<u>Covid-19 in Bangladesh</u>

Economy, fiscal sustainability and implications for recovery

Zahid Hussain

Ex-Lead Economist

The World Bank, Dhaka

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Covid-19 and the Economy

Macroeconomic impact

- Shutdowns and social distancing, full and partial, caused disruptions in all sectors of the economy.
- GDP growth decelerated; industrial and service sector growth slowed; agriculture resilient.
- Macroeconomic stability stood ground despite incipient pressure on inflation, trade and fiscal balance.
- Booming formal remittances and increased budget support from development partners helped rapid accumulation of foreign exchange reserves

Increased poverty and deprivations

- The pandemic **reversed the country's steady trend of poverty reduction** over the past two decades, at least temporarily—plenty of telephone-based survey evidence in the 2nd half of 2020 and first half of 2021.
- Driven by widespread **losses in employment and labor earnings** in urban areas and spillover effects in rural areas. Large effects on food security.
- **Reverse migration**, scale and duration not seen in recent memory
- **Vulnerability** of poor and lower middle class exposed
- Increased **learning poverty** with schools closed for over 18 months
- National **health system severely stressed**; adverse impact on non-Covid health care

Fiscal Response

Tax Policy Response

- **Income tax relief**--increase in tax free limit, reduction in minimum and maximum tax rate, a tax rebate for taxpayers who file income tax returns online for the first time.
- **Corporate tax reductions**--reduction in tax rate for non-publicly traded companies, reduction of tax rate at source of local supply of essential commodities, and withholding tax rate on export proceeds
- **VAT rate reductions** (Advance Tax on imported raw materials for manufacturing industries) and exemptions (penalty and interest in case of failure to submit the VAT return)
- **Preferential treatment on import duties** for various essential raw materials for targeted industries.

Foregone revenue 0.1% of GDP (IMF estimate)

Public expenditure response

27 stimulus packages were announced with a combined support of over $15 billion, of which **fiscal cost = $4.6 billion** (IMF Policy Tracker July 2021).

- **Expansion of existing social transfer programs** for vulnerable households
- **Wage support** for export-oriented industries
- Increasing the target for **procurement and distribution of paddy**; support for **farm mechanization**
- Subsidy for **partial remission of commercial bank's suspended interest** of April and May of 2020;
- **Stimulus package** for the micro and cottage entrepreneurs
- **Vaccines, healthcare equipment, testing; compensation** against COVID-19 related health risks of officials, doctors and field staff; hiring of additional healthcare workers

External Resource Mobilization

- Development partners **expanded support** from newly established Covid-19 windows--$8 billion received on account of Covid-19 (ADB Covid 19 Policy Database, Nov. 2021)

- Record high (low conditionality) budget support, emergency project aid, accelerated disbursement from existing pipeline through restructuring, new technical assistance

Debt Sustainability

Debt levels

- Total **public debt increased from at 35.9% of GDP in FY19 to 40.7% at end-FY21** driven primarily by increase in primary deficit (IMF); modest compared with the projected rise in global public debt stocks in just one year, from 83 to 96% (IMF Fiscal Monitor, 2020).

- External debt constitutes 15.8% of GDP, comprised mostly of long-term loans from multilateral and bilateral lenders at concessional or semi-concessional rates with generous grace periods.

  - The average maturity of new debt commitments is close to 34 years, with an average interest rate of 1%

- **Above does not include contingent liabilities**. The government provides guarantees and counter guarantees against loans incurred by SOEs. As of June 30, 2021, the face value of these guarantees stood at about US$ 8.8 billion.

Low Risk of Debt Distress (WB-IMF DSA 2020)

Bangladesh remains at a low risk of external and total public debt distress despite shock caused by COVID-19.

- External debt indicators are below their thresholds and the public debt level is below the benchmark under the baseline and stress test scenarios.

If the impact from COVID-19 are more protracted, debt indicators will worsen but still expected to remain below thresholds.

Future infrastructure projects will be financed with external debt, but **favorable debt dynamics** in the medium-term keep PPG external debt stable

Debt dynamics Parameters

- Arithmetically, the debt ratio a country can in principle sustain is governed by the following equations (Blanchard 2021):
- $d_t = (1 + r)/(1 + g)\, d_{t-1} - s$ (1)
- $d_t = d_{t-1} \Rightarrow s = (r - g)/(1 + g)d$ (2)
- where d_t and d_{t-1} are the debt-to-GDP ratios in time periods t and t − 1, respectively; r and g are real interest and growth rates, respectively; and s is the primary balance as a percent of GDP.
- Debt sustainability requires the primary balance to be sufficient to cover the debt service.
- If the rate of interest, r, is higher than the rate of economic growth, g, the primary balance, s, needs to be positive, meaning the country needs to run a primary surplus.
- But if r – g is negative, countries can run a primary deficit (negative s) while keeping the debt ratio constant.

Sustainable Primary Deficit

- Primary balance required to keep 40% debt ratio; the equation augmented to take seigniorage into account.

		Growth								
	-0.040	0.040	0.045	0.050	0.055	0.060	0.065	0.070	0.075	0.080
Nominal Interest rate	0.030	-0.034	-0.036	-0.038	-0.041	-0.043	-0.045	-0.047	-0.049	-0.051
	0.040	-0.030	-0.033	-0.035	-0.037	-0.039	-0.042	-0.044	-0.046	-0.048
	0.050	-0.027	-0.029	-0.031	**-0.034**	**-0.036**	**-0.038**	-0.040	-0.042	-0.044
	0.060	-0.023	-0.025	-0.028	**-0.030**	**-0.032**	**-0.034**	-0.037	-0.039	-0.041
	0.070	-0.019	-0.022	-0.024	**-0.026**	**-0.029**	**-0.031**	-0.033	-0.035	-0.037
	0.080	-0.016	-0.018	-0.020	-0.023	-0.025	-0.027	-0.030	-0.032	-0.034
	0.090	-0.012	-0.014	-0.017	-0.019	-0.021	-0.024	-0.026	-0.028	-0.030
	0.100	-0.008	-0.011	-0.013	-0.016	-0.018	-0.020	-0.022	-0.025	-0.027
	0.110	-0.005	-0.007	-0.010	-0.012	-0.014	-0.017	-0.019	-0.021	-0.023
	0.120	-0.001	-0.004	-0.006	-0.008	-0.011	-0.013	-0.015	-0.018	-0.020
	0.130	0.002	0.000	-0.002	-0.005	-0.007	-0.009	-0.012	-0.014	-0.016
	Note: x| negative value indicates primary deficit									

Projected Primary Balance

	Actual				Projections			
	FY 2016/17	FY 2017/18	FY2 2018/19	FY 2019/20e	FY 2020/21p	FY 2021/22p	FY 2022/23p	FY 2023/24p
	(Percent of GDP)							
Total Revenues and Grants	10.2	9.7	10	9.7	9.8	10	10.4	10.8
Total Expenditures	13.6	14.3	15.4	15.2	15.8	16	16.3	16.3
Primary Balance	**-1.6**	**-2.8**	**-3.4**	**-3.2**	**-3.6**	**-3.4**	**-3**	**-2.6**
Source:	Ministry of Finance, IMF, and World Bank.							

GDP growth assumed to rise from 5.1% in FY22 to 6.4% in FY24; inflation 5.7-5.8%;

Public compensation/GDP at 2.1%; increased capital expenditure from 5.9% of GDP to 6.4%

Recovery underway

The economy briefly

Real Sector		FY19	FY20	FY21	
GDP growth (%)		7.9	3.5	5.4	
Real private consumption growth (%)		4.9	3.0	3.8	
Private investment rate (% of GDP)		25.3	24.0	23.8	
Public investent rate (% of GDP)		7.0	7.3	7.0	
Real trade growth (%)		4.8	-14	-8	
External balance (mln $)					
Current account balance		-4.5	-4.7	-3.8	
Change in reserves		179	3169	9274	
Money and prices					
Inflation		5.5	5.6	5.6	
Private credit growth (%)		11.3	8.6	8.3	
Fiscal balance (Tk in crores)				May-21	May FY20
Revenues		251,881	265,909	275,558	226,857
growth (%)			5.6	21.0	
Expenditures		391,729	421,900	313,080	294,253
growth (%)			7.7	6.4	
Deficit		-139,848	-155,991	-37,522	-67,396
Growth recovery driven by consumption growth					
Investment rate and trade growth below pre-pandemic levels					
Reserve accumulation despite persistent current account deficit					
No evidence of stimulus in credit and deficit outcomes					

Worst in rear view mirror?

- In the second half of 2021, mobility back to pre-pandemic levels, factories functioning, exports rising, increased tourism and shopping —unfolding of pent-up demand.

- Real GDP growth could range from 6 to 7% in the near-term depending on progress in vaccination, global recovery and domestic reforms

- Recent WB survey data from poor areas in Dhaka and Chittagong suggest there was a gradual recovery of livelihoods in those areas.

Radical uncertainty pertaining to epidemiological (Omicron variant), global and policy developments

Emerging pressures on macro-financial stability

- Headline **inflation (y-o-y) in October 2021 was 5.7%, above Bangladesh Bank's 5.5% target**. Cost-push will drive it up further the rest of the year
- With phasing out of moratorium on debt payments and default recognition, **recognized NPLs** at end-September 2021 **increased to 8.2%** of total loans
- **External balance under pressure** with rising current account deficit. Import payments have surged and official remittance inflows are returning to pre-pandemic normal.
- **Exchange rate depreciated 1.2%** in last 6 months; BB sold $1.95 billion so far in FY22.
- **International reserves may decline** to 5-6 months of goods and service imports in 2022. IMF says official foreign exchange reserves overstated by $7 billion

Can debt financed fiscal expansion accelerate recovery?

A Plethora of Lows

- Revenue/GDP, expenditure/GDP, Deficit/GDP, Public Debt/GDP, quality of expenditures (output and outcomes)—all low by any standard

- Some good lows (debt/GDP), some bad lows (quality of expenditures), the rest unclear both theoretically and empirically

- Can more debt boost growth?

From debt to Growth

(Philipp Heimberger, Do Higher Public Debt Levels Reduce Economic Growth?, 2021)

- **Conventional wisdom**: Positive aggregate demand effects in the short-run and crowding-out effects in the long-run
  - ***Aggregate demand***: An increase in the budget deficit raises disposable household income, especially when there is slack in the economy. This boosts the aggregate demand for goods and services.
  - ***Crowding-out mechanisms***: Higher interest rates may crowd-out investment in the private sector; net exports may fall due to an appreciation of the exchange rate; higher inflation may drag growth; higher debt boosts uncertainty, expectations of higher inflation and financial repression.
- **Unconventional view**: An initial increase in public debt level may – especially when the output gap is large – not only temporarily boost aggregate demand but increase the long-run growth rate through hysteresis (shadow of present over future).
- Some endogenous growth models yield results consistent with a positive effect of public debt on growth in the transition stage to the new steady state, depending on what is being financed with the debt

What do the evidence say?

- Reinhart and Rogoff (2010) finding that public-debt-to-GDP ratios above 90% in advanced and 60% in Emerging Economies are associated with markedly lower economic growth rates sparked a major debate.
- Subsequent research shows threshold estimates are highly sensitive to data and specification choices—little evidence of universal thresholds.
- Existing threshold estimates of the public-debt-to-GDP ratio widely scattered from 8.4% to 147.5% of GDP.
- Country-specific nonlinearities in the relationship between public debt and growth are more complex than what has often been suggested by referring to the stylized facts presented in Reinhart and Rogoff (2010).

Bottomline

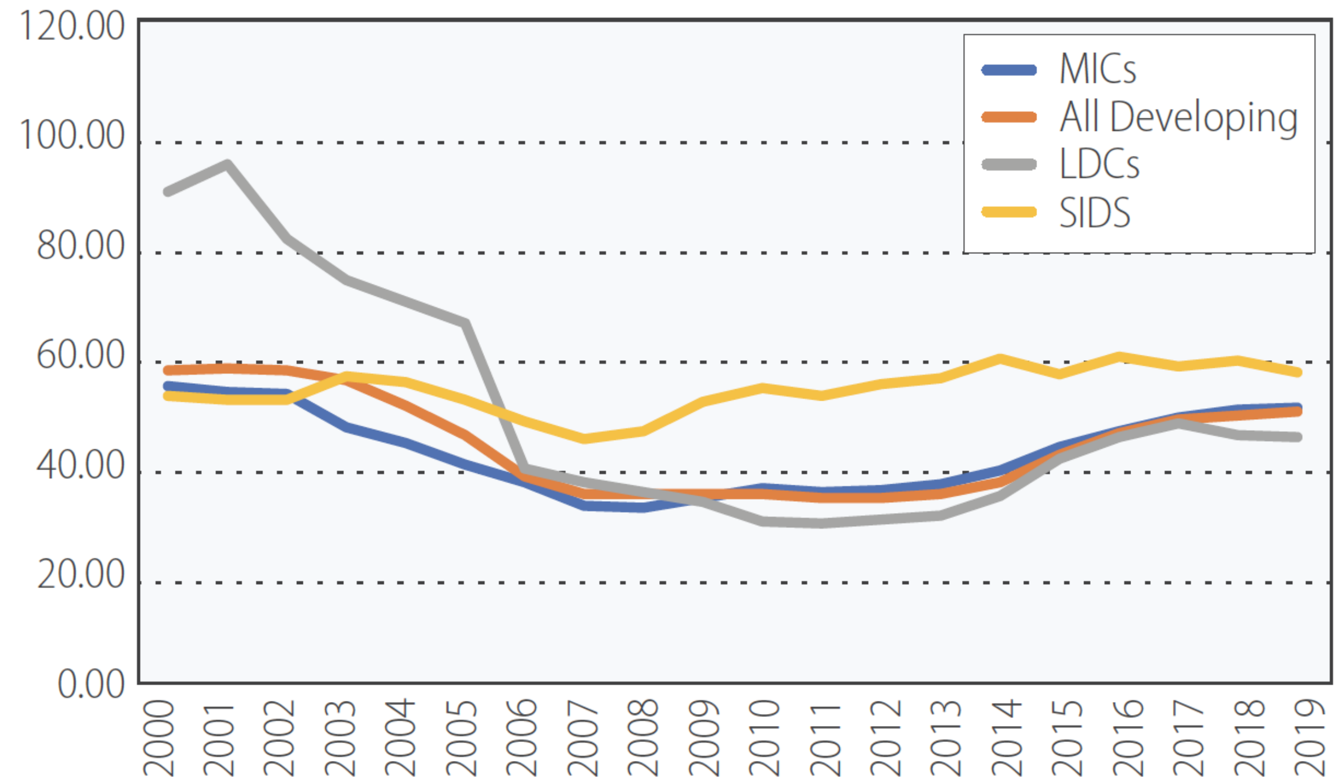
- Empirical findings refer to the average effect of public debt on growth.
- Given the variance, there may be country cases with positive or negative growth effects of higher public debt levels.
- Positive if the additional government spending raises future productivity by increasing the productive stocks of public infrastructure and private human capital.
- Governments may be confronted with unsustainable debt levels if interest payments increase strongly.

Conclusions

There is space for increasing public debt

Figure 1

Public debt (median, share of GDP)



Source: FSDO/UN-DESA calculation based on IMF WEO data.

Risks as well

- **External risks**. Recent energy price increases and global supply chain disruptions have blurred distinctions between opportunities and risk.
- **Fiscal risks**. A shortfall in international support for vaccination programs, cost overruns on major infrastructure projects, and weaker domestic revenues.
- **Financial sector risks** due to deviations from international regulatory and supervisory standards.
- **Corporate debt risk**, measured by Bloomberg, is high in the absence of developed capital markets—a potential contingent liability driven by political economy (policy capture)

Fiscal expansion with caution

- EMDE experience shows whether getting into a debt crisis or out of it, there is a limit as to how much **favorable r-g** it can accomplish (IMF 2021).

- The big difference comes from **primary deficits, valuation effects** through the impact of exchange depreciation on foreign currency denominated debt, **below-the-line transactions** in financial assets (injection of capital in banks, repayments of non-concessional borrowing), **bailouts** of state-owned enterprises, or **government guarantees** that have been called.

- Caution is warranted because of concerns about the ability of government to adjust if things go wrong.

Low public debt levels and a low risk of debt distress provide buffer, not insulation.

Walking the talk

- Our problem has never been the lack of intention to spend more, the problem is in our ability to turn intentions into meaningful actions

- ADP implementation rate declined to an eleven-year low recently

- Targeting and execution challenges in social protection programs and subsidized credit for CMSEs have dragged domestic economic recovery

Limited political energy, substantial procedural blockages and corruption compromise the good intentions