BIDS Public Lecture Series

Macroeconomic Management in a Post-Covid Uncertain Global Environment

Sadiq Ahmed

February 2023

Published by

Bangladesh Institute of Development Studies (BIDS)
E-17, Agargaon, Sher-e-Bangla Nagar
G.P.O Box No. 3854, Dhaka-1207
Telephone: +880-2-58160430-37
Fax: +880-2-58160410
E-mail: publication@bids.org.bd
Website: www.bids.org.bd

Price: Tk. 100.00; US $ 5

Cover Design & Layout
Ahshan Ullah Bahar

Printed in Bangladesh at Matrivasa Printing & Packaging, 129, DIT Extension Road, Fakirapul, Dhaka-1000.

Contents

1. Development Context	1
2. Covid-19 and Recovery	2
3. Heightening Global Uncertainties	4
4. Bangladesh Development Impact	8
5. Government Policy Responses	14
6. The Way Forward	27
7. PostScript	30
REFERENCES	32

Macroeconomic Management in a Post-Covid Uncertain Global Environment*

SADIQ AHMED

1. Development Context

At birth on 16 December 1971, Bangladesh was one of the poorest countries in the world. Per capita gross national product (GNP) was below $100; the poverty rate was in the 80 per cent plus range, and human capital was in dire straits. Bangladesh faced heavy discrimination in resource allocation and development priority before birth (Islam, 2003). The war of independence further destroyed infrastructure, means of production, and livelihoods. Yet, sound economic management with a focus on macroeconomic stability, private sector development, agriculture, trade openness, human development, and poverty reduction paid off handsomely (Ahmed, 2005; 2015; 2017). Rapid gross domestic product (GDP) growth fueled by strong agriculture, exports of labour-intensive readymade garments (RMG), and a large inflow of foreign remittances caused GDP to expand rapidly, create jobs, and reduce poverty. The focus on human development and poverty programmes saw big improvements in human development indicators and sharp reductions in moderate and extreme poverty (Table 1). In 2015, Bangladesh became a lower middle-income country (LMIC) under the World Bank definition, and by 2019 GDP growth rate was approaching 8 per cent per annum, which was among the highest globally.

---

*This is an updated and revised version of the presentation at the "Annual BIDS Conference on Development (ABCD) 2022: Post-Covid Challenges in an Uncertain and Divisive World" held on 1-3 December 2022 at Lakeshore Hotel, Gulshan, Dhaka, Bangladesh.

Table 1: Development Performance 1972-2019

Indicators	1972	2000	2019
GNI per capita ($)	88	581	2,209
Poverty (UPL) (%)	82.0[1]	52.3	21.8
Life expectancy (years)	44.9	63.6	72.3
Infant mortality (%)	140.0	58.0	22.0
Adult literacy (%)	20.2	52.8	73.9
Population growth rate (%)	2.4	1.4	1.2

Source: Bangladesh Bureau of Statistics and World Bank World Tables 1993.

Spurred by these successes, the government of Bangladesh adopted the Perspective Plan 2041 (PP2041) in March 2020 (Government of Bangladesh, 2020), which aspired to reach upper middle-income country (UMIC) status and eliminate extreme poverty by 2031. The government plan was to accelerate the GDP growth rate further from 8 per cent to 9 per cent per year as a major vehicle to secure these ambitious targets.

2. Covid-19 and Recovery

The advent of the Covid-19 pandemic in early 2020 shook the world as human lives were lost and economic activities collapsed. Bangladesh was also hurt badly but less devastatingly than North America and Western Europe. Nevertheless, economic activities were hurt, unemployment increased, and short-term poverty surged. GDP growth collapsed to 3.5 per cent in FY2020, down from 7.9 per cent in FY2019. The investment rate slowed, and exports plunged. A saving grace was the strong performance of agriculture and remittances. The government responded well with a range of health and social measures to tackle Covid-19 and a series of economic stimulus packages aimed at recovering manufacturing activities, RMG exports, and micro and small enterprises. The global

[1] Refers to 1973 based on daily intake of 2122 calories per person.

discovery of the Covid vaccine and anti-covid medications greatly facilitated covid management as Bangladesh adopted an effective way to procure and administer the vaccines.

The results of these policy interventions were very good (Table 2). By the end of FY2021, exports had recovered; remittances were plentiful; and imports boomed. The overall balance of payments was in surplus, aided by capital inflows primarily from official assistance. Reserve build-up soared to $46.4 billion by June 2021 and reached an all-time peak of $48 billion in August 2021. The Reserve level was adequate to meet 7.5 months of imports. When measured against adequacy in terms of short-term debt coverage, reserves were adequate, and the ratio of short-term debt to reserves was only 0.3, which is well below the reference value of 1. GDP growth and private investment recovered, and the inflation rate was low and stable at around 5-6 per cent. There was optimism that the economy could revert to the pre-covid growth path of PP 2041.

Table 2: Post-Covid Economic Recovery

Economic Indicators ($ billion)	FY 2019	FY 2020	FY 2021	FY 2022
GDP growth (%)	7.9	3.5	6.9	7.3
Per capita GNI ($)	2,209	2,326	2,591	2,824
Private investment rate (% of GDP)	25.3	24.1	23.7	24.1
Inflation rate (CPI month-on-month)	5.5	6.0	5.6	7.6
RMG exports	34.1	28.0	31.5	42.6
Total exports (GNFS)	46.7	39.5	44.3	59.3
Foreign remittance earnings	16.4	18.2	24.8	21.0
Total export earnings (G+NFS+FS)	63.6	58.7	69.9	81.4
Imports (GNFS)	65.9	59.4	70.5	96.3
Total import payments (G+NFS+FS)	69.0	62.6	73.9	99.9
Current account deficit	(-) 5.3	(-) 4.7	(-) 4.6	(-) 18.7
Net foreign direct investment (FDI)	2.5	1.3	1.4	2.2
Net medium- & long-term loans (MLT)	5.5	6.2	7.0	9.7
Reserves	32.7	35.8	46.4	41.8
Short-term debt	11.2	10.0	14.0	20.7
Reserves (month of total import payments)	6.0	6.9	7.5	5.0
Short-term debt to reserves	0.3	0.3	0.3	0.5

Source: Bangladesh Bureau of Statistics and Bangladesh Bank.

Progress on the health recovery front was also good. The loss of human lives was contained, and labour force participation returned to normal levels. Although poverty and employment data are not available owing to the Covid-19-related delays in conducting the respective Household Income and Expenditure Survey (HIES) and Labour Force Survey (LFS), the government firmly believes that the recovery of exports and GDP growth has reversed the uptick in poverty and unemployment and restored the normal pace of poverty reduction linked to GDP growth.

3. Heightening Global Uncertainties

Armed with good economic outcomes, Bangladesh adopted an aggressive growth recovery policy in FY2022. An expansionary credit policy was adopted with tight control over interest rates, known as the 6/9 policy, whereby ceilings were imposed on both the deposit rate (6 per cent) and the lending rate (9 per cent). The policy was officially announced in April 2020 and implemented in July 2020. The idea was to lower the cost of borrowing to increase private credit growth and investment. This growth-oriented interest rate policy was further boosted with an expansive fiscal policy reflected in rising fiscal deficits. The aim was to revert the growth path to the 7-8 per cent range as a step to restore the pre-covid growth momentum.

As against this optimism in Bangladesh, there were growing dark clouds on the external front. There are six strands of these uncertainties:

Covid supply disruptions: While the progress with covid vaccines and medications, along with huge stimulus packages, had helped recover economic activities in Europe and North America, Covid-related supply disruptions globally, especially in China, put a brake to this recovery.

Emerging inflationary pressures: Supply disruptions put pressure on prices of manufactured goods hit by supply shortages. In this environment, huge fiscal stimulus, especially in the USA, put further pressure on prices. Inflation started accelerating in the USA and Europe. Demand for energy increased, which pushed up global energy prices. These inflationary pressures had started to mount well before the Ukraine War (Table 3).

Russia's war on Ukraine: On 24 February 2022, Russia invaded Ukraine. USA and Europe responded by imposing heavy economic sanctions on Russia. These developments disrupted the global energy, food, and fertiliser markets. Russia is a major global supplier of energy and fertiliser, while Ukraine is a big player in the wheat and edible oil markets.

The rise of the US Dollar: An added difficulty for inflation management outside the USA is the rapid rise in the value of the US Dollar against major currencies. For example, the Euro plunged from a local peak of 1.22 USD/Euro on 1 June 2021 to a low of 0.96 USD/Euro on 28 September 2022, before recovering to 1.03 USD/Euro on 19 November 2022. This is the result of a combination of rising interest rates in the USA and greater confidence in the stability of the US economy. Since most global commodity prices are quoted in the US Dollar, this has added to the inflationary pressure on imports outside the USA.

Increase in global interest rates: Advanced economies have responded to inflationary pressures by tightening credit growth through interest rate increases. It has raised interest rates for global capital flows, including short-term rates used for trade financing. A popular benchmark short-term interest rate is the US dollar-based

London interbank offer rate (LIBOR). The USD LIBOR has increased from a low of 0.175 per cent on 1 December 2021 to 4.665 per cent on 18 November 2022. This is a massive increase in the interest rate and reflects more broadly the high cost of international borrowing at this time.

The risk of recession in Europe and the USA: Rising interest rates to fight inflation and the global energy crisis are slowing down economic activities in Europe. Although the US economy has remained buoyant despite rising interest rates, there is a risk that a recession may also set in the USA. The housing market, an important driver of demand and economic activity in the USA, has slowed considerably. The US government is optimistic that it will avoid a serious recession, but the risks of a slowdown are substantial. Slowing economic activity in the face of rising inflationary pressure has fueled the fears of a global stagflation phase that can create substantial additional economic and social turmoil globally and in developing countries.

Table 3: Indicators of Global Inflationary Pressures

Inflation indicator (Price Deflators in SDR)	2020	2021	2022
Exports			
Advanced economies	-2.2	10.1	11.5
Emerging markets and developing economies	-5.8	15.9	19.2
Fuel exporters	-22.0	38.8	37.4
Non-fuel exporters	-2.9	12.8	16.4
Imports			
Advanced economies	-3.3	9.5	13.3
Emerging markets and developing economies	-2.9	13.9	17.4
Fuel exporters	-0.8	11.1	16.0
Non-fuel exporters	-3.2	14.3	17.6

Source: IMF *World Economic Outlook*, October 2022.

The combination of covid supply disruptions, fiscal stimulus and the Ukraine War proved devastating for the global economy. Inflation rates in Europe and the USA surged to the 8-11 per cent range and, along with the hike in commodity prices, they contributed to huge global inflationary pressures in 2022. While Europe and USA have instituted tight demand management policies through major hikes in interest rates, the uncertainties with the Ukraine War and the lingering supply constraints linked to Covid-19 have made it difficult to predict global inflationary outcomes for 2023. Most likely, inflationary pressures will continue in the near term.

The outlook for global GDP growth and trade flows is, at best, uncertain, but most likely, there will be a slowdown from the post-Covid recovery phase. The IMF expects that world GDP and trade will likely decelerate noticeably in 2023 (Table 4). Along with inflation, rising interest rates, the rising US dollar, and a slowdown in export prospects owing to a slowdown in the world economy can have some serious difficulties for the balance of payments and external debt of developing countries.

Table 4: World Demand Outlook (IMF Projections)

Indicator (percent change)	2021	2022	2023
World output	6.0	3.2	2.7
Advanced economies	5.2	2.4	1.1
USA	5.7	1.6	1.0
EU	5.2	3.1	0.5
World trade volume (G&S)	10.1	4.3	2.5
Imports: Advanced economies	9.5	6.0	2.0
Emerging market and developing economies	11.8	2.4	3.0
Exports: Advanced Economies	8.7	4.2	2.5
Emerging market and developing economies	11.8	3.3	2.9

Source: IMF World Economic Outlook, October 2022.

4. Bangladesh Development Impact

The sharp deterioration in the external environment outlook has substantial adverse implications for Bangladesh's development prospects, and the downside risks must be managed adequately and comprehensively. A combination of higher energy prices, global inflation, the rising value of the US Dollar, the rising cost of borrowing, and a slowdown in global demand for exports present a tough set of development constraints that are beyond the control of Bangladesh's policymaking. Yet, if left unaddressed with countervailing policy measures, the combined effects of these constraints could seriously jeopardize the progress of Covid-19 recovery.

Implications for the Balance of Payments and External Debt Outcomes

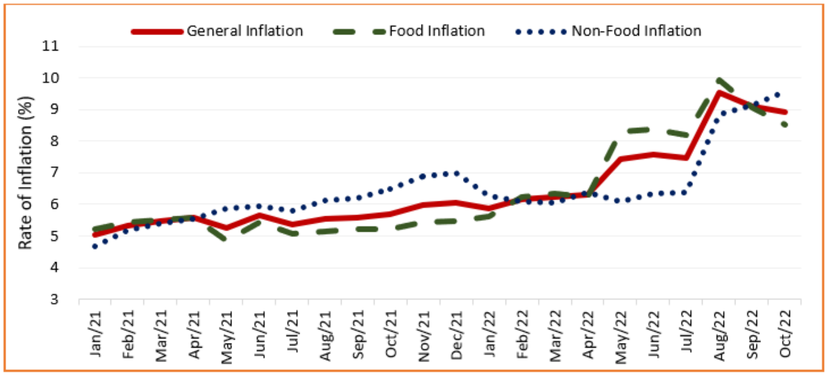
Higher energy prices, higher global inflation, and the rising value of the dollar have increased the cost of imports. Bangladesh has imposed import controls and high tariffs to lower import demand. It has also sought to implement periodic power outages to reduce energy imports. Furthermore, banks have slowed the opening of new LCs due to a shortage of foreign exchange. All these developments have reduced import inflows substantially. Data for the first four months of the fiscal year 2023 (July-October) show that imports (coif) have fallen from an average value of $7.4 billion per month in FY2022 to $6.9 billion. Reports show that imports have reduced further in November, although Bangladesh Bank has not yet released this data. On the other hand, debt servicing cost has increased, remittances are sluggish, and export earnings growth has slowed considerably. The balance of payments (BoP) outcome would depend upon the magnitude of the slowdown in exports and remittances. Even so, the most likely result will be a significant reduction in the current account deficit.

On the financing side, there are major uncertainties. As noted in Table 2, the large BoP deficit in FY2022 required a substantial drawdown of reserves and an increase in short-term debt. As a result, the vulnerability of the BoP has increased. The ratio of short-term debt to reserves increased sharply from 0.3 to 0.5. During the first four months of FY2023, reserves were further reduced to finance import requirements and debt payments. Consequently, reserves fell to $34.3 billion as of 16 November 2022. The short-term debt-to-reserve ratio increased to 0.6. Further use of reserves or short-term debt to finance the BoP in FY2023 will be imprudent. It means the BoP deficit must be contained within the limits of available financing from net MLT and net FDI. If export demand falls significantly, as projected in Table 4, and remittances do not recover and stay at their current low monthly trend, there could be serious difficulties in managing imports through controls.

Inflationary Pressures

Inflationary pressures have been mounting since January 2021, but they gathered momentum from February 2022, fueled by a surge in food prices (Figure 1). As the war in Ukraine unfolded and global food and fuel prices spiked, Bangladesh's inflation accelerated, crossing 9 per cent in August 2022. While inflationary pressures declined marginally in September and October, at around a 9 per cent rate, inflation remains high and much above the FY2023 budget target of 5.6 per cent.

Figure 1: Recent Inflation in Bangladesh, January 2021 to December 2022



Source: Bangladesh Bureau of Statistics.

Fiscal Outcome

The fiscal outcome in recent years is shown in Table 5. Several interesting results about the fiscal situation in Bangladesh emerge. First, Bangladesh's tax effort has been weak and stagnant at around 7-8 per cent of GDP for a fairly long time. Second, Bangladesh's fiscal deficit as a per cent of GDP has been traditionally low but rising in recent years, growing from 2.6 per cent of GDP in FY2017 to a projected level of 5.5 per cent of GDP in FY2023. Third, for 165 million people, the size of government expenditure as a percentage of GDP is modest (14.1 per cent). With pre-committed fixed expenditures of around 7 per cent of GDP (including wages, material cost, interest cost, and transfers to local governments and public enterprises) and rising fiscal subsidies (projected to grow to 1.9 per cent of GDP in FY2023), very little is left for funding core programmes in health, education, infrastructure, and social protection. Indeed, annual development spending has grown only modestly over the past five years, from 3.5 per cent of GDP in FY2017 to 5 per cent in FY2022, all funded through deficit financing. The fiscal constraint to development is a long-standing issue that was addressed adequately even prior to the ongoing crisis.

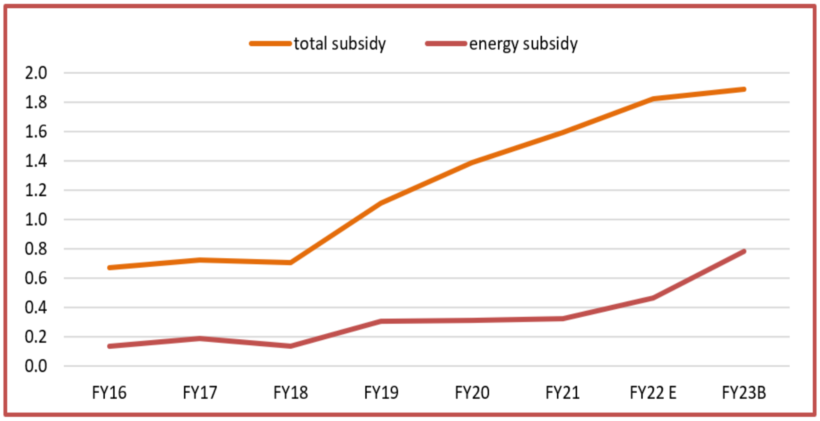
Table 5: Fiscal Summary (Taka billion)

Fiscal Year	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22 (B)	2021-22	2022-23 (B)	2022-23 (P)
Total revenue	2008	2166	2520	2631	3286	3890	3372	4330	3817
Tax revenue	1778	1943	2260	2208	2698	3460	3010	3880	3417
Non-tax revenue	230	223	260	423	588	430	362	450	400
Total expenditure	2615	3044	3893	4154	4600	6037	5104	6780	6280
revenue expenditure	1804	2020	2381	2548	2906	3666	3105	4184	3881
Development expenditure	811	1024	1512	1606	1694	2371	1999	2596	2399
Overall balance	-607	-878	-1373	-1523	-1314	-2147	-1732	-2450	-2463
Overall balance (including grant)	-598	-869	-1356	-1503	-1284	-2112	-1710	-2417	-2430
Financing									
External	79	73	330	471	487	1044	703	988	988
Grants	9	9	17	20	30	35	22	33	33
Loan	142	139	448	571	577	1122	814	1125	1125
Amortization	-72	-75	-135	-120	-120	-113	-133	-170	-170
Domestic	528	810	1043	1051	777	1135	1027	1463	1475
Bank	-85	117	295	817	327	765	755	1063	1075
Non- bank	613	693	748	234	499	370	272	400	400
GDP	23243	26392	29514	31705	35302	39765	39765	45141	45141
Total Revenue/GDP	8.6	8.2	8.5	8.3	9.3	9.8	8.5	9.6	8.5
Tax/GDP	7.6	7.4	7.7	7.0	7.6	8.7	7.6	8.6	7.6
Revenue Expenditure/GDP	7.8	7.7	8.1	8.0	8.2	9.1	7.8	9.1	8.6
Development Expenditure/GDP	3.5	3.9	5.1	5.1	4.8	6.0	5.0	5.8	5.3
Total Expenditure/ GDP	11.3	11.5	13.2	13.1	13.0	15.2	12.8	15.0	13.9
Fiscal Deficit /GDP	-2.6	-3.3	-4.7	-4.8	-3.7	-5.4	-4.4	-5.4	-5.5

Source: Ministry of Finance, *Monthly Fiscal Reports*, and the Budget FY2023; B=Budget, P=Projected.

The fiscal constraint worsened in FY2022 and is projected to tighten further in FY2023 owing to the growing subsidy bill (Figure 2). The subsidy bill soared to 1.8 per cent of GDP in FY2022 and is budgeted to grow further to 1.9 per cent of GDP in FY2023. A part of the subsidy pressure emerges from the energy sector. In an effort to prevent a full pass-through of the global energy price increases to local consumer prices, the government has absorbed some of the shocks in the budget. As a result, the fuel subsidy bill grew from 0.3 per cent of GDP in FY2021 to 0.5 per cent of GDP in FY2022 and is budgeted to rise further to 0.8 per cent of GDP in FY2023. As explained later, to finance these increases in subsidy in the face of a stagnant revenue base, the government has resorted to higher fiscal deficit and lower spending in priority areas.

Figure 2: The Soaring Subsidy Bill (% of GDP)



Source: Ministry of Finance, *Monthly Fiscal Reports*.

Even though the fiscal deficits are not very high, rising fiscal deficits have increased the vulnerability of the budget to external shocks (Table 6). The interest cost of fiscal deficit is growing, while the primary balance deficit is also rising. For example, interest cost now eats away at some 21 per cent of total government revenues. When amortisation is considered, total debt service costs remain in the 60 per cent range. Importantly, public debt as a share of total revenues is growing rapidly, which raises concerns about the government's debt-carrying capacity and the narrowing fiscal space to finance development. Rising public debt without commensurate progress in the treasury's revenue-earning capacity reflects the growing fiscal vulnerability of public debt.

Table 6: Growing Fiscal Vulnerability of Public Debt

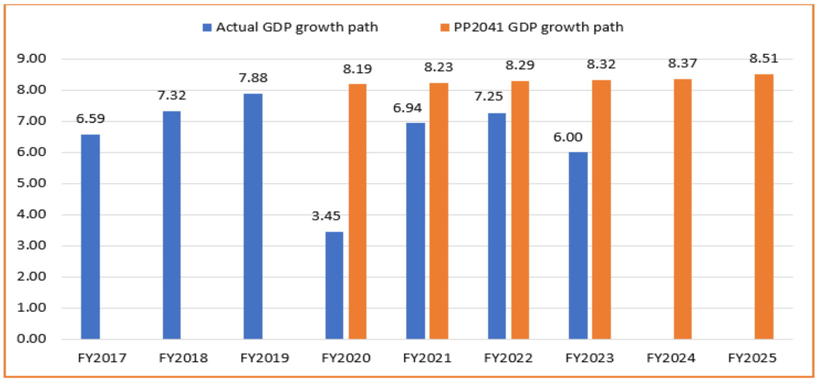
Fiscal year (taka billion)	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23 (P)
Total revenue	2,008	2,166	2,520	2,631	3,286	3,372	3,817
Total public debt (MLT)	6,123	7,186	8,536	10,062	11,443	13,510	15,984
Foreign	2,242	2,751	3,198	3,748	2,242	5,006	5,993
Domestic	3,881	4,435	5,338	6,314	3,881	8,504	9,991
Fiscal deficit (%of GDP)	-2.6	-3.3	-4.7	-4.8	-3.7	-4.4	-5.5
Primary deficit (% of GDP)	-1.1	-1.7	-3.0	-3.0	-1.7	-2.6	-3.7
Interest cost (% of total revenue)	17.6	19.3	19.6	22.2	21.5	21.0	21.0
Public debt (% of total revenue)	305	332	339	382	348	401	419
Debt service (% of total revenue) *	58	50	56	62	81	56	61

Source: Ministry of Finance. *Total debt service data obtained from IMF Article 4 Debt Sustainability Analysis.

Growth Outcome

The acceleration of GDP growth prior to Covid-19 has been a major positive feature of Bangladesh's development. Covid-19 put a brake on this trend, and GDP growth plummeted in FY2020. Although there was an encouraging recovery in FY2021 and FY2022 (Figure 3), the growth rates were still below the PP2041 growth path. The government hopes to see a continued increase in GDP growth rate in FY2023 and beyond. While projections beyond FY2023 are premature at this stage, given large global uncertainties and the current challenging macroeconomic environment, it is most likely that GDP growth in FY2023 will slip below the level achieved in FY2022. Already there are concerns that manufacturing growth will slow owing to import controls, power cutbacks, energy shortages, and increasing production costs. Growth of exports slowed in the first five months of FY2023. The worsening external environment suggests that export growth may continue to slow further owing to the slowdown in the global economy, especially in the Euro Zone, while global inflation and rising interest rates will hurt production and investments. In its October 2022 *World Economic Outlook*, the IMF projects Bangladesh's growth rate at 6 per cent for 2023, which is still very good by global standards.

Figure 3: PP2041 Growth Path and Actual Growth Path (% per year)



Source: BBS and Government of Bangladesh Perspective Plan 2041.

Looking forward, the main policy question is how quickly the macroeconomy is stabilised to restore the long-term growth momentum in FY2024 and beyond. The quicker the macroeconomy is stabilised, the better the chances for a rapidly sustained recovery of economic growth. How has the government responded to address the macroeconomic challenges? How effective are these policies? What are the prospects for a quick restoration of macroeconomic stability? We turn to these important questions.

5. Government Policy Responses

The macroeconomic imbalances have emerged from three sources: inflationary pressure, the balance of payments pressure, and fiscal pressure. Addressing these issues requires using at least three policy instruments that best relate to each of these areas:

monetary policy instruments to ease the inflationary pressure, exchange rate policy to lower the balance of payments pressure, and tax/expenditure policy measures to reduce the budgetary pressure. Their combined use as a coordinated set of policy actions can help avoid the bluntness of any single instrument and reinforce the effectiveness of each of the policy reforms.

Monetary Policy

Nobel Laureate Milton Friedman famously stated that inflation is always and everywhere a monetary phenomenon (Friedman, 1970). It is a truism because, without monetary impulse, changes in individual prices alone cannot create sustained inflation. The debate about this extreme monetarism concerns the worry that using monetary policy instruments only can be blunt and hurt economic growth. For temporary inflationary pressure, one can ignore the need to use monetary policy. But for a prolonged period of inflation, as presently, it is too risky to avoid the use of monetary policy instruments. Finance Ministers and Central Bank Governors across many countries, including the USA, UK, Canada, Australia, and India, have recognised this challenge and have raised interest rates to reduce aggregate demand. The European Central Bank (ECB) has also hiked interest rates.

Bangladesh generally had a positive track of good monetary management ever since the monetary policy crisis of the 2010-2011 period that showed how loose monetary policy could cause havoc in the asset and foreign exchange market and contribute to high inflation. The correction course adopted in 2012 tamed inflation and stabilised the exchange rate. This sound monetary policy prevailed for a fairly long time with very good results until the adoption in

April 2020 of the highly contentious 6/9 interest rate policy. It was presumed that this would be a temporary intervention that would be re-examined after the post-covid economic recovery. Most surprisingly, the policy is still in place even as the inflation rate has surged to 9 per cent plus, suggesting that the real lending rate has become negative.

The implication of this interest rate policy for the rate of growth of private credit is shown in Table 7. Overall, there was a surge in domestic credit growth in the post-Covid years, understandably because of the monetary and fiscal stimulus packages to push up the economy from the Covid-induced downturn. What is concerning, though, is the huge pick-up in private credit in FY2022 and FY2023.

Faced with negative or zero real costs of borrowing, it is hardly surprising that private credit has grown. Most importantly, total credit, including private credit growth, accelerated even as inflationary pressures heightened over the March-September 2022 period. At a time when credit growth should have been tightened to reduce demand pressure on inflation and imports, the government's monetary and credit policy was focused on further increasing demand, presumably to promote growth. There is a clear inconsistency in monetary policy management with the need for macroeconomic stability.

Table 7: Trend in Domestic Credit Growth

	June 2020-June 2021	June 2021-June 2022	September 2021-September 2022	March 2022-September 2022 (annualised)
Private credit	8.2	13.5	13.9	14.0
Government credit	22.2	27.3	28.5	48.6
Public enterprise credit	2.7	24.0	24.6	14.0
Total domestic credit	11.1	16.1	16.4	19.2

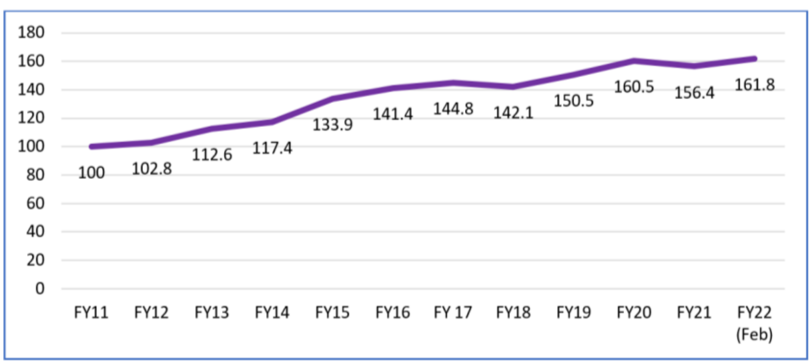
Source: Bangladesh Bank.

Exchange Rate Management and Trade Policy

Bangladesh Bank was well aware that the Taka was appreciating in real terms steadily against major currencies like the US Dollar and the Euro and against the basket of currencies used by Bangladesh Bank to calculate the real effective exchange rate (REER). The REER trend shows that the value of Taka appreciated in real terms by 62 per cent between FY2011 and FY2022 February (Figure 4). It was clearly unsustainable, as has become evident now. So, the depreciation of the Taka was long overdue. Between February and 31 July 2022, the exchange rate depreciated by an average of 11 per cent.

Following the failure of initial attempts to control the slide in the exchange rate in the open market through reserve injections, on June 1, the Bangladesh Bank announced that it would free up the exchange rate and let it be market determined. The announcement to free up the exchange rate was a smart move. More flexible exchange rate management than in the past would allow the exchange rate to play its role in export growth and the reduction of imports.

Figure 4: Trend in Real Effective Exchange Rate (FY2011=100)



Source: Calculated from Bangladesh Bank data.

Yet, this was a short-lived reform. The government reverted back to tariff increases and import controls and depleted its reserves to arrest the correction of the market-based exchange rate. Not only that Bangladesh Bank abandoned the idea of a market-determined rate, but it also adopted as many as four exchange rates: An official exchange rate of Taka 95/$ for official debt servicing and official imports, an exchange rate of Taka 99/$ for exporters, an exchange rate of Taka 108/$ for remittances; and an average rate between exporters and remittances for importers. This multiple currency practice has greatly complicated exchange rate management. The fixed rate for remittances without regard to market conditions has caused a sharp slide in remittances. Importantly, the ability of the exchange rate to match demand with supply has been side-tracked. Between 1 July and 9 December 2022, Bangladesh Bank lost a further $7.9 billion in reserves in its efforts to control the exchange rate.

As noted, import controls and shortage of foreign exchange in the banking system and the open market have sharply lowered imports. While selective import controls can play a short-term emergency adjustment role, the resort to import controls as the main instrument of the balance of payments management is fraught with risks. First of all, it only works on the demand side. The supply-side incentives for exporters and remittances are lost. This absence of exchange rate-based incentives is a major policy gap, at a time when BoP pressures are intense, and growth of both export earnings and remittances is slowing down. Additionally, control-based import management can cause serious supply disruptions, discourage domestic and foreign private investments, hurt exports, and lower GDP growth.

The role of imports as a growth enabler cannot be over-emphasised. The global experiences with import controls, including in South Asia, have shown that they are inconsistent with the strategy to increase GDP growth. It is especially true of an LMIC like Bangladesh that is seeking to secure UMIC status within the next eight years. Bangladesh is heavily dependent on imports for raw materials, primary energy, capital goods, and technology. As such, it is natural that both the capital intensity of production and import intensity will grow over time. Indeed, a steady growth rate of imports at around 8 per cent in USD terms between FY2014 and FY2019 was a major contributor to the GDP growth acceleration of Bangladesh.

The surge in the value of imports that happened in FY2021 and FY2022 is largely explained by the 30 per cent increase in import prices between FY2019 and FY2022. It is the average price shock that has happened to the imports of all non-oil exporting countries in the developing world. On the positive side, Bangladesh gained considerably from the 28 per cent increase in global export prices for non-oil exporting countries in the developing world. Consequently, compared with a trend growth rate of 7 per cent in exports in USD terms between FY2014 and FY2019, Bangladesh exports grew by 28 per cent between FY2019 and FY2022. To a large extent, this was the result of gains from export price increases. There was still a significant terms of trade loss, but not overwhelming.

Fiscal Policy

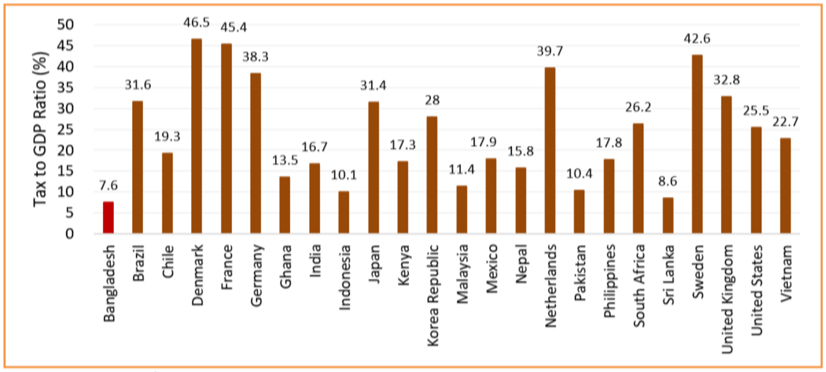
The new national budget for FY2023, effective from 01 July, gave an opportunity for the government to accelerate its stabilising policies. Bangladesh made solid progress with economic recovery in

FY2021 from the covid-19 induced downturn. While the government was keen to push the recovery further using the new FY2023 budget, this eagerness should have been tempered with the reality that the macroeconomy must be stabilised first. This is the topmost priority for the immediate short term, and the new budget ought to have acknowledged that and built its fiscal policy responses along that task.

Unfortunately, the FY2023 budget gave the wrong signal. The budget was built around a higher GDP growth target than in FY2022 and a higher fiscal deficit than in FY2022. Public expenditure was projected to increase by a massive 33 per cent over the estimated expenditure for FY2022, largely fueled by the burgeoning subsidy bill; the fiscal deficit was projected at 5.4 per cent of GDP compared with 4.4 per cent of GDP realised in FY2022. These spending and deficit targets are inappropriate in the current situation of high inflation and import pressure on the exchange rate.

Tax reforms: As noted earlier, the fiscal policy pressure on economic management has been mounting for a while due to the slow growth in tax revenues. The Bangladesh tax/GDP ratio is one of the lowest in the world (Figure 5) and has basically stagnated at 7-8 per cent of GDP over the past six years (Table 1). Much has been written and known to the government about the need to modernise the Bangladesh tax structure to increase tax efficiency, tax buoyancy, and revenue growth. Unfortunately, no significant tax reforms have happened for over a decade (Ahmed, 2021).

Figure 5: Bangladesh Tax Performance in a Global Perspective (2021)



Source: OECD Revenue Statistics 2021.

As with the past budgets, the FY2023 budget did not have any strategic approach to tax reforms. The budget adopted a range of small tax measures that are a mixed bag of different elements, including supplementary tax increases for a large number of imported goods, some reductions in corporate income tax, some tax incentives, some removal of exemptions and a few administrative measures to increase tax coverage. It is nearly impossible to assess the overall revenue implications of these piecemeal proposals systematically. Regarding implication for resource allocation, it paints a mixed picture with a positive incentive for non-garment exports by extending them the same tax incentives as for RMG, but a further increase in the anti-export bias of trade taxes as reflected in an increase in the average nominal protection owing to new supplementary duties.

The long overdue reform of the personal income tax system, which is the key to improving tax buoyancy and tax collection, has not happened. These include such measures: bringing all income under the personal tax net irrespective of source, simplifying tax filing requirements by eliminating the income-expenditure balancing that is an instrument of tax harassment and corruption, moving to a truly self-assessment tax filing system with limited, focused, and productive audits, removing discretionary approach to tax filing by removing the interface between tax filers and tax collectors and simplifying tax filing through online submissions and payments. The VAT Law of 2012 is still not properly implemented. Trade taxes have not been streamlined to lower trade protection. The property tax reform, which is essential to strengthening the revenue base of the local government institutions, has not happened.

Against this backdrop, the most likely revenue outcome will be the status quo. The total revenue (tax and non-tax) amounted to 9.3 per cent of GDP in FY2021 (7.6 per cent tax to GDP ratio and 1.7 per cent non-tax revenue to GDP ratio). Notwithstanding rising revenues from a rapid increase in the import bill in FY2022, total tax revenues amounted to Taka 3,010 billion, or 7.6 per cent of GDP, which is the same as in FY2021. It amounted to a shortfall of Taka 381 billion (1 per cent of GDP) over the highly ambitious FY2022 budget tax revenue target. For FY2023, the budget targets a large 29 per cent increase in tax revenues over the actual collection in FY2022. Given the sharp reduction in the import bill, the expected decline in GDP growth, and the fact that there were no substantial revenue measures in the FY2023 budget, this another highly ambitious revenue target for FY2023 will be missed. Indicative projections suggest the tax revenues will likely grow to Taka 3,417 billion (14 per cent increase) as against the budget target of Taka 3,880 billion (29 per cent increase). As a share of GDP, tax revenue in FY2023 will remain roughly unchanged at around 7.6 per cent of GDP.

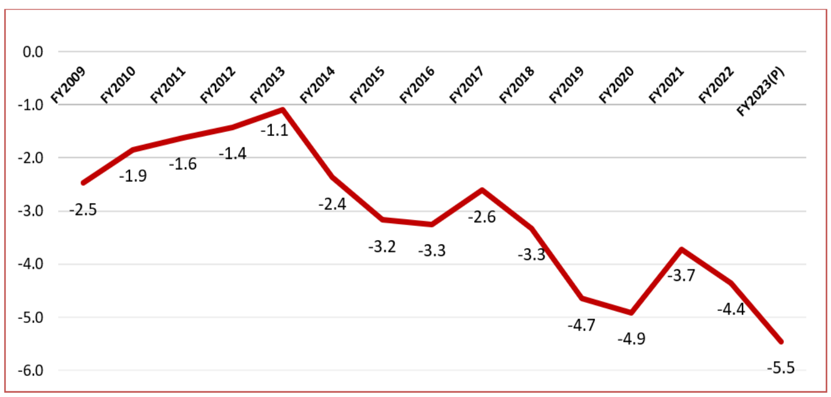
Non-tax revenues in FY2022 declined to 0.9 per cent of GDP, substantially lower than what was achieved in FY2021 because of the one-time surrender of surpluses of state-owned enterprises (SOEs) in FY2021. No reforms to improve the financial performance of SOEs were included in the FY2022 budget. So, total revenue fell 8.5 per cent of GDP in FY2022. The contribution of non-tax revenue is budgeted to stay at 0.9 per cent of GDP in FY2023 since, again, no reforms for SOEs are included. Therefore, total revenue in FY2023 will remain unchanged at 8.5 per cent of GDP, which is a massive 1.1 per cent of GDP lower than budgeted.

Expenditure reforms: The main stabilisation policy responses in the budget were to lower the import duty for a few sensitive items and the strategy to use subsidy policy judiciously to reduce the inflationary impact of global energy and fertiliser price increases. The concern here is the fiscal sustainability of this expansive subsidy policy. Fiscal subsidies are estimated to have reached Taka 725 billion (1.8 per cent of GDP) in FY2022 and are projected to surge to Taka 850 billion (1.9 per cent of GDP) in FY2023. In this scenario, subsidy alone will eat up 21 per cent of total revenues. Given other fixed spending items, wages and salaries (2 per cent of GDP), pension (0.8 per cent of GDP), supply and maintenance (1 per cent of GDP), transfers to local governments and SOEs (1.4 per cent of GDP) and interest cost of debt servicing (1.8 per cent of GDP), there will be very little fiscal space for spending on social protection and high priority development spending on health, education, and infrastructure.

The FY2023 budget recognised this handicap and proposed a fiscal deficit of 5.4 per cent of GDP to fund this critical spending. Even this level of fiscal deficit would be barely adequate to finance needed spending on health, education, infrastructure, and social protection. Additionally, the projected revenue shortfall will create further expenditure difficulties unless the government increases the fiscal deficit, which, in turn, will hurt the adjustment efforts.

This absence of an increase in fiscal revenues as a share of GDP will constrain the FY2023 budget's ability to support either stabilisation or GDP growth. Without expenditure cutbacks, the projected shortfall in tax collection (1.1 per cent of GDP) and rising budget subsidy will increase the budget deficit to 6.4 per cent of GDP. It is likely that the government would respond by cutting the annual development programme (ADP) and social protection as it has been doing in recent years. Assuming a similar pattern of expenditure cutbacks in FY2023, the budget deficit will likely be contained at around 5.5 per cent of GDP. Even so, the budget deficit will continue to rise (Figure 6). The growing fiscal deficit is inconsistent with the need to tighten demand to lower BoP and inflationary pressures.

Figure 6: Trend in Fiscal Deficits (% of GDP)



Source: Ministry of Finance, *Monthly Fiscal Reports*.

The fiscal policy conundrum facing Bangladesh is a serious handicap to the Bangladesh development path. Not only is the government unable to respond to the adjustment needs to cut demand pressure by lowering fiscal deficits, but the fiscal policy support for growth and poverty reduction is severely curtailed by weak tax performance. Total expenditure as a share of GDP is already very low. Since over 50 per cent of Bangladesh's spending is fixed spending, the way that the government is accommodating higher subsidy bills without blowing up the fiscal deficit is by further cutting the already low social protection and development spending.

The impact of this expenditure adjustment policy on public spending on health, education, and social protection is illustrated in Table 8. Spending on these high-priority items is not only meagre but declined further in recent years as a share of GDP. For example, in FY2022, Bangladesh spent a mere 0.5 per cent of its GDP on healthcare, 1.5 per cent on education, and 0.8 per cent on social protection (excluding civil service pensions). In contrast, the subsidy bill was 240 per cent higher than health spending, 24 per cent higher than education spending, and 131 per cent higher than spending on social protection. The prospects for supporting human capital formation and poverty reduction through fiscal policy are rather bleak without a major breakthrough in tax efforts.

Table 8: Impact of Fiscal Adjustment on Social Sector Spending

(As % of GDP)	FY2019	FY2020		FY2021		FY2022		FY2023	
	Actual	Budget	Actual	Budget	Actual	Budget	Estimated	Budget	Projected
Health	0.62	0.81	0.54	0.83	0.61	0.82	0.53	0.82	0.6
Education	1.67	1.93	1.65	1.88	1.71	1.81	1.45	1.83	1.64
Social protection (Excluding civil service Pensions)	1.01	0.98	0.92	0.94	0.81	0.90	0.78	0.86	0.74
Subsidy (including incentives & cash loans)	1.1	1.1	1.4	1.1	1.6	0.9	1.8	1.9	1.9

Source: Ministry of Finance, *Monthly Fiscal Reports* and *Medium-Term Macro Policy Statements* (MTMPS).

Summary of the Effectiveness of Policy Responses

The Bangladesh economy is facing some tough macroeconomic stability challenges. The current account deficit has soared, some 30 per cent of foreign reserves have been depleted since August 2021, short-term debt has increased, and inflation has accelerated. Inflows of remittances have slowed, and there are signs that export growth might be faltering.

The government has responded by partially depreciating the currency, introducing multiple exchange rates, putting import controls, raising tariffs, and increasing budget subsidies on fertilisers and energy products. Import controls have slowed imports and lowered the current account deficit. But there is continued pressure on the balance of payments, a shortage of foreign exchange, and substantial inflationary pressure. The large loss of reserves and the prevalence of multiple exchange rates have increased the short-term vulnerability of the foreign exchange market. Continued failure to increase tax efforts has increased the budget deficit; the subsidy bill is soaring; and public spending on infrastructure, health, education, and social protection is much lower than needed to accelerate growth, reduce poverty, and improve income distribution.

Despite the need to tighten demand, Bangladesh's policymaking remains focused on propping up the economy to accelerate GDP growth through monetary and fiscal policies. The government is trying to promote economic growth by putting a cap on the lending rate at 9 per cent. The tax effort has either fallen or remained stagnant while the fiscal deficit has increased. These growth-oriented policies have come into serious conflict with the need for stabilising the macroeconomy through policies to reduce aggregate demand. Low and negative real lending rates have increased demand for private credit, adding to inflationary and balance of payments pressures. The growing fiscal deficit has similarly boosted demand instead of reducing it. A lack of exchange rate flexibility has put the of BoP adjustment pressure on import controls and reserves.

In the absence of demand management policies, inflationary pressures have continued to increase. Price control over energy products has lowered the inflationary pressure of soaring global energy prices, but there is a natural limit owing to revenue constraints. Import controls are hurting GDP growth and private investments and, if taken to the limit, can impose some serious long-term costs. The lack of fiscal space is constraining public investment and the ability to boost GDP growth.

6. The Way Forward

Bangladesh is facing macroeconomic stability challenges that it needs to address swiftly. At the same time, Bangladesh is seeking to restore the GDP growth path of the PP2041 that was derailed by Covid-19. In the medium to long term, there need not be any conflict between macroeconomic stability and GDP growth acceleration. Indeed, macroeconomic stability is necessary to achieve sustained GDP growth, as Bangladesh has already learned from its pre-Covid growth acceleration experience. At this time, the policy focus must be recast to stabilisation, and policymakers must not let the growth considerations derail the macroeconomy.

How could economic policymaking be used to reconcile macroeconomic stability with growth objectives? The best way forward would be to redirect the exchange rate and monetary and fiscal policies to economic stabilisation, while structural reforms should focus on the growth agenda.

Restoring macroeconomic stability: Using any single instrument will not be adequate. A combination of flexible exchange rate management, some tightening of credit growth, and judicious use of tax and expenditure measures are required to support the adjustment agenda.

Bangladesh took the first positive step to make the exchange rate flexible, but it abandoned it quickly, fearing political backlash from a downward trend in the exchange rate. It was a costly reversal and contributed to a further loss of reserves. The problem that the government faced with exchange rate flexibility is that it did not combine this flexibility with demand management. Rapid credit growth and growing fiscal deficit undermined the flexibility of the exchange rate. Adopting a uniform and market-based exchange rate is an essential element of the policy package that is needed to restore the balance of payments stability while promoting export and remittance growth to support investment and GDP growth. But this must be combined with proper demand management policies to reduce demand pressures on the foreign exchange and domestic markets.

Regarding demand management, a flawed policy that has not yet been corrected is the 6/9 interest rate policy, which makes monetary policy ineffective in increasing the market interest rate that is required to lower the demand for credit. Even as inflation accelerated and exceeded the 9 per cent rate, the lending cap remained at 9 per cent, making borrowing rates negative in real terms. The removal of the 6/9 interest rate policy is necessary to reduce pressure on BoP and domestic inflation.

Regarding fiscal policy, the government has been unable to take adequate tax reforms necessary to lower the fiscal deficit while expanding critical public sending to support the adjustment and growth agenda. The fiscal deficit continues to rise, adding to demand pressures. The tax reform challenge is a big endeavour and involves major structural and institutional reforms that cannot be addressed through ad-hoc tax measures at the time of the budget. For example, separating tax policy from tax collection and substantially reforming the National Board of Revenue (NBR) are critical institutional reforms needed to boost tax revenues.

On the expenditure front, the attempt to lower inflation by trying to insulate the international price increases in energy and fertiliser from affecting domestic prices has basically taken away the flexibility to protect the income of the poor through increases in public spending on health, education, and social protection. Subsidies have also increased because of incentives for exports and remittances. These incentives will not be needed if the exchange rate is freed up. In the absence of tax measures, a good policy reform would be to cut back the large 1.9 per cent of GDP subsidy bill to a modest level and use the savings to increase spending on social protection and reduce the budget deficit.

Restoring the growth momentum: Regarding the growth momentum, it is a medium-to-long-term development agenda that must be steadily pursued. There might be a trade-off between growth and stability in the near term. Restoring stability requires a cutback in demand that will likely have a dampening effect on GDP growth. It is inevitable and it is best to recognise this upfront and moderate the GDP growth target somewhat. A 6 per cent GDP growth target for FY2023 is very healthy and is by no means a signal of defeat or retreat. But if macroeconomic stability is not restored, the balance of payments deficit and inflation could hurt growth over the medium-to-longer term, which can be far more costly.

Since inflation hurts the poor and the low-income group relatively more than the rich, an important fiscal policy measure would be to put priority on spending on health, education, and social protection to support the income of the poor and the vulnerable. Acceleration of income-transfer programmes for the poor and vulnerable will be a strong policy move to protect the poor from the adverse effects of inflation. In health, the most urgent reform is the introduction of universal health care through government-funded health insurance schemes for the poor.

The medium-term growth agenda requires substantial reforms outside the fiscal policy. These relate to strengthening the investment climate through reducing business costs, improving trade logistics, improving energy and transport services, investing in R&D, and developing skills. The implementation of the 8FYP Fiscal Policy Framework is essential to restore the growth momentum to the PP2041 growth path. Among other fiscal reforms, it calls for the tax-to-GDP ratio to grow from 8 per cent of GDP in FY2020 to 12 per cent of GDP by FY2025. Bangladesh is way behind on this. This ought to be a top policy priority. An expert Tax Reform Commission might be helpful in developing a sound tax reform programme that is not diluted by vested interests. India, for example, benefited substantially from an independent Tax Reform Commission.

7. PostScript

Over the past several weeks, the government has been engaged in discussions with the IMF on a macroeconomic adjustment programme. The IMF has issued a press statement that a staff-level agreement on a programme has been reached. The government has confirmed this. This is a strong positive development. While the details of the programme in terms of specific policy reforms being supported by the IMF have not yet been made public, it is expected that the program will address many of the issues raised in this paper. The three critical policies are the implementation of a uniform market-based exchange rate; removal of the 6/9 interest rate policy and increase in the lending rate; and tightening of fiscal policy with a combination of tax measures, subsidy reduction, and increased spending on health, education, and social security.

It is important to note that the value that the IMF brings is not the $4-5 billion resources disbursed over a three-year period but rather the discipline of helping the government implement difficult but required policy reforms. Without implementing the required policy reforms, the IMF programme may not restore macroeconomic stability. The best example of a homegrown and successful implementation of an IMF programme in South Asia is one in India that was implemented under the watch of the then Finance Minister Manmohan Singh between October 1991 and June 1993. The reforms implemented were far-reaching and have been deepened in one form or another since then. Those reforms set the stage for the modernisation of the Indian economy, away from controls to a market economy. India has never looked back since then and has not required another IMF programme.

REFERENCES

Ahmed, S. (2005). *Transforming Bangladesh into a middle-income economy*. New Delhi: Macmillan.

Ahmed, S. (2015). *Growth with equity: contemporary development challenges of Bangladesh*. Dhaka: Bangladesh Institute of Bank Management.

Ahmed, S. (2017). *Evidence-based policy making in Bangladesh: Selected case studies*. Dhaka: Policy Research Institute of Bangladesh.

Ahmed S. (2021). Institutional dimensions of tax reforms in Bangladesh. Draft Chapter 6, *Bangladesh Institutional Diagnostics*, Francois Bourguignon editor. Cambridge University Press (Forthcoming).

Government of Bangladesh (2020). *Making vision 2041 a reality: The perspective plan of Bangladesh 2021-2041*. Dhaka, Bangladsh: General Economics Division, Planning Commission, Ministry of Planning.

Islam, N. (2003). *An economist's tale: making of a nation Bangladesh*. Dhaka: University Press Limited.

Friedman, M. (1970). *Counter-revolution in monetary theory*. Wincott Memorial Lecture, Institute of Economic Affairs, Occasional paper 33.