increase of liquidity in the banking system due to only partial sterilization of capital inflows. In view of the rising trend in non-food inflation, this presents a serious risk. Also, while the underlying policy protects exporters who do USD-based contracts with major trade partners, those trading in other currencies remain exposed to exchange rate volatility against those currencies. Using a basket of trading partners' currencies as a benchmark for intervention, rather than implicitly pegging the taka against the USD, could help Bangladesh maintain export competitiveness from a broader perspective.

Table 8: Exchange rate (Taka/unit of foreign currency) changes and Inflation differential

	Aug-15	Aug-16	% Change	Inflation differential*
USD	77.80	76.89	-1.17	6.29
Euro	88.38	86.12	-2.55	6.37
Indian Rupee	1.20	1.15	-4.11	0.53
Pakistani Rupee	0.76	0.73	-4.04	3.87
British Pound	118.81	100.73	-15.22	6.36
Chinese Yuan	12.03	11.57	-3.83	4.96
Japanese Yen	0.62	0.76	22.86	5.62
Malaysian Ringgit	18.84	19.09	1.28	4.30
Canadian Dollar	58.00	59.15	1.98	5.28
Singapore Dollar	54.58	57.12	4.65	6.95
Thai Bhat	2.15	2.21	2.64	7.30
Swedish Korna	8.90	9.06	1.83	6.45
Indonesian Ruphia	0.01	0.01	-2.58	0.04
Vietnamese Dong	0.00	0.00	0.41	5.77

Source: Bangladesh Bank, Oanda and WDI
*Difference between the inflation rate of Bangladesh and referred countries

The management of foreign exchange reserves remains challenging.

A comfortable reserve level is important for absorbing external shocks and uncertainties without disrupting the economy. The current level of reserves is equivalent to nearly 8 months' of imports. A major part of Bangladesh's official reserve assets is maintained in the form of convertible foreign currencies (83.7 percent), short-term deposits with overseas commercial banks, overnight investments, and foreign bonds. BB has consistently maintained reserves in safe but low-yielding foreign government securities with high liquidity. The return on these investments has declined from 1.15 percent in 2011 to 0.61 percent in 2015, although they have persistently exceeded the 6-month USD London Interbank Offered Rate (LIBOR) rate (Table 9). Countries with the extent of import dependency such as Bangladesh tend to maintain similar reserves-to-GDP ratios. From these perspectives, Bangladesh's reserves does not appear to be inordinately high. However, the experience of the reserve heist and the inability to recover large chunk of it so far shows that reserve management is not just about balancing liquidity and return but also about security of the funds from being stolen. BB's capacity on all these dimensions need continuous strengthening.

Table 9: Return on Bangladesh Bank Foreign Assets

	2011	2012	2013	2014	2015
Total income on foreign currency financial assets (Tk in Billion)	9.6	9.4	10.5	10.1	12.3
Total foreign currency financial assets (Tk in Billion)	841.5	916.8	1255.9	1737.7	2011.6
Rate of Return (%)	1.15	1.02	0.84	0.58	0.61
Six Month USD LIBOR Rate (%)	0.507	0.69	0.41	0.33	0.49

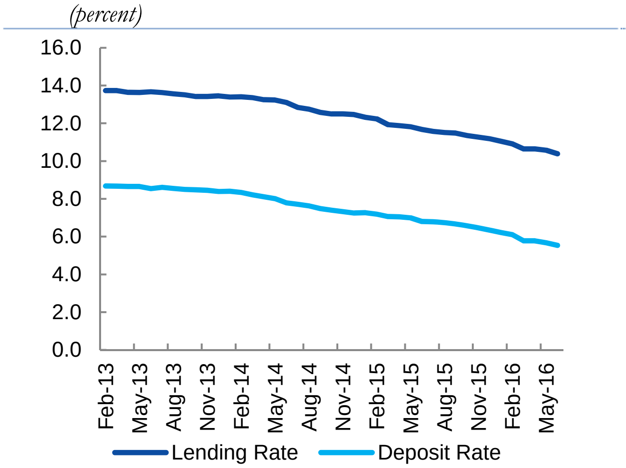
Source: Bangladesh Bank (Annual Reports), and Global-Rates

A problem of plenty. Growing amounts of foreign exchange reserves demonstrate the comfortable position of Bangladesh in terms of foreign trade. However, it leads to pressure for sterilization, inflationary pressure, and asset price bubbles. The stagnation of private investment has contributed to the excess of savings over investment leading to reserve accumulation. This needs to change. The government needs to stimulate domestic investment by improving the climate for private sector activity. Greater exchange rate flexibility may be allowed in an orderly manner, which would enable reducing further accumulation. Given a continued, steady surplus in the financial account, the government might consider liberalizing the financial account. In view of the current situation, capital outflows could be liberalized further, allowing private firms and individual investors to invest abroad. However, this process would need to be gradual and cautious based a careful assessment of the medium and long-term outlook for saving-investment balance and the trends in international capital movements.

Financial Sector. *Interest rates have been declining, but the financial sector remains plagued by falling profitability and rising concerns about non-performing loans and capital inadequacy, particularly in the state owned commercial banks. Large loan restructurings have so far failed to produce the intended results. Trading in the stock exchanges has stagnated and the price indices are broadly unchanged.*

Deposit and lending rates continued to decline. The weighted average deposit rate declined by 1.26 percentage points to reach 5.54 percent in FY16. (Figure 11). Lending rates declined by 1.28 percentage points to reach 10.39 percent. This left the interest rate spread constant at 4.85 percent and marginally below the ceiling of 5 percent set by the BB. Despite continuous pressure by the BB and the excess liquidity in the market, the spread has remained high. The downward stickiness of the interest rate spread indicates that there are more fundamental issues within the financial sector such as containing the volume of non-performing loans (NPLs) and persistently high interest rates on National Savings Certificates.

Figure 11: Lending & Deposit Rate



Source: Bangladesh Bank

T-bill yields have also declined. The weighted average yield on the 182 day T-Bill in FY16 declined by 1.68 percentage points over the previous 12-month period, while the 364 day T-Bill yield declined by 1.45 percentage points. During FY16, the call money rate eased to 3.71 percent from 5.79 in FY15. The high level of liquidity in the market made the T-Bills an attractive investment option for primary dealers.

The banking sector has continued to struggle. The banking sector, which dominates the financial sector in Bangladesh, has been plagued by scams, NPLs and poor governance. Its performance was mixed in recent years. On the positive side, the banking sector experienced significant growth in its net profit in 2015 compared to the previous year.[26] According to the BB, the increased profitability in the banking sector was attributable to the decline in loan loss provisioning in 2015. Both Return on Assets (ROA) and Return on Equity (ROE) increased by 10 and 130 basis points respectively in 2015 (Table 10).

The decline in interest margins persisted (Table-9).

Driven by excess liquidity in the money market and a declining lending rate, banks are moving towards more non-interest/investment income to generate profits. What is even more worrying for the banking sector in the medium to long run is the decline in the capital adequacy ratio. Over the last year, the capital adequacy ratio declined to 10.8 percent. However, eight banks were identified as having capital bases lower than the level consistent with the BASEL III Framework. When analyzing this ratio closely, it is evident that the overall industry was pulled down mainly by the performance of the State Owned Commercial Banks (SCBs) and Specialized Development Banks (SDBs). It therefore was not at all surprising that SCBs requested significant recapitalization funds during the FY17 budget process. During FY16, the SCBs were allocated Tk 20 billion for recapitalization. BB profits have been declining too. The reverse repo operations to sterilize liquidity created by the acquisition of excess foreign exchange by BB contributed significantly to the 25 percent decline in BB's operating profit in FY16 relative to the previous year. Over the same period BB's interest expense increased to Tk 8.01 billion from Tk 1.20 billion.

Table 10: Banking Sector performance 2011-2015

Ratio	2011	2012	2013	2014	2015
ROA	1.3	0.6	0.9	0.7	0.8
ROE	14.3	7.8	10.7	8.1	9.4
Net Interest Margin	3	2.8	2.1	1.8	1.7
Interest Income to Total Assets	7.5	8.1	7.7	6.9	6.2
Net Interest Income to Total Assets	2.5	2.2	1.7	1.5	1.5
Non-Interest Income to Total Assets	2.9	2.7	2.7	2.8	2.7
Non-interest expense to Total Income	40.5	42	47.1	46.5	48.6
Capital Adequacy Ratio	11.3	10.5	11.5	11.4	10.8
Classified Loans to Total Loans	6.2	10	8.9	9.7	8.8
Classified Loans to Capital	43.6	74.2	59.8	67.7	60.8
Provision to Classified Loans	63.8	44.4	61.6	56.2	51.8

Source: Bangladesh Bank (Financial Stability Report)

NPLs are on the rise.

The declining capital adequacy ratio can be explained partly by the rise in NPLs, especially within the SCBs. This further compounds the risk to the banking sector and significantly hampers its stability. As of June, 2016, NPLs in the banking system increased by 23 percent over December, 2015 to reach Tk 633.7 billion, or nearly 10 percent of total outstanding loans. The situation is even more severe in the SCBs, where NPLs account for nearly 24.3 percent of total classified loans. At the aggregate level SCBs account for nearly 48 percent of total NPLs. Industry experts expect this to rise even further as some borrowers may fail to make repayment of installments against the restructured large loans. During 2015, the BB permitted the restructuring of loans worth nearly Tk 141 billion. The timeline for repayment is

[26] Bangladesh Bank (2016). Financial Stability Report, 2015.

expected to start in the third quarter of 2016. NPL formation has yet to peak. Large loan restructuring, loan rescheduling, an inability to classify loans as distressed due to stay orders from the high court, and loans given to merchant banking subsidiaries with managing negative equity portfolios are masking true NPL numbers, which are likely above reported NPLs.

The capital market remained lacklustre in FY16.

While the government has taken several steps since the FY11 market crash, equity markets still have not been able to lure back retail investors at previous levels. The DSEX, the benchmark index of the Dhaka Stock Exchange (DSE), was at 4,507.58 on June 30, 2016, less than 1 percent higher than a year earlier. The other two indices also ended only slightly higher. The aggregate turnover at the bourse declined to Tk 1,072.46 billion in FY16, Tk 51.06 billion lower than the Tk 1,123.52 billion registered in FY15. Portfolio investments in the DSE declined by nearly 35 percent in FY16. While portfolio investment accounts for a very small percentage of the bourse's market capitalization, this represents a significant decline and may worry that local investors reduce holdings as well. Slow credit growth and poor dividend declarations have been the key drivers behind the sluggish performance of the capital market in FY16.

Monetary Policy.

A cautious stance has been maintained overall, with some easing of policy rates in the second half of FY16. This led to a large deviation of growth in reserve money, the monetary policy operating instrument, from the monetary program target. Excess liquidity continues to swell, despite some pick up in the demand for credit in the private sector.

Reserve money growth overshot its target.

Although monetary policy overall has remained cautious with broad money growth below the 15 percent target, the growth of reserve money overshot considerably the 14.3 percent target envisaged in the Monetary Policy Statement (MPS) for the second half of FY16. This overshooting is largely due to more than expected increase in the foreign exchange reserves of the BB. As a result, liquidity in the banking system increased, which was only partially mopped up through the BB's reverse repo operations.

Following successive years of significant deviations between the announced MPS stances and their implementation in the guise of "accommodative" monetary policy, there was a widespread realization that the BB's inability in the past to adhere firmly to its announced monetary program targets had fueled inflation, contributed to the creation of asset market bubbles, and weakened Bangladesh's balance of payments position. The BB recognized the imperative for prudent monetary policy and accordingly established quantitative targets for key monetary aggregates in each and every MPS in recent years (Table 11). The BB took a series of monetary tightening measures and allowed the exchange rate to move freely. These tightening measures helped contain the expansion of monetary aggregates close to the monetary targets of the BB. The objective of monetary tightening was to restore both internal and external imbalances by taming inflation and thereby also stabilizing the exchange rate. The BB adhered to the monetary targets stated in the MPS and maintained a cautious policy stance.

Overshooting is attributable to reduced policy rates.

Monetary easing in the last half of FY16 through the 50 basis points reduction in repo and reverse repo rates led to overshooting of the reserve money growth target. The growth of net foreign assets is largely beyond BB's control and significantly exceeded the monetary program target, raising the need for the BB to enhance its sterilization operations. But lower reverse repo rates diffused the banks' incentive to park their excess reserves in BB reverse repo instruments. The resulting increase in excess liquidity helped reduce lending rates which in turn boosted demand for credit in the private sector. Declines in interest rates over the last two and a half years - the 1-year T-bill, 5-year T-bond, national savings certificate, banking sector average deposit and average lending rate - encouraged businesses and consumers to take loans in the backdrop of a relatively stable political environment over the past year and a half. In addition, foreign currency loans have become less lucrative as the interest rate differential between foreign and domestic loans is narrowing.

Table 11: Monetary Program Performance

	FY 12		FY 13		FY 14		FY 15		FY 16	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual	Target	Actual
Net Foreign Assets	-8.9	11.6	14.0	43.9	10.0	41.2	3.6	18.2	11.1	23.0
Net Domestic Assets	21.9	18.5	18.4	11.8	18.6	10.3	20.2	10.7	16.2	14.4
Domestic credit	19.1	19.6	18.9	10.3	17.8	11.6	17.4	10.0	15.5	14.0
Public Sector credit	31.0	19.1	20.3	8.3	22.9	8.9	25.3	-2.6	18.7	2.6
Private Sector credit	16.0	19.7	18.5	10.8	16.5	12.3	15.5	13.2	14.8	**16.6**
Broad Money	17.0	17.4	17.7	16.7	17.0	16.1	16.5	12.4	15.0	16.3
Reserve Money	12.2	9.0	16.1	15.0	16.2	15.5	15.9	14.3	14.3	30.1
Inflation (end of period average)	7.5	8.7	7.5	6.8	7.0	7.3	6.5	6.4	6.1	5.9
Growth	6.5-7.0	6.5	6.1-6.4	6.0	5.8-6.1	6.1	6.5-6.8	6.6	6.8-6.9	7.1

Source: Bangladesh Bank and Bangladesh Bureau of Statistics

More recent monetary developments have generally been moving in the right direction to achieve the MPS targets. In its monetary policy operations, the BB should continue to focus primarily on the quantitative targets and not on policy instruments like interest rates. It is beyond the capacity of any central bank to influence or target both, and the BB is no exception. Like most developing countries, the transmission of monetary policy is inefficient in Bangladesh. Development of the treasury bills and bond market will be keys to boost the effectiveness of the monetary policy transmission mechanism.

Fiscal Policy.

A large revenue shortfall relative to the original budget led to an increase in the overall budget deficit, despite the usual undershooting of the ADP expenditure target. Domestic financing of the deficit nearly doubled, with an excessive reliance on costly non-bank sources. Consequently, the fiscal room for maneuver has shrunk despite a stable debt to GDP ratio.

The budget deficit increased relative to last year, but remained below the original budget target.

The dependence on high cost domestic borrowing continued. The government leaned heavily on domestic nonbank sources, despite large excess liquidity in the banking system. This is unnecessary, given that there is an aid pipeline of US$23 billion. At 3.4 percent of GDP, domestic financing was the highest in FY15. Still, this financing did not crowd out the supply of bank credit to the private sector because most of the financing came from non-banking sources and the demand for bank credit by the private sector was weak, albeit recovering. The good news is both domestic and foreign debts remain on a sustainable path.

Revenue collections increased by a percentage point of

However, there was a significant shortfall in revenue collection relative to the original budget target. The National Board of Revenue's (NBR) collection increased by 14.6 percent to Tk 1555.2 billion (9 percent of GDP) in FY16, exceeding the

GDP relative to FY15.

lower revised target of Tk 1500 billion. The drastic downward revision became unavoidable because total revenue collection in the first half of FY16 posted a growth rate of 15.8 percent against the annual target of 42.8 percent. NBR invigorated its tax collection drive in the last two quarters of FY16, leading to the increase in the tax to GDP ratio by 0.8 percentage points relative to FY15 (Table-12).

Table 12: Fiscal Outcomes (central government)

	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17(b)
	Taka in billion					
Total Revenue	1146.9	1281.3	1403.8	1459.7	1829.2	2427.5
o/w Tax Revenue	952.3	1074.5	1160.3	1288.0	1609.2	2104.0
Total Expenditure	1524.3	1745.4	1882.1	2043.8	2570.5	3406.1
Current Expenditure	893.0	993.8	1105.6	1189.9	1503.8	1889.7
o/w Pay and allowances	210.7	216.4	263.5	288.4	424.9	507.8
o/w Interest payments	203.5	239.2	282.1	309.7	316.7	399.5
Annual Development Program	375.1	500.0	553.3	603.8	834.9	1107.0
Overall balance	-377.3	-464.1	-478.3	-584.2	-741.3	-978.5
External Financing	71.9	126.9	97.1	72.3	364.8	363.1
Domestic Financing	305.4	331.9	381.4	511.7	376.5	615.5
o/w Non-Bank	33.5	57.3	199.7	506.6	336.9	226.1
	% of GDP					
Total Revenue	10.9	10.7	10.4	9.6	10.6	12.4
o/w Tax Revenue	9.0	9.0	8.6	8.5	9.3	10.7
Total Expenditure	14.4	14.6	14.0	13.5	14.9	17.4
Current Expenditure	8.5	8.3	8.2	7.9	8.7	9.6
o/w Pay and allowances	2.0	1.8	2.0	1.9	2.5	2.6
o/w Interest payments	1.9	2.0	2.1	2.0	1.8	2.0
Annual Development Program	3.6	4.2	4.1	4.0	4.8	5.6
Overall balance	-3.6	-3.9	-3.6	-3.9	-4.3	-5.0
External Financing	0.7	1.1	0.7	0.5	2.1	1.9
Domestic Financing	2.9	2.8	2.8	3.4	2.2	3.1
o/w Non-Bank	0.3	0.5	1.5	3.3	1.9	1.2

Source: Ministry of Finance

The vast undershooting of the revenue target was expected.

Bangladesh does not do nearly as well on tax collection as do countries at a similar level of per capita income and economic structure. Bangladesh's taxable capacity is underexploited. Three key reasons underlie this outcome:

- Tax policy has too many distortions. There are too many loopholes in VAT, SD, CD, and direct taxation codes. The policies on indirect taxation have not kept up with the development of the market economy in the country. The policies on direct taxation penalize the honest and reward tax evaders.
- Tax administration is inefficient. Its reach is neither wide nor deep enough, and is taxpayer unfriendly. It continues to use outdated systems and procedures.

Paying taxes is at times more cumbersome than evading taxes. Efforts to digitize tax administration have not gone deep enough to be a game changer.

- Corruption is a hindrance, depriving the government of revenues. Bangladesh consistently ranks among the bottom ten in Transparency International's Corruption Perception Index.

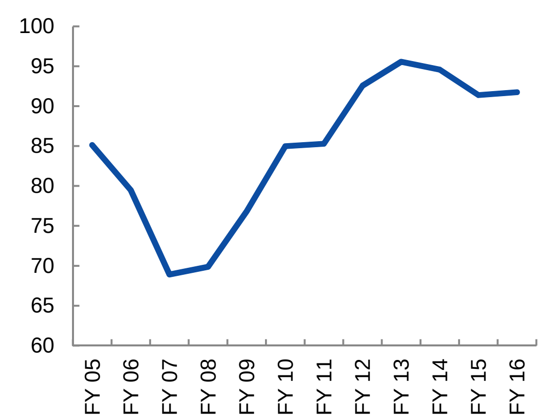
Without progress on reforming tax policies, modernizing tax administration and addressing leakages, tax collection performance will continue to languish below the country's taxable capacity.

Consensus remains to be established on the reform agenda. The VAT and Supplementary Duty Act 2012 aiming to apply a uniform tax rate of 15 percent for almost all goods and services awaits implementation. The ownership gap between government and other relevant stakeholders is yet to be bridged. The business community demanded a number of amendments to the Act. The Joint Committee that was constituted in October 2014 and included both the NBR and Federation of Bangladesh Chamber of Commerce and Industries (FBCCI) representatives accepted some of the key elements of the Act. For example, the Act envisages a number of significant changes, including the abolition of the truncated base and tariff value. At present, there are at least 20 service items where VAT is applied on a truncated base. The new Act will introduce an integrated online system for VAT registration, return submission, refund and payment. This hinges on the development of necessary soft and hard infrastructure, human resources and skill development, training of VAT officials, and preparation of relevant stakeholders on compliance. The Joint Committee proposed several other amendments. These include imposing a 4 percent VAT on supply value for the service sector; differential treatment of bargaining shops and reduced VAT on a number of commodities including iron and steel. These would bring back the very problems in the VAT system that the new Act was intended to redress.

Growth of public expenditure in FY16 was below target.

Expenditure for major two sources of non-development spending, 'Subsidies and Current Transfers' and 'Interest Payments,' were within target. The government disbursed Tk 12 billion for recapitalization of the state-owned commercial banks (SCBs). The money went mainly to the scam-hit BASIC Bank. Note that a budgetary provision of Tk. 50 billion was made in the FY16 budget for bank recapitalization. Subsidies declined by about 39 percent in the revised budget (relative to FY15), thanks to the fall in fuel and fertilizer prices in the international market. Bangladesh Petroleum Corporation (BPC) continued to earn profit in FY16. Since fuel prices fell and the electricity prices at the retail level were raised, the government was able to cut subsidies in these areas. An emerging Achilles heel in the recurrent budget is the 47.5 percent growth in expenditure on interest payments for national saving certificates (Table 13). As a result, despite a decline in the debt-to-GDP ratio relative to FY14, the effective interest rate in FY17 budget is higher than FY14 (Figure 12).

Figure 12: ADP Implementation
(percent of Revised ADB)



Source: IMED, Ministry of Planning

Expenditure on the ADP continues on the same path.

The performance shortfall remained nearly unchanged in FY16, with 86.1 percent of the original ADP budget allocation spent, compared with 85.3 percent in FY15. The ADP was slashed by Tk 60 billion (6.6 percent) to bring the size down to Tk. 910 billion. The project aid component was reduced by Tk 53.4 billion (or 15.5 percent), while the allocation for funding from the government was reduced by only Tk 6.6 billion (1.1 percent). The number of unapproved ADP projects that get allocations in the revised ADP has been rising in successive fiscal years. The end of fiscal year bunching problem continues, with low budget execution during the first eleven months of the financial year followed by a huge spike in expenditures in June. This month alone typically contributes over 22 percent of the spending on an average, but it surged to 30.9 percent in FY16.

Table 13: Interest Payments and Debt

	FY14	FY15	FY16RB	FY 17B
Foreign Interest (% of Total Interest)	5.7	5	5.1	4.3
Domestic Interest (% of Total Interest)	94.3	95	94.9	95.7
o/w Interest on National Savings Certificates	28.4	31.5	36.4	41.9
Interest Rate on Domestic Debt (%)	9.7	10.7	9	9.6
Interest Rate on Foreign Debt (%)	0.8	0.7	0.6	0.6
Effective Interest Rate (%)	5.8	6.4	5.4	5.9
Foreign Interest (% of GDP)	0.1	0.1	0.1	0.1
Domestic Interest (% of GDP)	2	1.9	1.7	2
Total Debt (% of GDP)	35.9	31.9	33.9	34.5
Domestic Debt (% of GDP)	20.3	18.2	19.2	20.4
Foreign Debt (% of GDP)	15.6	13.6	14.7	14.2

Source: Ministry of Finance

RB is Revised Budget & B is Budget

Implementation of fast track projects needs to be accelerated.

The government has prioritized seven mega projects under the 'fast track' initiative.[27] In addition to the seven projects, two new projects have recently been included in the list, the Padma Bridge Rail Link (PBRL) project and the Construction of Single Line Dual Gauge Track from Dohazari-Ramu-Cox's Bazar and Ramu to Ghundum near the Myanmar border. Except for the Padma and Rooppur first phase, work progress is in the low single digits. The current allocation levels are inadequate for all except Padma, Payra, and Rooppur (Table 14). The overall progress of the 'fast track' projects has remained below respective targets. In view of the low level of private investment and the significant infrastructure deficit, better quality and timely implementation of the ADP, particularly that of growth enhancing infrastructure projects, should be a top policy priority.

27 Padma Multipurpose Bridge (PMB), Dhaka Mass Rapid Transit Development Project (DMRTDP) known as Metro Rail project, 2x1200 MW Ruppur Nuclear Power Plant (RNPP), Matarbari 2x600 MW Ultra-Super Critical Coal-Fired Power Project (MUSCCFPP), 2x660 MW Moitri Super Thermal Power Project (MSTPP), LNG gas terminal for importing liquid gas project, Deep Seaport at Sonadia in Cox's Bazar (scrapped recently) and Deep Seaport at Paira, Patuakhali.

Initiatives to improve implementation need persistent follow-up.

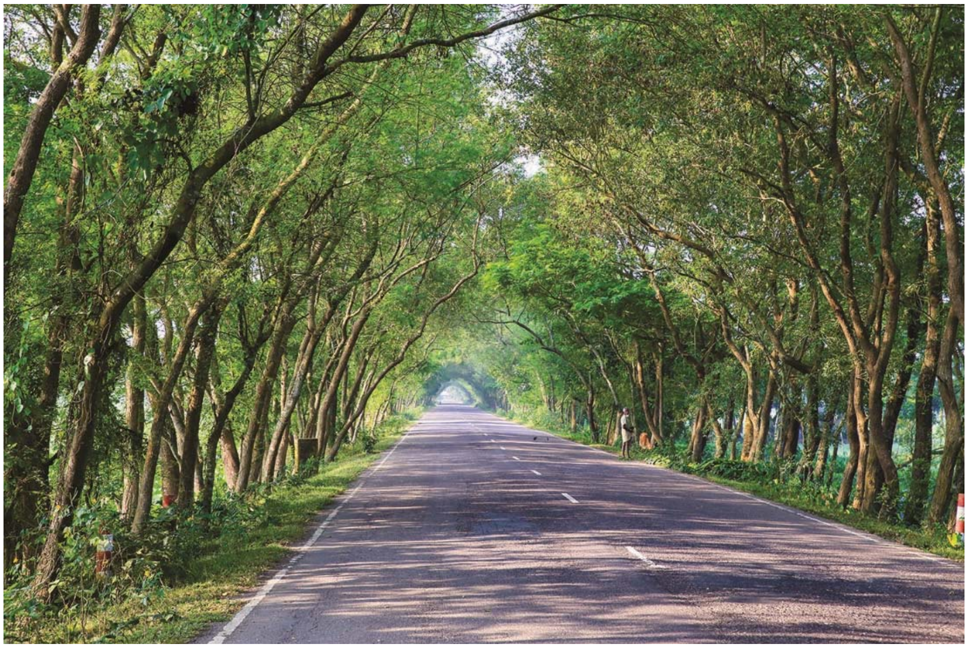
The government has recently taken a number of initiatives to accelerate ADP implementation. These include the creation of a Project Preparatory Fund (PPF) to facilitate quality at entry for timely and effective implementation of development projects; appointing Project Director(PDs) through direct interviews by the line ministries and divisions; assigning a dedicated official to each government agency for monitoring and evaluating respective projects and delisting longstanding 'non-operational' projects from the ADP. The Implementation Monitoring and Evaluation Division (IMED) regularly provides recommendations in its annual progress reports based on the challenges faced during the project cycle. These require much better follow up with implementing ministries.

Table 14: Summary of Fast-Track Mega Projects
(TK in billion)

Projects' Name	Total Cost	Work progress (%)	**Total Expenditure until FY16	Total Cost - Cumulative expenditure	Allocation in FY 17	Years required to completion
Padma Bridge	287.93	32	100.35	187.58	60.26	3.11
Padma Rail Track	349.88	-	-	-	41.02	8.53
Maitree super thermal power project	149.99	2.1	-	-	25.4	5.91
Matarbari Power Project	359.84	1.2	4.26	355.58	24	14.82
Metro Rail	219.85	-	7.6	212.25	22.27	9.53
Rooppur Nuclear Power Plant (feasibility phase)	50.87	80	44.01	6.86	6.18	1.11
Dohazari-Gundum Rail	183.04	2.1	3.13	179.91	6.14	29.31
Payra Sea port	11.28	2.1	3.13	8.15	2	4.07

Source: Ministry of Finance

C. Structural Reforms



The pace and direction of structural reforms have been uneven. Positive developments include the setting of a new mechanism to review interest rates paid on savings instruments and their use in financing the budget and the approval in principle of a new power bill that allows introducing independent system operator in a more coordinated manner. However, the implementation of the new VAT and Supplementary Duty Act 2012 has again been pushed back to July 2017.

New mechanism established to review interest rates paid on savings instruments and their use in financing the budget.

The government has formed a permanent committee consisting of nine members to review and re-fix interest rates on savings instruments, and help tighten extensive government borrowing through savings certificates. The committee will assess the fiscal implications of borrowing via national savings certificates, while also looking at its impact on total revenue receipts, non-development expenditure and cash reserve portfolio of the government. An Additional Secretary of the Finance Division will be heading this committee. It will also include the representatives from the BB and the National Board of Revenue (NBR). Going forward, the Ministry of Finance will also announce any changes on a bi-annual basis, which is expected in January and October of each year.

Parliament passed 'The Finance Act, 2016' with limited reforms.

Some of these reforms include an increase in the source tax rate to 0.7 percent from 0.6 percent on export receipts. The initial budget proposal had the rate set at 1.5 percent. As in previous years, this rate was reduced during the passage of the budget. Jute exporters on the other hand will continue to enjoy the 0.6 percent rate on their export income till June, 2019. Another notable change in the budget was increasing the Supplementary Duty (SD) on premium cigarettes by 1 percent, while also simultaneously increasing the floor price of the lower value cigarettes and bidis. It is expected that these steps will help to contain tobacco consumption in Bangladesh, although more needs to be done. Through the Finance Act, the government has also reduced the investment ceiling for tax rebates for the individual taxpayers from 30 percent to 25 percent. In an attempt to encourage digital services in Bangladesh, all e-commerce activities have been given VAT exemption. This will definitely help small e-commerce entrepreneurs and also increase digital penetration in the country. The government has also introduced a 'Tax Day' to help publicize tax payment deadlines, in line with international best practice. Unfortunately, the government has pushed back the implementation of the new VAT and SD Act to FY18. Despite the reforms highlighted above, without the implementation of the new VAT law, the revenue target may prove difficult to achieve.

The cabinet has approved in principle, the draft of 'The Power Bill, 2016'.

The law includes a provision for the establishment of an independent system operator (ISO) to run the country's power system in a more coordinated manner. The punitive measures from the old law have been retained, and the bill includes a maximum jail time of 10 years along with a fine of Tk 0.1 billion for damaging power infrastructure. To prevent distribution losses, the law also prohibits any person or organization from engaging in electricity production, transmission, distribution and supply without prior approval of the Bangladesh Energy Regulatory Commission (BERC).

Rooppur nuclear plant financial deal with Russia.

The cabinet has approved the inter-governmental state credit agreement to be signed between Bangladesh and Russia for constructing the Rooppur Nuclear Power Plant. Under this agreement, a US$ 12.65 billion deal would be signed between Bangladesh and Russia. Of the total project cost, the Russian government will provide $11.39 billion via a Russian line of credit, and the rest will be raised by the Government of Bangladesh. This credit will have interest rate of LIBOR plus 1.75 percent. The credit is to be repaid in 30 years with a 10-year grace period and the loan repayment will start from March 15, 2027. It must be noted that the current external debt of Bangladesh stands at US$ 37.1 billion as of FY 16. Hence, this deal represents an increase of around one third.

The government has set a new policy for petroleum imports.

The policy keeps the scope for imports through both government-to-government contracts and open tenders. Previously, the BPC would only import petroleum products on government-to-government contracts. Under the new policy, 50 percent of the BPC's imports of petroleum will have to be on an open tender basis. The policy also introduced minimum standards that suppliers have to meet to partake in the tender process. These include conditions on the firm's turnover, working capital, capacity and experience. Similar standards were also introduced for state owned enterprises participating in the government-to-government process. It is expected that the introduction of this policy will help to improve the efficiency and transparency in BPC's petroleum import process. In the first open tender since the enactment of this new policy, a total of 13 firms participated. At a time when, market prices are low, it is expected the open tender process will help to facilitate savings of Tk 1 billion.

Domestic administered oil prices reduced.

The price of petrol and octane have been cut by Tk 10 to Tk 86 and Tk 89 respectively. The government has also reduced the cost of diesel and kerosene by Tk 3 to Tk 65 for both, and lowered the price of furnace oil price by 30 percent to Tk 42 a liter from Tk 60 a liter. There has been significant pressure on the government to reduce fuel prices over the last two years, as fuel prices started to decline in the international market. Low international fuel prices represent an important opportunity to reform domestic administration of energy prices, but the government remains reluctant. Delaying the reduction of petroleum prices allowed

BPC to recuperate some of its losses accumulated since 1999 and also partly repay its bank loans.

Bangladesh moves to expand Liquefied Natural Gas (LNG) usage.

To promote LNG usage in the country and to stem draining the country's gas reserves, the government has signed deals with Excelerate Energy Bangladesh Limited (EEBL) to build an LNG processing terminal in Cox's Bazar. EEBL will build the terminal within 18 months with an LNG storage capacity of 138,000 cubic meters. The government also seeks to discourage the usage of Compressed Natural Gas (CNG) and promote the use of Liquefied Petroleum Gas (LPG). BPC will appoint an international consulting firm to help conduct a feasibility study and assess the impact of such a move.

The cabinet approved the draft of 'The National Telecommunications Policy, 2016'.

The main aim of this policy is to boost tele-density and internet penetration, as well as expanding broadband access. In the short term, the government will try to achieve a target of raising tele-density to 90 percent from the existing 80 percent by 2018. It also targets to boost internet penetration from 34 percent to 45 percent, expand mobile broadband from 7 percent to 20 percent, and establish fiber optic cable connections to every district and upazila headquarters. In addition, high-speed wireless service is to be made available in every upazila headquarters to introduce digital broadcasting across Bangladesh. By 2021, the government aims to increase tele-density to 100 percent, raise internet penetration to 65 percent, and boost broadband availability to 40 percent of the population. All unions of the country are to be connected to the fiber optic cable network during this period, widening access to 50 percent of residences and organizations and internet facilities for up to 90 percent people.

Expansion of 3G services.

Complementing the new Telecommunication Policy, the government has decided to invest heavily in the state owned mobile operator Teletalk. The Executive Committee of the National Economic Council (ECNEC) approved a project worth Tk. 6.76 billion which will support Teletalk's efforts to modernize its network and service quality. This project will also help to expand 3G services to remote areas of the country. Teletalk is the smallest GSM operator in the highly competitive mobile services industry.

Government approved various projects to improve connectivity and infrastructure.

To boost regional connectivity, the Cross-Border Road Network Improvement Project worth of Tk 24.73 billion was approved by ECNEC, complementing the approval of the Akhaura-Agartala Dual Gauge Rail Link Project by ECNEC. With an outlay of Tk 10.95 billion, the project is expected to boost trade with the eastern states of India by making goods movement more efficient. Dhaka's notorious traffic congestion has caught the eyes of policymakers, and ECNEC approved a Tk 10.26 billion project for Dhaka North City Corporation (DNCC). The project is aimed at easing traffic congestion in Dhaka by developing an effective road network. It must be highlighted that Dhaka consistently ranks in the bottom five cities in the Economist Intelligence Unit's Livability Index, partly due to traffic congestion.

The Cabinet has approved in principle, 'The Bangladesh Standards and Testing Institution (BSTI) Act 2016'.

The law when enacted will help to replace the outdated BSTI Ordinance of 1985. While the law provides for stricter punishment for failing to meet BSTI regulations, it falls short of creating an environment for facilitating private investment and export growth.

D. Outlook

The near term outlook for Bangladesh is favorable, driven by exports and strong domestic demand, and supported by prudent macroeconomic policies, continued improvements in infrastructure provision, and ongoing structural reforms.

Weakness in global growth expected to continue.[28]

Global growth this year is projected at 2.4 percent, 0.5 percentage point below January forecasts.[29] Bangladesh's main export markets—the advanced economies—are projected to expand by only 1.7 percent this year, 0.5 percentage point slower than had been expected in January. Investment continues to be soft, and the export prospects of advanced economies have worsened. Despite a boost from lower energy prices and improvements in labor markets, advanced-economy growth is expected to level off in 2016, rather than strengthen as previously expected. Growth disappointments have extended into 2016 for emerging market developing economies (EMDEs), which are prospective new markets for Bangladesh. Aggregate growth for EMDEs is projected at 3.5 percent for 2016, just above the post-crisis low reached in 2015. However, there is a significant difference in the prospects of commodity exporters and importers. After stagnating last year, growth in commodity exporting EMDEs for 2016 is expected to be 0.4 percent—substantially lower than the 1.6 percent forecast in January, reflecting a significant downward revision in commodity price forecasts, weak global trade, volatile capital flows, and persistent domestic challenges. In contrast, growth projections for

28 The discussion on the external outlook draws heavily from the World Bank, *Global Economic Prospects*, June 2016.

29 Emerging market and developing economies (EMDEs) account for about half of this downward revision, in large part due to the significant downgrade to growth forecasts for commodity exporters, and amid heightened domestic uncertainties and a challenging external environment.

commodity importing EMDEs are little changed at 5.8 percent for 2016, and are expected to be broadly stable at that level through 2018.

Continued low oil prices, together with tightening fiscal and monetary policy, remain a drag on activity in the GCC countries in the near term.

Growth in the Middle East and North Africa is projected to rise slightly in 2016 to 2.9 percent from the 2015 rate of growth, but 1.1 percentage points below the January estimate, largely due to a lower projected path for oil prices.[30] Given that oil exporting economies account for four-fifths of the region's GDP, the expected recovery in oil prices in 2017 is projected to lift regional growth to an average of 3.6 percent in 2017–18. However, the main reason for the slight improvement in regional growth in 2016 is stronger activity in the Islamic Republic of Iran, the region's second largest economy, which is forecast to grow 4.4 percent in 2016, up from an estimated 1.6 percent in 2015, following the removal of sanctions. Excluding the Islamic Republic of Iran, growth in oil-exporting countries in the region will be somewhat lower than in 2015, at 2.5 percent. Policy buffers continue to erode in oil exporting countries, reducing their ability to withstand further downside shocks. This does not bode well for the employment and earnings prospects of Bangladeshi migrant workers in oil exporting economies.

Brexit related uncertainties appear to be abating.

The outcome of the UK vote surprised global financial markets, with Brexit the materialization of an important downside risk for the world economy. As a result, the global outlook for 2016-17 has worsened, reflecting the expected macroeconomic consequences of a sizable increase in economic and political uncertainty. This uncertainty is likely to take a toll on confidence and investment, including through its repercussions on financial conditions and market sentiments. The initial financial market reaction was severe but generally orderly. The pound weakened by about 10 percent, equity prices fell in some sectors, and yields on safe assets declined. The implications of Brexit are still unfolding, in a process that is likely to last several years. Prolonged negotiations are likely to precede a new relationship between the United Kingdom and the European Union, and could still affect global growth negatively. Thus, growth in the Euro Area, a major trading partner of Bangladesh, is expected to remain steady but modest in 2016–18.

Commodity price declines projected to continue.[31]

Except food and precious metals, all the main commodity price indexes are expected to decline in 2016 due to ample supplies. Energy prices are expected to fall 16 percent, with average oil prices projected at $43/bbl in 2016. This implies marginally higher prices for the second half of 2016, as the oversupply in the oil market diminishes. Downside risks to the energy price forecast include higher-than-expected output and further weakening in EMDE growth. Supply disruptions among key producers could lead to higher prices. Non-energy commodity prices are expected to fall by 4 percent in 2016. Agricultural prices are projected to average marginally lower in 2016 than in 2015. The outlook reflects adequate supplies for most commodities but also takes into account reduced harvests in South America

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30 "The outlook assumes an average oil price of $41 per barrel for 2016, down from $51 per barrel assumed in January, and that the price will rise to $50 in 2017 and $53 in 2018. Other assumptions are that there is no further worsening of negative spillovers from the conflict in Syria; that the security situation in Iraq will continue to improve slowly in 2016; and that Libya's political agreement will be endorsed by the internationally recognized parliament in the east of the country and that the new government established under the agreement will take office." See World Bank, *Global Economic Prospects*, June, 2016.

31 Based on the World Bank, Commodity Markets Outlook, July 2016.

due to dry weather conditions. Agricultural commodity prices are also expected to be dampened by lower energy costs and plateauing demand for biofuels. Although the food price index is expected to grow only moderately next year, there is considerable dispersion among its key components: grains and beverages are both projected to fall 4 percent and raw materials by 2 percent, while edible oils and meals are expected to increase 3 percent. Fertilizer prices are projected to fall 18 percent in 2016 due to surplus capacity, weak demand, and low natural gas prices. Metals prices are projected to decline 11 percent in 2016, which follows last year's 21 percent drop, due to weak demand prospects and new capacity coming on line.

Table 15: Macro Outlook Indicators

	2013	2014	2015	2016 e	2017 f	2018 f
Real GDP growth, at constant market prices	6.0	6.1	6.6	7.1	6.8	6.2
Private Consumption	5.1	4.0	5.8	5.3	5.0	4.3
Government Consumption	5.8	7.9	8.8	10.7	10.4	7.6
Gross Fixed Capital Investment	5.4	9.9	7.1	8.9	11.9	11.3
Exports, Goods and Services	2.5	3.2	-2.8	-0.3	8.6	12.9
Imports, Goods and Services	1.2	1.2	3.2	-8.9	12.1	15.0
Real GDP growth, at constant factor prices	6.1	6.1	6.5	7.1	6.8	6.2
Agriculture	2.5	4.4	3.3	2.6	2.9	3.0
Industry	9.6	8.2	9.7	10.1	9.3	8.8
Services	5.5	5.6	5.8	6.7	6.5	5.6
Inflation (Consumer Price Index)	6.8	7.3	6.4	5.9	6.1	6.2
Current Account Balance (% of GDP)	1.6	0.8	1.5	1.7	0.0	-0.4
Financial and Capital Account (% of GDP)	2.3	1.9	1.2	0.9	2.2	2.2
Net Foreign Direct Investment (% of GDP)	1.2	0.8	0.9	0.9	0.8	0.7
Fiscal Balance (% of GDP)	-3.9	-3.6	-3.9	-4.3	-4.4	-4.7
Primary Balance (% of GDP)	-1.9	-1.5	-1.8	-2.3	-2.3	-2.9
Debt (% of GDP)	34.4	33.9	33.6	34.4	34.4	34.8

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice

Notes: e = estimate, f = forecast.

Growth in Bangladesh is projected to remain resilient.

Real GDP is could grow at 6.8 percent in FY17, reflecting weaker private consumption growth (5 percent) and government consumption growth (10.4 percent) relative to the preliminary estimates for FY16. (Table 15). Growth is projected to ease to 6.2 percent in FY18, driven by slower consumption growth in both the public and private sectors, as well as somewhat slower investment growth. Without boosting Total Factor Productivity (TFP) growth and private investment relative to GDP, Bangladesh is unlikely to sustain 7 percent growth going forward. Delivering necessary energy, infrastructure, and regulatory improvements remains critically important to ensure sustained and inclusive GDP growth with strong employment creation. Two essential road projects have recently been completed, which, if managed well, should contribute significantly to reducing travel time and transport costs, thus boosting productivity and trade (Box 1).

Box 1: The Dhaka-Chittagong and Dhaka-Mymensingh Highways Opened to Traffic

The 190 km long four-lane Dhaka-Chittagong highway formally opened in late July, facilitating trade and road communications between the capital and the Bangladesh's largest port city. Considered the country's economic lifeline, the highway will significantly boost exports and imports, and contribute to economic dynamism. It is Bangladesh's busiest road with daily traffic exceeding 40,000 Passenger Car Unit per day. But the highway had only two lanes and was struggling to accommodate the rising volume of traffic, with regular tailbacks. The highway has been expanded to four lanes from two. The time over-run was 3 years and cost over-run was 130 percent, indicating that significant room for improvement remains in implementing infrastructure projects. The travel time between the two cities has declined to five hours from 10-15 hours. Around 95 percent of the imported and exported goods are transported along the Dhaka-Chittagong highway, including more than 75 percent of Bangladesh's RMG exports. The reduction in travel time significantly reduces transportation costs. More work is needed to realize the full benefit of the highway by barring slow-moving vehicles from plying the road and building enough rail overpasses, flyovers and bridges.

The completion of Dhaka-Mymensingh highway is another significant addition to the road infrastructure. In this case, the time overrun was 2 years and the cost overrun was 100 percent. The journey on this 87 km highway - from Joydebpur intersection to Mymensingh – is still interrupted by construction work on several kilometers in Bhaluka that are yet to be completed. These interruptions notwithstanding, one can reach Mymensingh from Joydebpur in only one and a half hours, a journey which used to take at least three hours or more due to the dilapidated condition and narrowness of the road. The traffic chaos at the entries and exits of the highways around the capital hinder realizing the full benefit of the four lane highways.

Improved ranking on trade logistics.

Bangladesh has made significant progress in the Logistics Performance Index (LPI) 2016 ranking.[32] Bangladesh's ranking improved by 21 places due to a jump in rankings on customs, infrastructure, logistics quality and competence, and tracking and tracing (Table 16).

Table 16: The Logistics Performance Index

	Overall		Customs		Infrastructure		International shipments		Logistics quality and competence		Tracking and tracing		Timeliness	
	score	rank	score	rank	score	rank	score	rank	score	rank	score	rank	score	rank
2014	2.56	108	2.09	138	2.11	138	2.82	80	2.64	93	2.45	122	3.18	75
2016	2.66	87	2.57	82	2.48	87	2.73	84	2.67	80	2.59	92	2.90	109

Score: The LPI index is a multidimensional assessment of logistics performance, rated on a scale from 1 (worst) to 5 (best)

- Improvements were reported in customs and other official clearance procedures. About 50 percent of the survey respondents reported provision of adequate and timely information on regulatory changes and 40 percent reported expedited customs clearance for traders with high compliance levels.

[32] The Logistics Performance Index is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics. The LPI 2016 allows for comparisons across 160 countries. It is based on a worldwide survey of operators on the ground (global freight forwarders and express carriers), providing feedback on the logistics "friendliness" of the countries in which they operate and those with which they trade. Feedback from operators is supplemented with quantitative data on the performance of key components of the logistics chain in the country.

- On infrastructure, 80 percent of the respondents reported satisfaction with telecommunications and IT infrastructure.
- On logistics quality and competence, 70 percent of the respondents spoke highly of the freight forwarders, 100 percent confirmed that they were able to choose the location of the final clearance and 90 percent reported improvement in private logistics services.
- On tracking and tracing, the improvement in ICT infrastructure will have been enabled by GPS tracking used by private logistics operators.
- Still, Bangladesh's rank deteriorated significantly on timeliness, with 10 percent of respondents reporting often or nearly always encountering incidents of compulsory warehousing/transloading, another 10 percent reporting pre-shipment inspection, 30 percent reporting criminal activities (such as stolen goods), and another 30 percent reporting solicitation of informal payments as the causes of major delays.

Other indicators also point to sustained strong growth.

The most recent data on a number of indicators that were anemic in the first half of FY16 showed a pickup in the second half of the year. Growth in NBR tax revenues, imports of industrial raw materials, capital machinery, exports, indices of manufacturing, and flows of credit to the private sector have improved significantly relative to the same period last year (Table 17). Exports in July-August, 2016 grew by 8.4 percent relative to the same months in 2015. There are two significant exceptions—growth in imports of construction materials and growth in remittances, both of which show significant deceleration relative to the same period a year earlier. Remittances in July-August 2016 declined by 15.3 percent relative to July-August 2015. Hence, there is no room for complacence.

Table 17: High Frequency Indicators (%)

	2016	Same period 2015
NBR Tax Revenue growth, Jan-June	12.1	11.2
ADP implementation, Jan-June (% of Revised)	66.7	61.4
ADP implementation, Jan-June (% of original)	62.6	57.3
Industrial raw materials import growth, Jan-May		
LC Opening	4.0	-7.9
LC Settlement	5.1	0.3
Growth in import of construction materials, Jan-May		
LC Opening	-6.5	28.2
LC Settlement	12.9	13.1
Growth in import of capital machinery, Jan-Jun	19.8	0.0
Remittances growth, Jan-July	-8.4	3.0
Growth in quantum Index of manufacturing		
Large and medium, July-March	12.3	12.1
Small scale, October-December	7.9	10.0
Credit flow to private sector, Jan-Jun	7.9	5.7
Exports, July-June	9.4	2.4

Sources: Bangladesh Bank, IMED, NBR, and EPB

Stable near term outlook.

Inflation may edge up in FY17–18 on account of higher public sector wages, a one-off effect from the introduction of the new VAT, and overheating with actual output exceeding the potential. The current account surplus is projected to swing into deficit over the medium term. The fiscal deficit is projected to remain below 5 percent of GDP.

Policy outlook.

The overall fiscal framework underpinning the FY17 Budget is prudent, with sustainable deficit and debt levels and an improved composition of spending. However, the revenue targets are aspirational while the size of the ADP is large in relation to the government's ability to implement spending. The FY17 Budget fell short of providing specific directions on policy reforms in the near and medium term. On the monetary front, policy continuity has been maintained, although the BB could be more aggressive on containing price pressures and moving towards the inflation target.

The revenue target is ambitious.

The revenue target of 12.4 percent of GDP in FY17 is ambitious in light of the poor revenue performance in recent years and the lack of any major revenue increasing policy or institutional reforms in the budget (Table-11). The required revenue growth rate, relative to the revised FY16 estimate, is more than 35 percent, compared with the 14.6 percent growth rate recorded in FY16. A 2 percentage points increase in the revenue-to-GDP ratio would represent the largest ever increase and the highest ever revenue buoyancy. Capacity expansion and automation identified as the key drivers for achieving the revenue target (raising the number of taxpayers from 1.2 million to 1.5 million). After accounting for the autonomous gains in revenue due to economic growth and price developments, the total revenue yield from discretionary measures is estimated at no more than Tk 300 billion.

Improved expenditure allocation.

The FY17 budget anticipates spending equivalent to 17.4 percent of GDP, which is not excessive given Bangladesh's development and service delivery needs. The level is 2.1 percentage points of GDP higher than the FY16 revised budget (RB). Expenditure allocations to social infrastructure in the FY17 budget has rebounded after several years of decline. Out of total budgetary spending, the share of social infrastructure is projected at 28.3 percent in FY17, the same level as in FY11. Expenditure on all key social welfare and development sectors like education, health, food and social security had stagnated or declined in recent years relative to GDP, and their share in total spending declined at a time when social service delivery needs were expanding. Thus, the increase in allocations to social sectors is a step in the right direction.

ADP implementation will remain challenging.

The FY17 budget projects an expanded size of the ADP, reflecting an increase of 50.9 percent over that of the revised FY16 budget. The ADP allocation for FY17 seems high in nominal terms, and it has crossed the Tk 1 trillion ($12.7 billion) mark. As usual implementation will remain challenging and based on past experience, actual ADP utilization may be 15 - 20 percent less than the budgeted amount. The sectoral allocation pattern of the ADP for FY17 indicates a further increase in allocations for the transport sector owing to the Padma bridge project, along with major railways and Dhaka Metro projects. The emphasis on transportation is appropriate and consistent with the need for better inland connectivity.

Trade policy reforms are stalling.

The Seventh Plan heavily emphasizes export-oriented trade policy as a prerequisite for high-growth in the manufacturing sector, but the budget lacks a similar focus on export-orientation, which requires a decline in the share of the domestic market that is protected.[33] The emphasis in the FY17 budget is on a mix of protection to domestic activities and revenue mobilization. The 4 percent regulatory duty (RD) has been reduced to 3 percent after many years. What is new in the tariff structure is the introduction of a 15 percent tariff slab to the existing five.[34] While the new slab breaks the huge gap between the 10 percent rate for intermediates and 25 percent for final consumer goods, it provides the opportunity to offer protection to selected intermediate goods, thus departing from the long tradition of only protecting final consumer goods. However, with supplementary duties being adjusted in both directions, the average nominal protection rate (NPR) remains stuck at around 25 percent, while the top NPR, a protection indicator of most import substituting consumer goods, has been lowered marginally from 87 percent to 85.6 percent. The result is a further rise in the effective protection to industries such as textiles, construction, electrical and chemical industries, all of which have the benefit of the highest NPR of 85 percent. Some of these may be considered infant industries that warrant time-bound protection, unlike others such as biscuits and ceramics, which appear to be permanent beneficiaries of protection. The implementation of the new VAT Law was aborted, among others, due to stiff resistance from protection-seeking industries that have come to rely on SD as the primary instrument for protection.

Monetary policy is not firm enough to reduce the inflation rate in line with competing countries.

While there was pressure for relaxing the monetary policy stance in order to stimulate private investment, the modest relaxation reflected in the BB's MPS for July-December 2016 is open to debate. The risks of expansionary monetary policy were dramatically illustrated during FY10-11, when M2 growth averaged 22 percent per year and private credit growth accelerated to 25 percent per year. Excess liquidity did not increase private investment but instead fueled inflation, depreciated the exchange rate, and contributed to the generation of land and stock price bubbles.

Although the liquidity growth targets in MPS 2016 July-December are not as expansionary as in FY10-11, they nevertheless are on the high side. The evidence suggests that the higher growth of liquidity is unlikely to help private investment or GDP growth but may simply feed into inflation.[35] The MPS does not adequately address existing inflationary pressures and the continued appreciation of the real exchange rate. With global inflation slowing dramatically to the 2-3 percent range,

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33 Theory and evidence show clearly that the policy of sustained high protection to domestic import substituting industries creates an inherent anti-export bias of incentives to become a drag on exports or its diversification.

34 1%, 3%, 5%, 10%, 15%, and 25%.

35 There is no obvious correlation between the flow of credit to the private sector and investment. The private investment rate remained nearly flat at around 22 percent of GDP during FY10-16, irrespective of the behavior of growth of private credit and the pattern of real interest rates. Private credit growth has ranged from a high of 26 percent to a low of 11 percent, with little discernable impact on the private investment rate. Similarly, the real average lending rate has fluctuated between a low of 2 percent to a high of 7 percent without influencing the private investment rate. This lack of sensitivity of private investment rates to private credit growth and real interest rates suggests that neither is a constraint to private investment in the present conditions. The binding constraints include the high cost of doing business, difficulties of procuring land, the high rates of corporate taxation, the severe shortage of energy (especially natural gas), the inefficiency of trade logistics (especially transport costs), and the limited availability of skills.

Bangladesh needs to reduce domestic inflation through firmer fiscal and monetary policies.

Inflation control and exchange rate management deserve much more policy attention than is reflected in the MPS. A 12-13 percent expansion of M2 is consistent with the government's GDP growth target of 7.2 percent and an inflation target of less than 5 percent. It is not advisable to target inflation at 5.8 percent when all the external competitors and export markets have much lower inflation. Growth with stability is the need of the hour in a poor country like Bangladesh where so many people face continuing vulnerability.

E. Challenges and Policy Responses

Downside domestic risks related to terror attacks, vulnerability of remittances to shocks in GCC countries, weak bank balance sheets, and revenue shortfalls are the key concerns. The challenge is to boost productivity and private investment by reforming business regulations, mitigating infrastructure and energy deficiencies, and enhancing the efficiency of financial intermediation. Greater investment—in infrastructure, productivity enhancing technology, and human capital—could lay the foundation for stronger growth.

Risks to the outlook are predominantly domestic and weighted to the downside.

Domestic risks to growth and fiscal positions include setbacks in implementing reforms affecting the allocation of labor, land and capital, such as the removal of impediments to productivity. Delays could be driven by entrenched political obstacles to the implementation of reforms (e.g. the new VAT law). Postponing reforms would compromise future productivity, dampen growth prospects and increase fiscal pressures. Although Bangladesh's systemically important banks do not rely heavily on wholesale funding, vulnerabilities in bank balance sheets may lead to financial stress and weigh on lending. Several banks must raise their capital adequacy ratios to meet Basel III requirements. Some corporate borrowers, particularly state-owned enterprises, are facing a deterioration in asset quality.

Security, financial and trade shocks are the main risks.

An escalation of terrorist attacks in recent months has heightened security concerns and created new types of uncertainties that could adversely impact investment, growth, and inflation (Box 2). Security shocks, such as terrorist attacks, have the potential to cause damage to the economy, particularly be weighing on investment and consumer confidence. Income and consumer spending, which accounts for 70 percent of the economy, could be significantly affected. Continued weakness in the state-owned banks could undermine growth prospects and affect fiscal sustainability, as would further delays in launching the new VAT. On the external side, a protracted slowdown in the European Union due to Brexit related uncertainties could hurt exports (Box 3). Remittances are vulnerable as persistent low oil prices could further worsen investment and employment in host countries.

Box 2: Impact of terror attacks

In addition to focusing global attention on vulnerability to terrorism, security risks could set back the steady progress of the economy in recent years. Although individual foreigners have been targeted before, the Holey Artisan Café attack is the biggest to hit Bangladesh in recent times, sending shock waves through the expat community, many of whom are involved in the garment trade or work for aid institutions. Such terrorist attacks have the potential to damage the economy by undermining investment and consumer confidence. An economic contraction may result if fear and uncertainty cause tens of thousands of workers to stay home and consumer spending, which accounts for 70 percent of the economy, is severely affected. The service sector, including hotels, beauty parlors and restaurants, have been badly affected in the immediate aftermath of the attack, as people are fearful to go to these places. Consumer transactions and turnout declined. Banks and insurers could also be hard hit—the former on concern of a looming economic slowdown and the latter on uncertainty about insurance claims.

A second potential economic impact could stem from the counter-measures that are adopted. The installation of security measures is costly. In addition, the cost of security measures at airports - in terms of time wasted in queues - is hard to calculate. There are other less obvious economic costs that are also difficult to measure. Terrorist attacks can result in greater spending on unproductive activities such as heightened counterterrorism measures, expanding para-military and police forces, and stricter border controls. The money diverted to extra surveillance and policing rather than investment and trade may eventually pose a drag on growth. Over time, this *friction in the economic system* can have substantial effects.

Apprehension of further attacks could hurt Bangladesh's economic prospects. It will decrease foreign investment and lead to more capital flight as investors feel insecure about making investment decisions in an uncertain security context. Domestic investment was already weak, with capital leaving Bangladesh. According to Swiss central bank data, Bangladeshi citizens' deposits with Swiss banks rose by nearly 9 percent to 551 million Swiss francs in 2015, compared with 506 million Swiss francs in 2014. Preventing future terror attacks will be essential to restoring investor confidence, and implement mega projects like the Dhaka metro rail and the Matarbari power plant. Security concerns may already be discouraging visits by foreign nationals and adversely impacting new projects as people will think about the security of their employees as well as their invested funds.

Terrorism fears could also have an adverse impact on export oriented sectors. The country's export-oriented sectors, especially the apparel industry, are once again facing an image problem when it comes to foreigners' security in Bangladesh.

External risks include weaker-than-expected global trade, increased protectionism, and an unexpected tightening of global financing conditions.

Bangladesh will not be immune to such developments, even though it is less integrated with global markets than many other developing countries. Apart from flat global trade, Brexit too poses a risk. Rising protectionist sentiments in advanced economies is a major concern. According to a World Trade Organization (WTO) report, 22 new trade-restrictive measures were initiated by WTO members per month during the mid-October 2015 to mid-May review period. This constitutes a significant increase compared to the previous review period, which recorded an average of 15 measures per month, and is the highest monthly average since 2011.[36] There seems to have been a relapse in WTO Members' efforts at containing protectionist pressures. Not only is the stock of existing restrictive measures continuing to increase, but new trade restrictions are creeping in, including both import and export measures. Despite a number of positive developments, the global trading environment remains challenging and continued vigilance is required. Financial volatility could return, triggered by geopolitical tensions or risks associated with the negotiations after Brexit vote. The global growth outlook could be further undermined by a lack of consensus for reform or rising real interest rates triggered by a drop in inflation expectations.

36 WTO, Report to the TPRB from the Director General on Trade-related Developments, July 4, 2016.

Box 3: Likely impact of Brexit in Bangladesh

In a referendum held on June 23, 2016, the United Kingdom voted to leave the European Union (EU). Brexit sent shockwaves across major markets. Immediate impacts across South Asia and in Bangladesh have been more subdued compared to earlier episodes of market volatility. Though Bangladesh is adequately insulated from Brexit, there are certain challenges which policymakers must be aware of in the coming months.

The most immediate impact of Brexit felt in Bangladesh has been the appreciation of the taka against the pound sterling (GBP). In the two days after the vote, there was a 10.3 percent appreciation of the taka against the GBP from Tk 116.19 on June 23 to Tk 104.28 on June 25, as well as a 4.8 percent appreciation against the euro from Tk 89.03 on June 23 to Tk 84.78 on June 25. Additionally, the 8 percent depreciation of the GBP against the USD implies about USD99 million valuation loss (measured in dollars) in Bangladesh's holding of foreign exchange reserves in GBP. This valuation loss constituted about 3.3 percent of Bangladesh's foreign exchange reserve holdings on June 23. Subsequently, the currency market stabilized at around Tk 104 against the GBP and Tk 88 against the euro. Unlike other stock markets, there was hardly any reaction from the stock markets in Bangladesh.

The medium-term impact of Brexit, if any, will likely come from the external sector. On the trade front, the UK represents the third largest export destination for Bangladesh after the United States and Germany. In FY16, the UK and the EU accounted for 11.1 percent and 54.6 percent, respectively, of total exports from Bangladesh. Exports to the UK grew by 18.9 percent in the FY16 relative to the same period last year, and to the EU as a whole they grew by 9.7 percent during this period. The depreciation of the GBP as well as the euro therefore risks eroding the competitiveness of Bangladeshi exports to these markets. With currencies having stabilized at this weaker level, it is unlikely that these currencies will go back to their pre-Brexit levels in the medium term. Achieving export growth of 8 percent or more for FY17 may therefore prove challenging for Bangladesh against the backdrop of a weakened GBP and euro.

Depending on the terms of the UK's exit, there are long term considerations for Bangladesh. Through the EU common market, Bangladesh is enjoying 12.5 percent duty benefit on its exports. Bangladesh may need to renegotiate Everything But Arms (EBA) benefits in the UK market, and may lose a champion for EU market access. Bangladesh also routes much (magnitudes not precisely known) of its exports to EU through the UK. With the implementation of Brexit, this trade will have to be redesigned. Whether or not this will mean an increase in trade facilitation costs depends on what kind of market access deal the UK negotiates with the EU. While Bangladesh, as a member of the Commonwealth, may get sympathetic consideration, there is a risk that the implementation of Brexit may lead to a build-up of protectionist and anti-globalization tendencies in the UK and elsewhere. Should this risk materialize, Bangladeshi exporters may face increases in transportation and financial services charges.

Another challenge on the external side centers on remittance flows from the UK to Bangladesh. Due to the presence of a large Bangladeshi diaspora, the UK is a major source of remittances, accounting for 6 percent of remittances received by Bangladesh in FY16. The rest of the EU accounts for only 2 percent of remittances received. Total remittances from the UK amounted to $805 million in FY15 and $862 million in FY16. A weak pound sterling could have an immediate impact on the remittances being sent from the UK as remitters choose to wait for the exchange rate to return to "normal" level. A lasting appreciation of the taka against the pound and euro would also act as a disincentive to remittance from UK, other things equal. While it is too early to identify a causal impact, during the first two months of FY17, remittances from the UK declined by nearly 31 percent over the same period last year.

Remittances are vulnerable to the impact of fiscal consolidation in most oil-exporting countries.

GCC countries have used their substantial reserves to maintain spending levels and their currencies have remained stable. But persistently lower oil prices have forced Gulf countries to rethink the way their economies are managed. Public expenditure cuts of 14 percent in Saudi Arabia, 11 percent in Oman, 9 percent in Algeria, 8 percent in Iraq, and smaller amounts in Kuwait, Qatar, and the United Arab Emirates have been outlined in their respective 2016 budgets. Energy subsidy reforms were implemented in all GCC countries in 2015 or early 2016. Modest efforts to expand revenue have also been implemented, including raising corporate and consumption taxes, but in the short term, these will not make up for large revenue losses in 2015 from plummeting oil prices. A GCC-wide agreement to enact a value-added tax at an expected rate of 5 percent at the beginning of 2018 was announced in March. The downward pressure on growth from fiscal consolidation will be reinforced in GCC countries by tightening monetary policy in tandem with any rate increase in the United States. While oil prices will recover only gradually over the medium term, supply shocks could lead to a spike in prices. Since

Bangladesh is a net oil importer, this would weaken incomes and output growth, although it may be support greater remittance flows.

A key challenge is to boost productivity and private investment by reforming business regulations, mitigating infrastructure and energy deficiencies, and enhancing the efficiency of financial intermediation.

Disabling regulations and bottlenecks in energy and transport, have become more binding in recent years as the economy expanded. These constraints stem from low public investment and inadequate infrastructure maintenance. Weak bank balance sheets and governance in the financial sector limit lending capacity, divert credit away from productive investment, and impose large fiscal recapitalization costs.

Room for expansionary macro policies is limited.

Even though low commodity prices have reduced fiscal and external vulnerabilities, and eased inflationary pressures, the scope for expansionary fiscal and monetary policies in Bangladesh remains limited because of binding structural constraints on the supply side. Expansionary policies could support activity in the event of an adverse shock, but the returns to such policies may diminish quickly. In an environment of binding structural constraints, rising risks and limited policy buffers, growth-sustaining structural policies are urgently needed. These measures would boost medium- and long-term growth, reduce vulnerabilities, and signal to investors that the government is committed to enhancing long-term prospects. If well targeted, they could also support short-term aggregate demand. Easing inflation pressures have allowed the BB to cut policy rates and maintain their accommodative policy stance. Since the drop in international commodity prices is responsible for only part of the decline in inflation, further policy easing is not warranted in view of rising core inflation and uptick of credit growth. Monetary policy rate tightening may also be required if inflation rises above target or more sharply than consistent with macroeconomic stability. Macroeconomic policies in the near-term need to focus on safeguarding stability. If the economy is hit by large temporary shocks, counter-cyclical fiscal policy responses would be needed. The exchange rate should be allowed to depreciate if the shocks are protracted.

Greater investment—in infrastructure, productivity enhancing technology, and human capital—could lay the foundation for stronger growth.

Growth in Bangladesh has been remarkably strong, bringing a steep decline in poverty rates over the past two decades. However, some of the tailwinds that have supported Bangladesh's recent strong performance (e.g. significantly lower oil prices and buoyant remittances) are likely to fade over the medium term. Policies should aim to fill public infrastructure gaps, encourage domestic and foreign direct investment, strengthen human capital, foster diversification, and reduce trade barriers. With diminishing fiscal space, financing for such investments may be limited.

Recapitalization alone is not enough.

Stressed assets in the banking sector imply impairment of bank capital, hence the need for recapitalization of systemically important banks to restore buffers against future contingences. The share of stressed assets (NPLs plus restructured loans) increased significantly in 2015.[37] From 2014 to 2015, the total amount of rescheduled loans increased by 50.1 percent. Public sector banks (which represent about 27 percent of total banking system assets) account for most of the problem. A resolution of the issue would facilitate easier access to loans by credit-worthy borrowers, and thereby boost investment. Sound insolvency legislation and procedures encourage bank lending and support the reallocation of resources to the most productive uses. Bankruptcy processes in Bangladesh are among the most challenging in the world, with insolvency processes that take an average of 4 years, and recovery rates of only about 27 cents on the dollar.[38] Such barriers to legal resolution of debts delay the exit of unviable firms, and hinder productivity gains from the reallocation of resources to more productive firms. In this regard, reforming the bankruptcy law to introduce time limits on the recovery of debts should help improve the business regulatory environment and lead to a more efficient allocation of resources.

Addressing energy bottlenecks remains critical for sustaining Bangladesh's long term growth.

These can be addressed with a combination of institutional reforms, additional generation capacity, privatization of state-owned generation and distribution companies, rationalization of utility tariffs, improved tariff collection, and measures to conserve energy. Despite progress in increasing power generation in Bangladesh, the peak electricity deficit has largely remained unchanged due to an increasing number of new connections given by the Rural Electrification Board in the rural areas. Reforms and cross border electricity trading with India, which have already started, hold great potential.

Address areas of fiscal vulnerability.

Against the backdrop of a fragile global economy, the priority for fiscal policy is to build fiscal buffers. This will give policy makers some flexibility to respond to future shocks with fiscal stimulus. The present weaknesses in tax laws and administration severely limit the capacity of the NBR, which cannot be expected to deliver the desired growth in revenue outcomes without fixing the tax laws through a comprehensive policy reform and supporting such policy reforms with concurrent tax administration reforms. Measures to raise tax revenues, which are low by any standard, will help generate fiscal space. Such measures include the introduction and implementation of the new VAT, reforming the Direct Tax Code, broadening the tax base, reducing exemptions, and improving tax administration. Efforts to raise revenue need to be complemented with better quality of spending and more effective implementation of much need public investment. On this front, appropriate measures include strengthened public financial management and a shift from recurrent spending to spending on physical capital (roads, ports, energy infrastructure) and human capital (health and education). To contain fiscal spending and inflationary pressures, untargeted subsidies could be further reduced. The priority needs to be to find ways of spending more efficiently existing allocations.

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[37] In 2015, the rescheduled loans were 4.5 percent of banks' total outstanding loans, 5 percent of total unclassified loans and 28 percent of total stressed advances, compared with 3.4 percent, 3.8 percent and 25.9 percent respectively in 2014. Source: The Financial Express, August 25, 2016.

[38] Doing Business Indicators 2016.

F. A Carbon Tax for Bangladesh?

Bangladesh's Climate Change Strategy and Action Plan in 2009 made it the first developing country to articulate such a coordinated action plan. It was also the first country to set up its own Climate Change Trust Fund to help mitigate and adapt to climate change. In 2011, the Bangladesh Constitution was amended to include protection of the environment and safeguarding natural resources for current and future generations. Bangladesh has the chance to lead again. While carbon taxes have, so far, mainly been introduced in developed countries, an increasing number of emerging markets are recognizing their benefits. If Bangladesh joins them, not only would it place the country in the forefront of a critical global movement, but the direct benefits could be significant.

Benefits for Bangladesh

Cleaner climate

Bangladesh is one of the countries hit hardest by climate change.

One estimate places annual losses from climate change at 2 percent of GDP by 2050,[39]and signs of Bangladesh's vulnerability can already be seen. Flooding in 2007 caused losses equal to around 1.25 percent of GDP, for example. The financial, infrastructure and human loses will only mount as the impacts of climate change worsen. Even though Bangladesh's contribution to climate change is minimal – less than half a percentage point of global emissions – it will be important to be seen to contribute toward global greenhouse gas abatement. In addition to giving the country a greater presence in international climate discussions – in which Bangladesh has a strong interest – it will help it to meet its commitments under the Nationally Determined Contribution (NDC) during the Conference of the Parties in

[39] Intended Nationally Determined Contributions (INDC): http://www4.unfccc.int/submissions/INDC/Published%20Documents/Bangladesh/1/INDC_2015_of_Bangladesh.pdf and Asian Development Bank (2014), "Assessing the cost of climate change and adaptation in South Asia" : http://adb.org/sites/default/files/pub/2014/assessing-costs-climate-change-and-adaptation-south-asia.pdf

Paris in 2015 (COP21). As part of its NDC during the COP21, Bangladesh committed to reducing climate-harming emissions by 5 percent compared to the "business as usual" scenario, and more if sufficient financial and technological resources are made available.[40]

Refocused and simpler taxes

A carbon tax can be part of a range of policies that help Bangladesh refocus its taxes away from "goods" and toward "bads".

Bangladesh has fairly high tax rates compared with some other countries in South and South-East Asia. For example, corporate tax rates of between 25 and 45 percent are higher than in Indonesia, Malaysia, Thailand, or Vietnam. Labor taxes are higher than in Sri Lanka or Pakistan.[41] Introducing a carbon tax could help rebalance the tax system away from workers and firms and toward the payment of taxes on things that cause harm. Carbon taxes – and "green taxes" more generally – can contribute toward reduced pollution. Further simplification and increased use of tobacco taxes could also be a part of the reorientation toward such Pigouvian taxes on goods with negative externalities. To maximize the positive impact of this shift, it will be important that Bangladesh continue to ensure that fuel is not implicitly subsidized and priced at below world prices, as has been the case in the past (and is still the case for some sectors that receive privileged pricing).

Carbon taxes can be simple to implement and tend to be less pro-cyclical than other taxes.

The carbon tax can be collected using the same administrative systems as existing taxes, or with only small modifications. In addition, when collected "upstream" through levies on fuel wholesalers (imports or producers), carbon taxes need only be paid directly by a few firms. Wholesalers then pass the tax on to retailers, who pass it on to consumers. This "keep it simple" approach is strongly recommended by administrations with experience implementing carbon taxes. In addition, a carbon tax does not (immediately) need to cover all carbon emissions. In Bangladesh, it could focus on fuel, since it may be difficult to collect carbon taxes from other sources, such as landfills or forestry. Typically, carbon taxes only cover two thirds to three quarters of total emissions, and even developed countries exclude emissions that are hard to measure.

Carbon taxes are becoming a significant source of revenue for governments around the world

As the number of jurisdictions implementing carbon taxes and other carbon pricing mechanisms has increased (from two in 1990 to 37 in 2016) so has the revenue raised. Governments that implement carbon taxes raised an estimated $14 billion from taxes in 2015 (and a further $34 billion from other carbon pricing instruments). The price of carbon emissions varies considerably from $1 to $130 per ton, with the vast majority set between $5 and $30.[42] The Bangladesh Carbon Tax

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40 During the COP21 in 2015, developed countries agreed to provide developing countries with significant financial and technical resources to help mitigate climate change. In particular, the COP21 decided that developed parties should provide $100 billion per year up to 2025 and a new bigger goal will be agreed by then (See paragraphs 51-71 of the COP21 Decision Document: https://unfccc.int/resource/docs/2015/cop21/eng/l09r01.pdf). Bangladesh's Intended Nationally Determined Contributions (INDC) available from: http://www4.unfccc.int/submissions/INDC/Published%20Documents/Bangladesh/1/INDC_2015_of_Bangladesh.pdf

41 World Bank (2015), "Bangladesh Public Expenditure Review Update": http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/SAR/2015/08/26/090224b08309d36c/3_0/Rendered/PDF/Bangladesh000P0c0expenditure0review.pdf

42 This is significantly below the $80 to $120 most scenario analyses find would be consistent with a goal of limiting global warming to 2^0 Celsius.

and help to reduce revenue fluctuations.

Tool (developed with support from the World Bank, and still in Beta mode) suggests that Bangladesh could raise up to 1 percent of GDP in tax revenues, at $30 per ton of CO2 equivalent (tCO2e), provided exemptions are minimal. In addition, revenues from carbon taxes are less susceptible to economic cycles than most other taxes as they are levied on carbon emissions. While these do vary with the economic cycle, they tend to do so by less than other factors that impact tax receipts. This helps to make them less pro-cyclical than other taxes, helping to shore up fiscal revenue during economic slow-downs.

Increased competitiveness

Resources raised through a carbon tax can be used to finance improved infrastructure and to reduce other taxes or duties.

Bangladeshi firms suffer from a significant lack of infrastructure, harming their competitiveness. A recent World Bank Systematic Country Diagnostic[43] found that transport and energy infrastructure are two of the country's major constraints to future economic growth. In addition, despite low tax receipts, Bangladeshi firms face high rates of taxation. Carbon tax receipts can be partially used to finance reductions in other taxes or duties. This has been done in several countries – notably in parts of Canada, where the local finance minister faces salary cuts if carbon tax receipts are not "returned" to households and firms through reductions in other taxes. India has also adjusted duties to align them with carbon emissions for some fuels. These resources, combined with any additional climate adaptation and mitigation resources raised following COP21 commitments, can also be used to reduce climate risk for firms and households (e.g. through climate resistant infrastructure). This can both be beneficial for firms and help to tilt Bangladesh's development toward a lower carbon growth path.

Carbon taxes can contribute toward the long-term competitiveness of Bangladeshi exporters.

Carbon taxes can help Bangladeshi exporters to show their environmental side in increasingly environmentally-conscious export markets. Several supermarkets in France began labeling the carbon footprints of products in 2008 and such labelling is being rolled out, including on imported goods.[44] Similar trends can be observed across several countries and a carbon tax can help Bangladesh and its exporters to get "ahead of the curve".

Lessons from other countries

Since several countries have already implemented carbon taxes or plan to do so, Bangladesh is in a good position to

Lessons from other countries include how to design the administration of carbon taxes, implement them, communicate with the public and firms, and moderate negative impacts of carbon taxes, about which some firms and consumers will have genuine concerns that need to be considered.

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43 World Bank. 2015. Bangladesh - More and better jobs to accelerate shared growth and end extreme poverty: a systematic country diagnostic. Washington, DC: http://documents.worldbank.org/curated/en/950731468000249915/Bangladesh-More-and-better-jobs-to-accelerate-shared-growth-and-end-extreme-poverty-a-systematic-country-diagnostic

44 See information on the 2011 Grenelle Act summarizing initial carbon ticketing at: http://www.developpement-durable.gouv.fr/IMG/pdf/Grenelle_Loi-2.pdf

learn from their experiences.

Keeping the design simple is key for success.

In particular, the tax can be kept simple by charging it "upstream" on relatively few producers/importers and allowing the costs to filter down. Charging individual consumers is administratively difficult. Existing administrative systems should be used to avoid the need to design new agencies, IT systems, and the like. The tax should (initially) focus on easy-to-identify sources of carbon emissions such as oil, coal and gas, while avoiding more challenging sources such as forest degradation or waste disposal. No country manages to tax 100 percent of carbon emissions.

Clear implementation rules and allowing time for firms and households to adjust are important.

For example, by levies could begin with a low price but increase regularly according to a pre-announced plan until it reaches its intended price. This gives time for firms and people to adjust but does not delay implementation too long. The scheduled price increases should be adhered to strictly in order to avoid introducing uncertainty, which could harm businesses and consumers. The final carbon cost can be linked to inflation to prevent erosion of the real cost of the carbon tax and also safeguard real revenues. Finally, it is important to avoid too many exemptions or reductions for specific groups as these can create political uncertainty for firms, open the door to unproductive lobbying, tax avoidance, corruption, and complicate implementation.

Finally, ensuring good communication and open discussion aimed at addressing the concerns of vulnerable firms and households is important.

In particular, it is essential to identify groups that could bear a particular burden as a result of the carbon tax and to discuss extensively with all concerned parties. The government can be prepared to "return" a significant amount to groups hit hard by reducing other tax rates (e.g. company tax) or through increased expenditure (e.g. social protection for the poor).

Carbon tax challenges

Carbon taxes can have significant benefits for Bangladesh but are not without challenges that need to be considered.

Policy-makers could justifiably be concerned about the impacts of carbon taxes on poorer segments of the population and on some economic sectors.

A carbon tax would lead to only small price increases but it will be important to moderate the impact on vulnerable firms and households.

The overall impact of a carbon tax on prices is fairly low. Some price adjustment can be offset with corresponding reductions in other taxes or duties. However, some sectors will be more impacted than others. Industries that currently benefit from preferential pricing will see the largest price increases in percentage terms. Addressing the impacts on poor households will be particularly important. Preliminary estimates suggest that the poorest 20 percent of households could face price increases equivalent to 1 percent of their total consumption, even at low ($5 per tCO_2e) carbon tax rates, largely through increased electricity tariffs, though they could be further impacted through fertilizer prices. Ensuring compensatory improvements in social welfare or public services for these households will be important.

Mitigating risks for exporting sectors

Policy-makers should consider the impact on exporting sectors.

In particular, there is a risk of "carbon leakage" if firms leave Bangladesh to countries without carbon taxes or other carbon pricing mechanisms. The evidence to date suggests that such negative impacts are minimal for the economy as a whole.[45] However, they may impact some sectors, and Bangladesh's garment sector may be one example that deserves consideration. The risks, however, are falling as more countries move to implement carbon taxes.

Carbon taxes can also bring benefits for firms, including those that export.

First, there is well-established empirical evidence that environmental regulations can stimulate innovation. A recent World Bank report argued that, while more research is necessary in developing country contexts, this may provide long-term benefits for some of the largest employers in developing countries, as they would be encouraged to make productivity-increasing investment. Second, it would allow firms producing in Bangladesh to market their products as more sustainable than those produced in other countries. Third, it would allow Bangladesh to pre-empt the potential imposition of "green taxes" on imports into other countries. While such taxes do not appear to be imminent, the recently agreed Trans-Pacific Partnership (TPP) does subject trade to other environmental protections.[46]

Mitigating risks for vulnerable households

Given the estimated impact of the tax on households, policy-makers should consider how to alleviate the costs for poorer households.

Risk-moderating options used in other countries have included: Reducing other taxes, such as payroll taxes; providing specific tax credits targeted toward poorer groups; boosting social protection schemes; financing a disaster risk fund that could be used to ensure resources are quickly available to support poorer households in the event of climate and other disasters.

Conclusion

A carbon tax can have significant benefits for Bangladesh but is not without challenges.

In addition to the benefits noted above, a carbon tax could help Bangladeshi exporters to get "ahead of the curve" as consumers in developed markets become more environmentally conscious. However, policy-makers could justifiably be concerned about the impacts of carbon taxes on poorer population and on some economic sectors. It will be important to consider these challenges as Bangladesh pulls itself, again, into the vanguard of environmental, tax and development movements.

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45 See section 3 of Kassoy, A. et al. (2015), "State and Trends of Carbon Pricing 2015", by World Bank, Washington, DC.: http://www.worldbank.org/content/dam/Worldbank/document/Climate/State-and-Trend-Report-2015.pdf

46 See: https://ustr.gov/tpp/#preserving-the-environment

Annex-1:

Updating the international extreme poverty rates of Bangladesh

Global Poverty Monitoring and the 2015 revision

One of the targets of the United Nations Millennium Development Goal (MDG) 1 was to halve the proportion of people living in extreme poverty between 1990 and 2015 globally. The extreme poverty was measured by the proportion of people living on less than an international poverty line of $1.25 per day in 2005 Purchasing Power Parities (PPPs). The latest comprehensive revisions on the international extreme poverty index took place in October 2015[47]. The two most notable changes were a switch to the use of the 2011 Purchasing Power Parities (PPPs) and an updated poverty line of $1.90 a day per person. PPP conversion rates are used to convert the international poverty line to local currencies. The market exchange rate reflects price differences in *tradable goods and services* only. In contrast, the PPP conversion (or exchange) rate reflects price differences of *all goods and services*. Since the poor consume both tradable and non-tradable goods, the PPP conversion rate is a better measure to use for poverty monitoring than a market exchange rate. Both PPPs and the global poverty line have to be periodically updated to reflect changes in prices, as the cost of living across the world evolves. In 2015, monitoring of the World Banks's extreme poverty index was updated and two related changes were introduced: (i) adoption of the 2011 PPP conversion rates to convert the global poverty line to local currency and (ii) updating of the global poverty line of $1.90 per day.

This update in the international poverty estimates and projections for Bangladesh was initially delayed pending further review.

For Bangladesh and four other countries (Cabo Verde, Cambodia, Jordan, and Lao PDR), however, the international poverty estimates continued to be estimated using the $1.25 a day poverty line the 2005 PPPs because the switch to the 2011 PPPs and the $1.90 poverty line changed the estimated poverty rates substantially. The adoption of the new poverty line and PPPs was postponed until further assessment of the price data used for the 2011 PPPs could be undertaken. are found to be of good quality and poverty rates based on the new poverty line and PPPs are reasonable.

In the 2016 update, the new poverty line and 2011 PPP were applied to Bangladesh after careful evaluation onf the 2011 PPP and its price data.

Based on the new poverty line of $1.90 per day and the 2011 PPPs, the World Bank revised the entire series of global poverty estimates from 1980 to 20123. The World Bank conducted a detailed assessment of the price data in Bangladesh in close collaboration with the Bangladesh Bureau of Statistics (BBS) and the Asian Development Bank (ADB). The assessment found that the 2011 PPP and the price data in Bangladesh are accurate and reliable. Based on these findings, the Technical Working Group of the World Bank recommended that the 2011 PPPs and the new global poverty line of $1.90 a day be adopted for estimating the international poverty numbers for Bangladesh. From this year, therefore, the international extreme poverty rate for Bangladesh is estimated at $1.90 a day using the 2011 PPP conversion (exchange) rate, and the entire series of international poverty rates for Bangladesh has been revised.

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47 Global Monitoring Report 2015/2016 : Development Goals in an Era of Demographic Change, World Bank, 2015 and A Global Count of the Extreme Poor in 2012: Data Issues, Methodology and Initial Results by Ferreira, et al, Policy Research Working Paper 7432, World Bank, October 2015.

Appendix

Appendix: Table : Bangladesh Macroeconomic Indicators

Description	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Growth Rates (%)								
GDP Growth	5.0	5.6	6.5	6.5	6.0	6.1	6.6	7.1
GDP Growth Per Capita	3.9	4.4	5.3	5.3	4.8	4.8	5.4	5.9
Per Capita GDP (current US$)	684	760	838	859	955	1087	1212	1356.3
Per Capita GNI (current US$)	738	822	905	932	1032	1159	1291	1436.2
Per Capita GNI Atlas Method (US$)	710	780	870	950	1010	1080	1190	1409
Inflation (%)								
Rate of Inflation (CPI, %) (year on year)**	7.6	6.8	10.9	8.7	6.8	7.3	6.4	5.9
Inflation (GDP deflator)	6.8	7.1	7.9	8.2	7.2	5.7	5.9	6.6
Saving & Investment (% of GDP)								
Gross Domestic Saving	20.3	20.8	20.6	21.2	22.0	22.1	22.2	23.9
Gross National Saving	28.6	29.4	28.9	29.9	30.5	29.2	29.0	30.1
Private Investment	21.9	21.6	22.2	22.5	21.7	22.0	22.1	21.8
Of which: FDI	0.9	0.7	0.6	0.9	1.2	0.8	0.9	0.9
Public Investment	4.3	4.7	5.3	5.8	6.6	6.6	6.8	7.6
Central Govt. Budget (% of GDP)								
Total Revenue	9.1	9.5	10.2	10.9	10.7	10.4	9.6	10.6
Total Expenditure	12.5	12.7	14.0	14.4	14.6	14.0	13.5	14.9
Overall Budget Deficit	3.4	3.2	3.9	3.6	3.8	3.6	3.9	4.3
Total Public Debt	39.6	37.3	38.3	37.4	35.8	35.3	34.6	35.8
Balance of Payments (% of GDP)								
Trade	35.0	32.6	41.2	43.0	40.1	38.4	35.0	33.1
Exports	15.2	14.1	17.6	18.0	17.7	17.2	15.7	15.1
Imports	19.8	18.6	23.6	25.0	22.4	21.2	19.3	18.0
Services & Income (net)	-3.0	-2.4	-3.0	-3.4	-3.7	-3.9	-3.1	-2.4
Current Transfers	10.0	10.1	9.7	10.06	9.95	8.64	8.14	6.95
Current Account Balance (including transfers)	2.4	3.2	0.7	-0.3	1.6	0.8	1.5	1.7
External Indicators								
Total Debt as % of GDP	39.6	37.3	38.3	37.4	35.8	35.3	34.6	35.8
External Debt (US$ b.)	23.0	22.4	25.4	25.5	25.4	30.4	32.6	37.1
Ext. Debt as % of GDP	22.4	19.4	19.7	19.1	16.9	17.6	16.7	16.8
BB Gross Reserves (US$ b.) (end of period)	7.5	10.75	10.9	10.3	15.3	21.3	25.0	30.4
BB Gross Reserves (in months of imports)	3.7	5.4	3.9	3.3	5.5	5.8	7.0	7.9
Money and Credit								
M2 Growth (%, year-on-year)	19.2	22.4	21.3	17.4	16.7	16.1	12.4	16.4
Net Domestic Asset Growth (%, year-on-year)	17.8	19.1	25.0	18.5	11.8	10.3	10.7	14.4
Ratio of Private Sector Credit to GDP (%)	30.9	33.9	37.2	38.7	37.7	37.8	37.9	38.7
Exchange Rate								
Nominal Period Average (TK/US$)	68.8	69.2	71.2	79.1	79.9	77.7	77.7	78.3
Nominal End of Period (TK/US$)	69.0	69.5	74.2	81.8	77.8	77.6	77.8	78.4
Real Effective Exchange Rate-REER Index, 2000-01=100 (8 Currency Basket)	91.3	97.7	89.4	91.4	101.5	107.2	119.6	131.7
Memorandum Items								
GDP at Current. Prices (Taka bill.)	7,051	7,975	9,158	10,552	11,989	13,436.7	15,158.0	17,295.7
GNI at Current. Prices (Taka bill)	7,610	8,621	9,883	11,445	12,954	14,332	16,142	18,315
GNI at Current. Prices Atlas Method (US$ bill)	106.1	118.3	133.5	146.8	158.3	171.2	191.3	229.6
GNI at Current Prices (US$ bill)	110.6	124.6	138.8	144.7	162.12	184.4	207.8	234.0
Population (mill.)*	149.91	151.6	153.4	155.3	157.2	159.1	161.0	162.9
Human Development Index (Value)	0.463	0.494	0.549	0.554	0.558	0.570		

Source: Bangladesh Bureau of Statistics, Bangladesh Bank, Ministry of Finance, The World Bank and IMF
*** Population data is from DECPG.**

Appendix: Table: Bangladesh Current Macroeconomic Indicators

	FY14	FY15	FY16	FY17 (Projection)	FY17 (July-Aug)	FY16 (July- Aug)
GDP Growth (%)	6.1	6.6	7.1	6.8	..	..
Inflation[2]	7.3	6.4	5.9	6.1	5.4	6.2
Export Growth (%)	11.7	3.4	9.8	9.3	8.4	4.7
Import Growth (%)	8.9	0.2	5.4	18.6	*3.0	*-7.2
Remittance Growth (%)	-1.6	7.7	-2.5	14.0	-15.3	-3.0
Reserves (Months of Import)	5.8	7.0	7.9	..	8.2	7.2
Exchange Rate (Taka per Dollar)	77.7	77.7	78.3	79.4	78.4	77.8
Total Revenue (% of GDP)	10.4	9.6	10.6	9.0	..	..
Total Expenditure (% of GDP)	14.0	13.5	14.9	13.3	..	..
ADP (% of GDP)	4.1	4.0	4.8	5.6	*0.03	*0.04
Fiscal Deficit (% of GDP)	3.6	3.9	4.3	4.4	..	..
ADP Utilization (% of ADP allocation)	94.6	91.4	91.7	..	0.6	0.6
M2 Growth (%)	16.1	12.4	16.4	15.5	*13.5	*12.6
Growth of Credit to Public Sector (%)	8.9	-2.6	2.6	15.9	*-3.4	*-0.5
Growth of Credit to Private Sector (%)	12.3	13.2	16.8	16.5	*16.0	*13.0

[1]Projections are based on IMF, World Bank and government estimates

[2] Base Year 2005/06

* July for relevant fiscal years

All growth rates are year-on-year

Source: Bangladesh Bank, Bangladesh Bureau of Statistics, Export Promotion Bureau, and WB staff estimate