Policy Research Institute
Policy Realism Impact

PUBLIC LECTURE

Macroeconomic Challenges and Policy Options in Bangladesh

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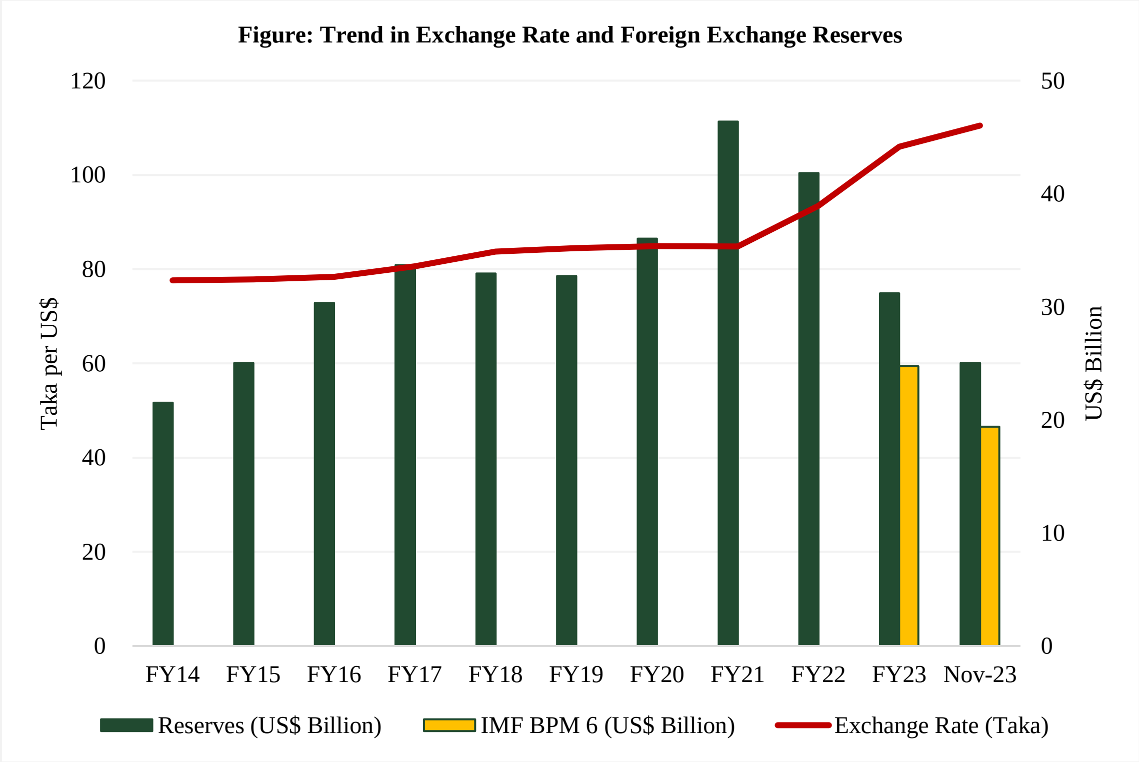
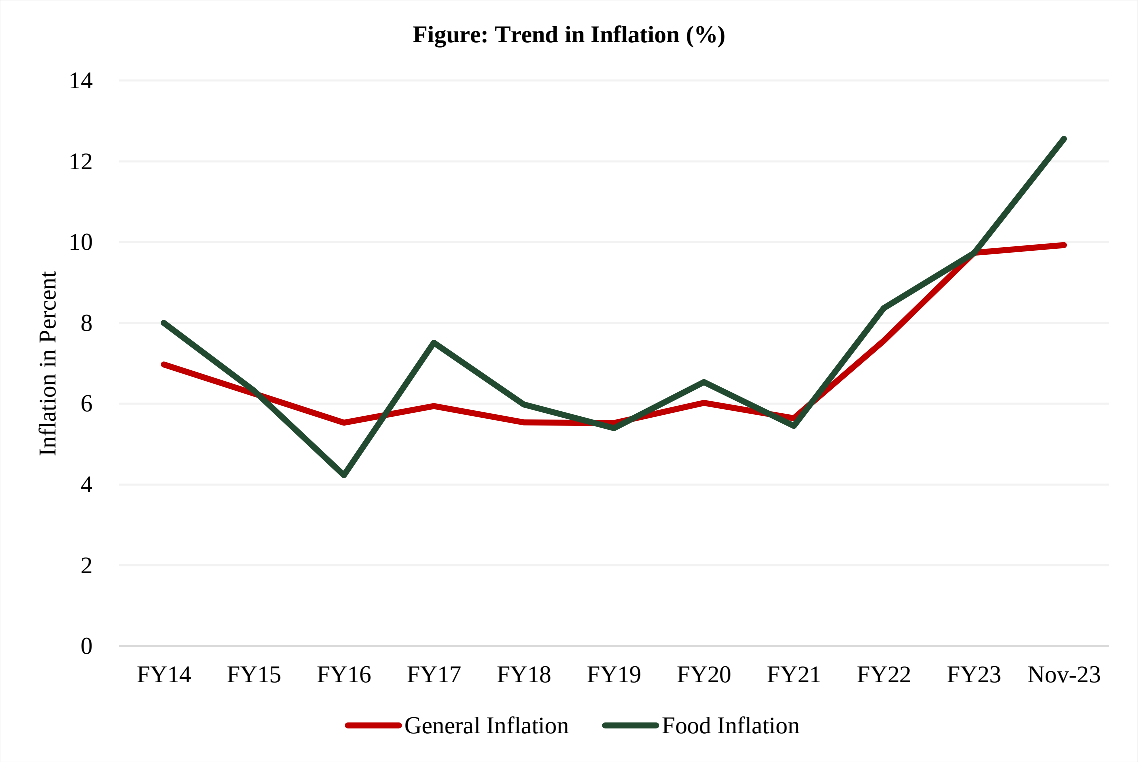
BACKGROUND

- Bangladesh economy is facing multiple challenges on the macroeconomic front
- Inflation is running high with negative impacts on the standard of living of most of the households
- The balance of payments (BOP) imbalances resulting from supply disruptions in the aftermath of the Covid-19 pandemic, the commodity price shocks at the outbreak of the Ukraine-Russia war, and inadequate domestic policy response
- The difficult BOP situation has been manifested through
- (i) rapidly declining foreign exchange reserves of Bangladesh Bank; and

ii) a sharp depreciation of Bnagladesh Taka against the US dollar and other major currencies

TREND IN THE EXCHANGE RATE, FOREX RESERVES AND CPI INFLATION





THE PROBLEMS FACING BANGLADESH ORIGINATED OVER A LONG TIME AND FROM MULTIPLE SOURCES

- Although the Terms of Trade shocks resulting from Post Pandemic supply side disruptions and the Russia-Ukraine war sharply deteriorated the BOP situation, Bangladesh's macroeconomic management has also been complicated by a number of domestic economic policies and developments. These include:

- Maintaining a fixed interest rate regime (9%-6%) for a long time despite rapidly changing global economic and financial environment
- Maintaining a virtually fixed exchange rate (ER) regime for more than a decade despite high inflation compared with trading partners and competitors
- Very low tax/GDP ratio and its declining trend. Bangladesh has the lowest tax/GDP ratio among its comparator countries
- A very shallow financial system along with significant weakening of the banking system

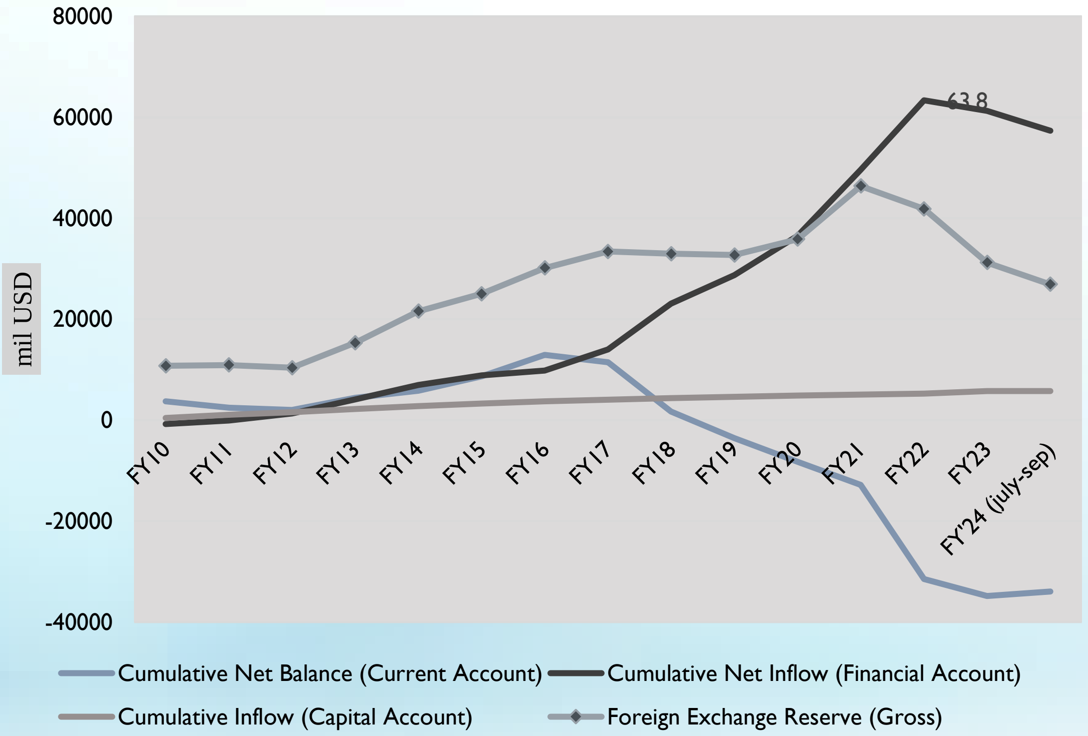
BANGLADESH BANK FOR A LONG TIME ONLY HOPED FOR POSITIVE SUPPLY RESPONSE TO FIGHT INFLATION

- The fixed interest rate policy (9%-6%) was the only monetary policy that Bangladesh Bank followed in recent years.
- Inflation fight remained unattended since, after fixing the interest rates, Bangladesh Bank could not have any other monetary policy instrument to influence the inflation outcome.
- At the same time, in addition to the liquidity support provided at the time of the pandemic, BB printed massive amounts of high-powered money in FY23 to finance budgetary spending. Liquidity support for banks facing withdrawal of funds and other special BB financing schemes also injected liquidity into the economy. The NDA of BB more than doubled in FY23, implying that the NDA expansion in one year was more than the cumulative NDA expansion of BB over the last 50 years since independence.
- There was a complete disregard for inflation fight from a central bank perspective, relying on the hope that improved domestic supply situation will help contain inflation.

STRUCTURAL PROBLEMS IN THE EXTERNAL SECTOR

- A review of the external sector developments indicate serious structural problems and policy lapses. Some of the structural problems include:
- Concentration of export products
- Concentration of export markets
- Very low per capita inflow of workers' remittances due to high share of unskilled workers
- Very limited service sector exports but large sums of service related payments on account of health, education, tourism, shipping, insurance and higher finance charges due to weak financial system and economic vulnerabilities.

SILENTLY BANGLADESH HAS BECOME DEPENDENT ON FINANCIAL ACCOUNT FLOWS



- In our usual discourse on BOP developments, we generally focused on the external current account balance and the contributing factors like developments in exports, remittances and import payments.
- While on a cumulative basis the current account balance (CAB) was positive until FY16, thereafter it turned negative and the cumulative CAB turned to negative $35 billion by FY23 from a cumulative surplus position of $12.9 billion in FY16.
- In contrast, the cumulative financial account (net) (FA) surplus sharply increased to $63.8 billion in FY22, before it started to reverse.
- When we examine the buildup of reserves, it is interesting to observe that until FY16, both CA and FA surpluses contributed to the growth of reserves. The situation changed thereafter as the CAB turned negative but reserves continued to increase supported only by the continued surge in FA surplus.

MANAGING FINANCIAL ACCOUNT IS THUS A MAJOR CHALLENGE FOR BANGLADESH—BUT ARE WE READY?

- There is nothing wrong with Bangladesh experiencing higher inflows through the financial account in recent years. Most dynamic emerging economies including India, Vietnam, Thailand and others have high financial account inflows.
- Attracting and managing financial account flows require **proactive management of interest rates**, containing the inflows if too much hot money is coming to complicate domestic monetary management, avoid fixing the exchange rate for a long time, keeping the domestic currency attractive through higher interest rates and by containing inflation and making investment climate attractive.
- A strong financial sector is a major attraction for the foreign portfolio and private capital investors. In particular foreign portfolio investors like to invest in good companies in the stock market, they want to invest in domestic bond and securities market, and in banks and companies with good governance structure.
- We must keep in mind that mismanagement of financial account and the resulting capital outflows were the main contributing factor for the Asian Crisis of 1990s. Those economies also kept their ERs virtually fixed, like Bangladesh, for a prolonged period prior to the Asian crisis.

THE FIXED ER REGIME AND ULTRA LOW GLOBAL INTEREST RATES CONTRIBUTED TO CARRY TRADE

- The policy of fixed ER in an environment of ultra-low interest rates globally, created incentives for the domestic firms to borrow in foreign currency without regard to the potential ER risk.
- The surge in private sector foreign debt to almost $26 billion was a manifestation of this phenomenon. Private borrowers were lured by low interest rates on foreign debt coupled with the virtually fixed ER regime of that time.
- The sudden ER depreciation of more than 32%-45% in the ER rate has increased the liabilities of the corporate sector by almost Tk 1.0 trillion, for which the companies had to take additional provisions and losses of this magnitude eroding the corporate sector profitability.
- As private sector lost its interest in foreign borrowing, inflows stopped, and outwards payments pressure increased leading to loss of reserves and accumulation of unsettled foreign payments. The improvement in the CAB, primarily through import compression, is important but could not reverse the loss of reserves.
- The outstanding $12 billion of short-term debt is a sword hanging over Bangladesh.

BANGLADESH BANK WAS MUCH SLOW IN REACTING TO THE EMERGING BOP PROBLEM—BUT MUST FIX THEM

- Bangladesh Bank got a long time to address the widening CA deficits, but the growing financial accounts inflows masked the underlying BOP problem until late in FY22.
- The growing levels of reserves made BB complacent about the sustainability of its virtually fixed exchange rate regime.
- But the situation has changed and the government needs to work on several front to:

(i) get out of the current difficult situation;

(ii) prevent future problems by putting in place mechanisms for exchange market operations; and

(iii) Adopt an interest rate policy which is proactive, flexible and market based.

BANGLADESH GOVERNMENT NEEDS TO WORK OUT A PLAN FOR SETTLING THE PAYMENTS LIABILITIES

- In addition to the short-term private sector debt of $12 billion, Bangladesh has many other unpaid liabilities which need to be quantified comprehensively. Right now there is no comprehensive official picture that is publicly available.
- Some of the other overdue payments include payments to: energy sector companies believed to be more than $4 billion; and unknown but sizable amounts to the international airlines, fertilizer importers, overdue payments to settle LCs, and repatriation of profits and dividends by foreign companies. There is also a huge pent up demand for imports, which could not be met due to shortage of dollars.
- The economy is already paying some of the costs: Fees/charges for LC settlement has gone up significantly; the rating agencies have downgraded Bangladesh and its economic and BOP outlook; airlines have increased their airfares in and out of Bangladesh by using much depreciated ER and some international airlines have reduced their flights to Bangladesh.
- The total amount, although unknown, may easily be close to the available reserves of Bangladesh Bank. Thus paying all of these private creditors at this time is not a viable option. The authorities needs to work out a comprehensive

LOW TAX COLLECTION IS A MAJOR DRAG AND THE ULTIMATE SOURCE OF MAJOR PROBLEMS IN BANGLADESH

- Low level of domestic resource mobilization coupled with other structural problems have diminished government's capacity to cope with the macroeconomic challenges and meet the political aspirations of the government.
- Some stylized facts presented below indicate the extent of the problem and the structural challenges facing Bangladesh on the revenue front.

FOR ITS PER CAPITA INCOME LEVEL BANGLADESH HAS ONE OF THE LOWEST TAX/GDP RATIO GLOBALLY

- Generally it is expected that tax/GDP ratio increases in a country in line with increase in per capita income.
- Bangladesh despite being close to Indian in per capita income terms, has much lower tax/GDP ratio.
- Despite being much higher per capita income, Bangladesh's tax/GDP ratio is lower than Pakistan
- European countries generally have much higher tax/GDP ratio—40% and above: France, Austria, Italy; 35%-40%: Germany, Greece, Poland and the UK

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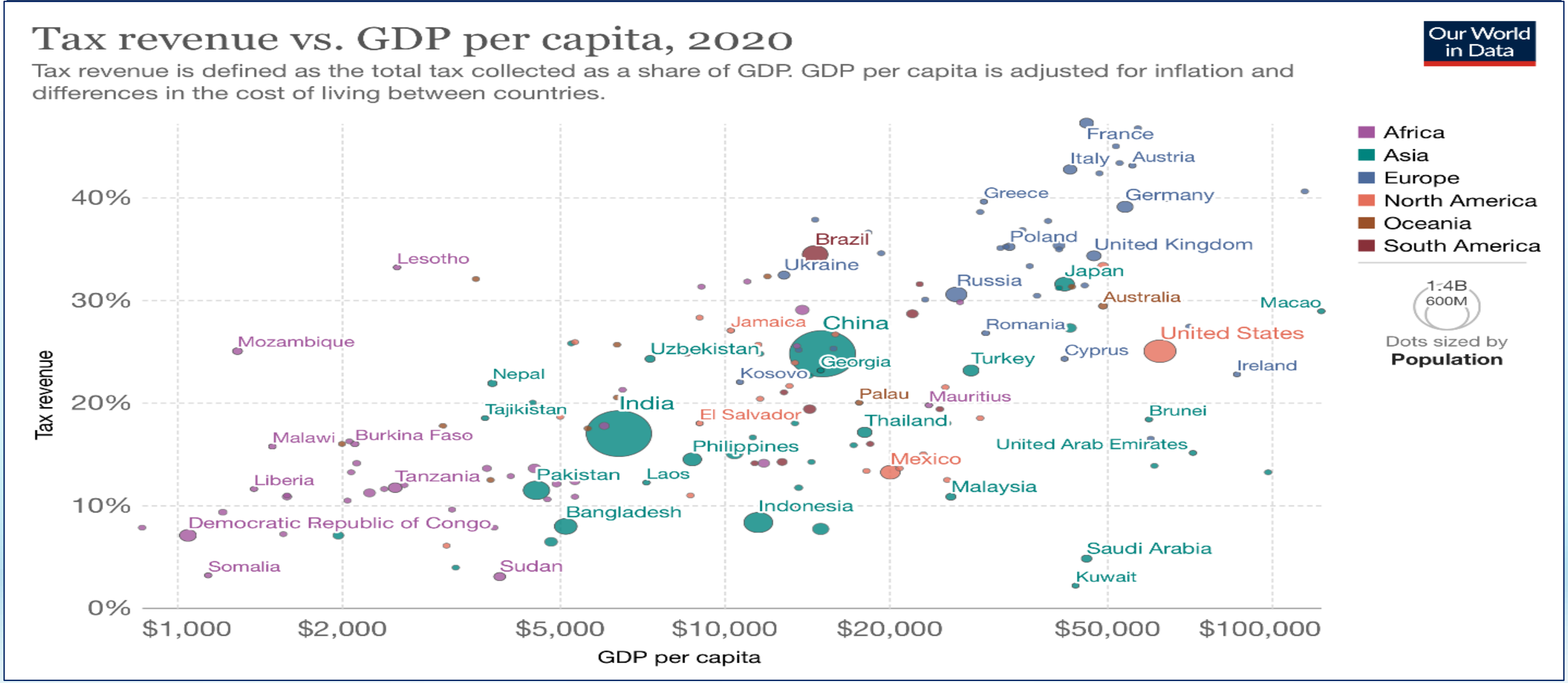
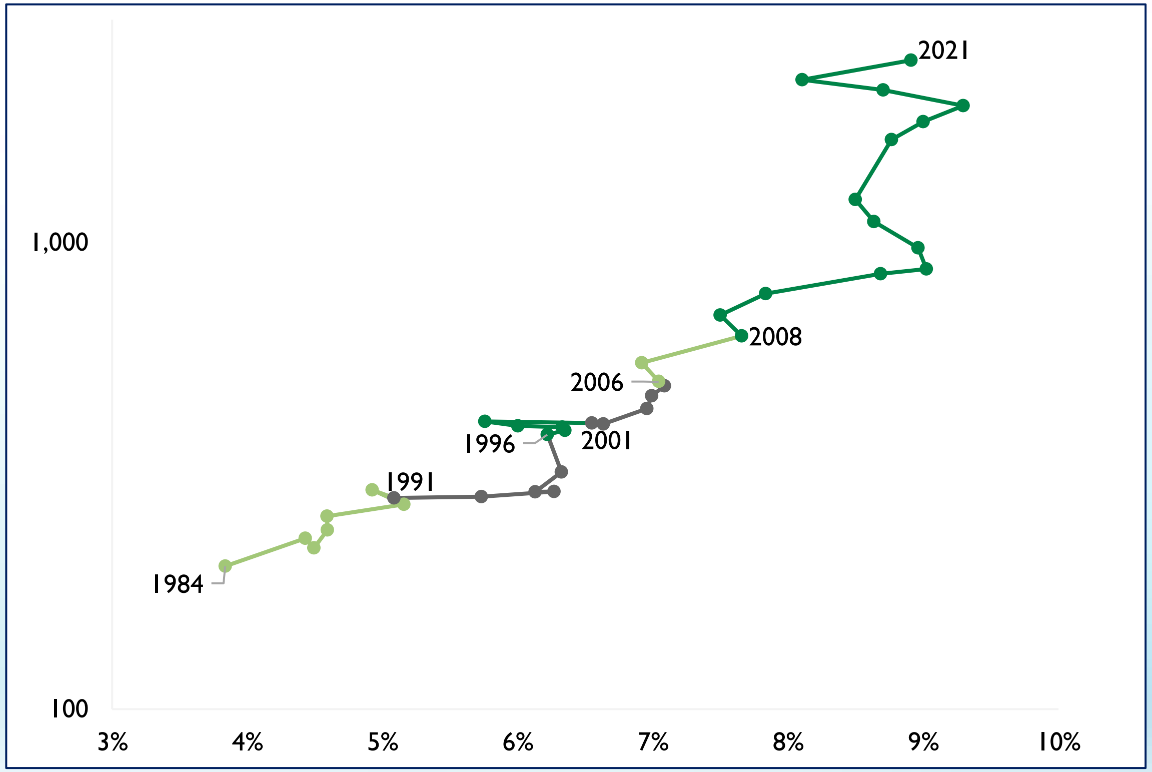
WHERE BANGLADESH STANDS IN A GLOBAL CONTEXT

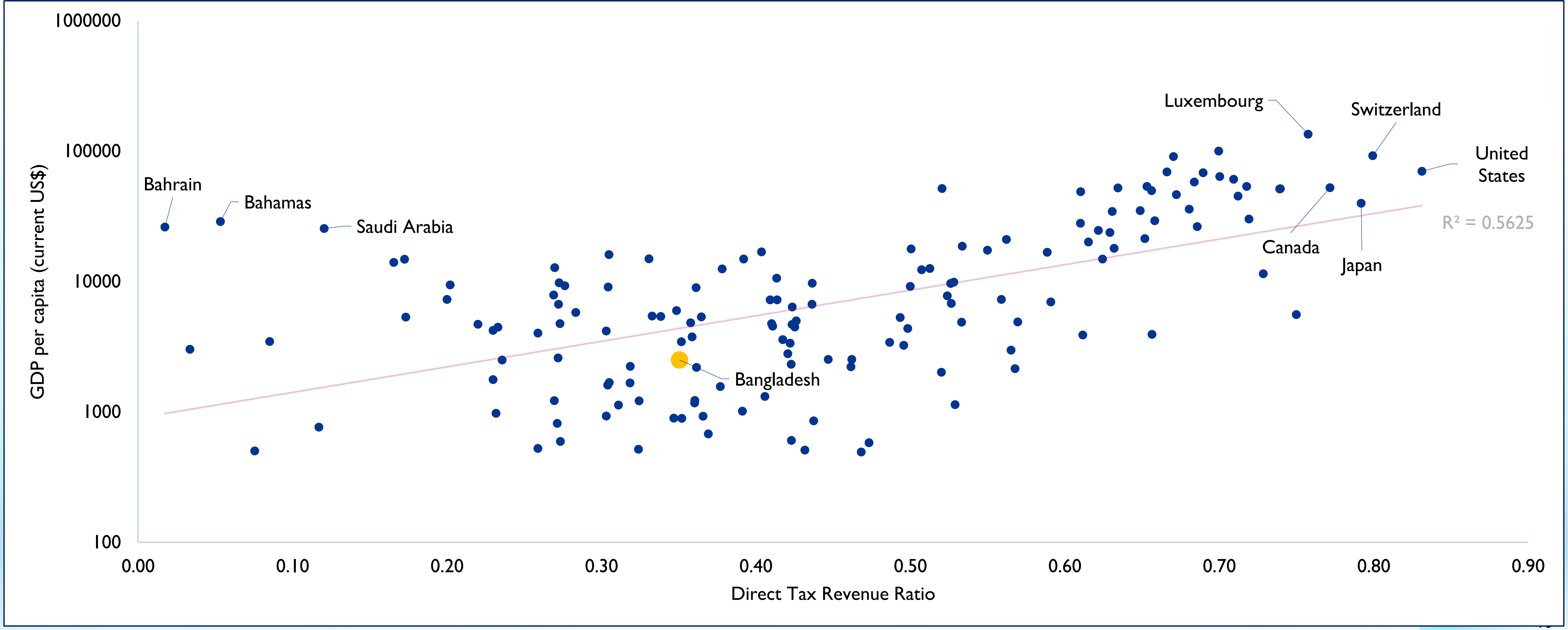


BANGLADESH'S TAX /GDP RATIO STALLED OR DECLINED SINCE 2012

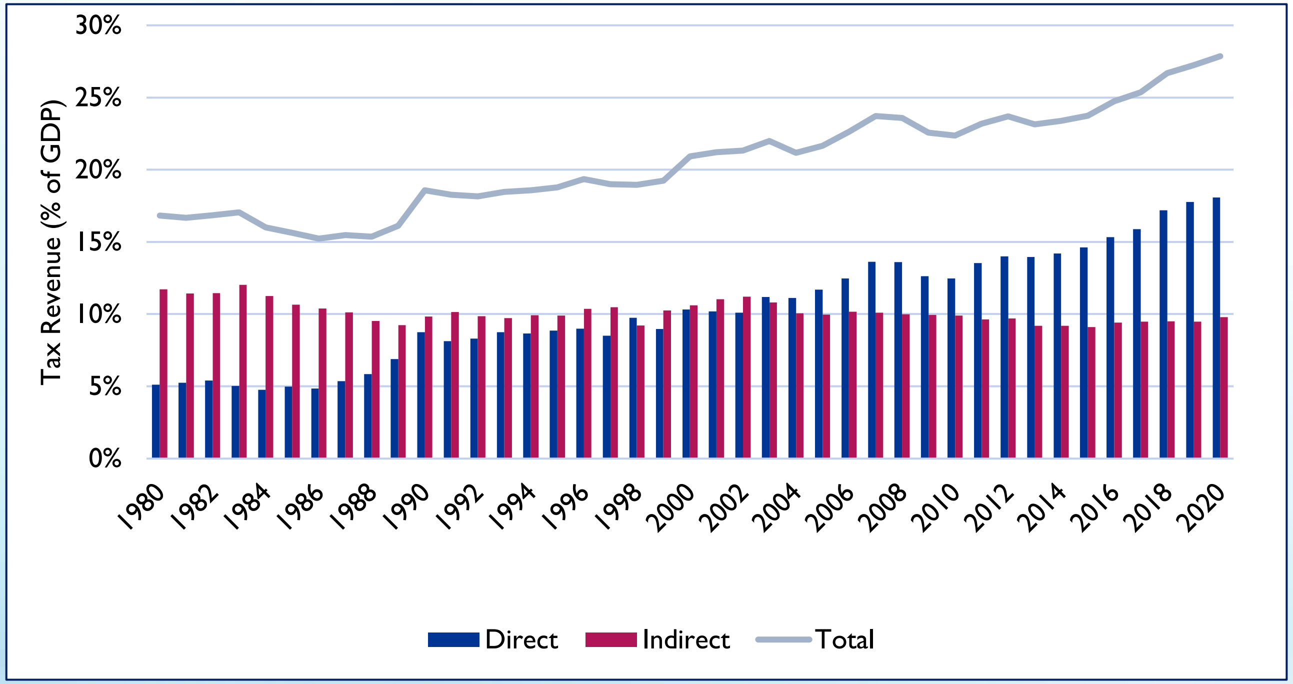
- In the early years, 1984-94, Bangladesh's per capita income did not increase much, but tax/GDP ratio almost doubled to 7%.
- Since 2001, per capita income started to increase along with the increase in the tax/GDP ratio. The ratio crossed the 9% level in 2012 when per capita income reached $1000 level.
- After 2012, the line became almost vertical, indicating that despite acceleration in per capita income the tax/GDP ratio was stagnant around 9% of GDP.



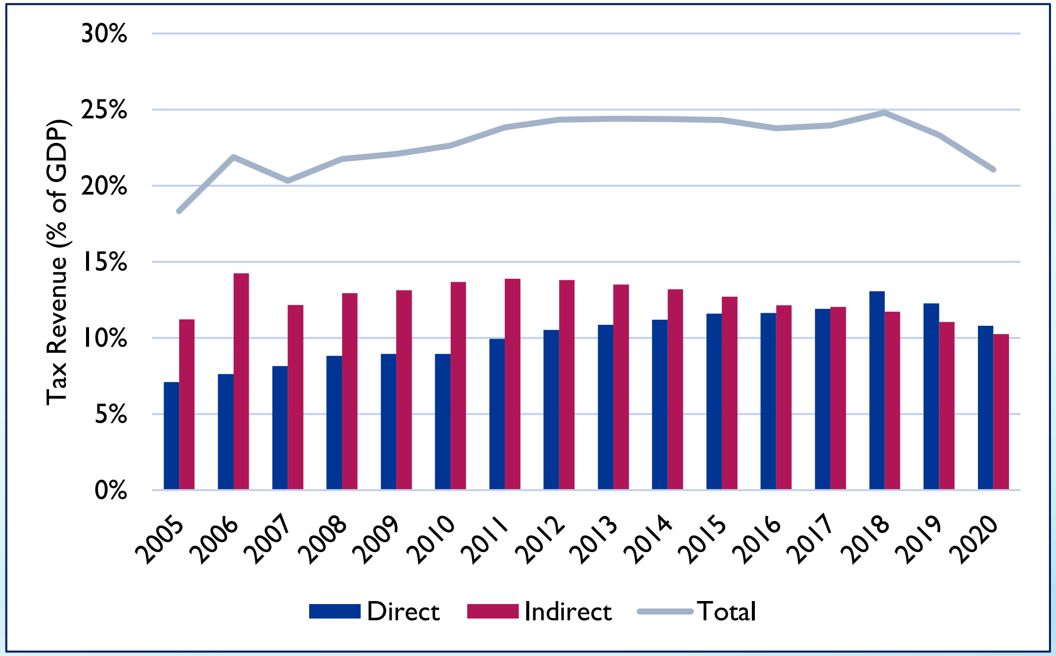
THE CONTRIBUTION OF DIRECT TAXES INCREASE WITH THE INCREASE IN PER CAPITA GDP OF COUNTRIES



Korea Is the Best Model for Transition to Reliance On Direct Taxes



Chinese Experience Demonstrates How The Loss of Indirect Taxes Were More Than Compensated by Gains in Direct Taxes



THE IMPORTANCE OF DIRECT TAXES MUST BE UNDERSCORED IN FUTURE TAX REFORM

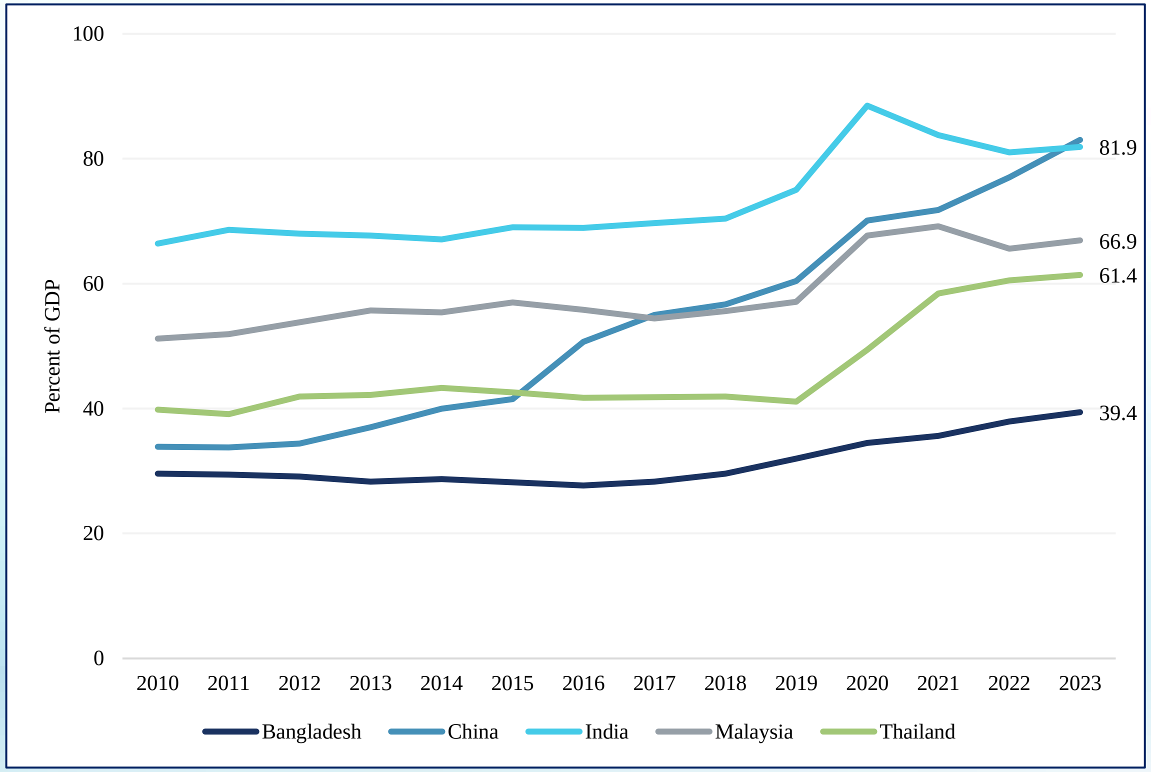
- The observed global phenomenon is that the ratio of direct taxes in total tax revenue or dependence on direct tax increases with the increase in per capita GDP. The best performer in collecting direct taxes is the USA where more than 85% of the total comes from direct taxes.
- At about 35% the ratio for Bangladesh is very unsatisfactory and has a long way to go.
- This phenomenon of increasing dependence on direct taxes is observed in almost all regional countries like India, China, Korea and Thailand.
- In all these countries, the share of direct tax increases over time with the increase in per capita GDP. Bangladesh is an exception. Thus future reform thrust at NBR should be more on direct taxes.
- Bangladesh cannot sustain its development objectives given its very low tax/GDP ratio. The size of the government is already small about 13%-15% of GDP and declining in relation to GDP. Bangladesh cannot achieve its cherished high middle and high income country status, given its current low level of domestic revenue mobilization.

THE REFORM AGENDA FOR REVENUE MOBILIZATION MUST BE BROAD BASED AND ENCOMPASS ADMINISTRATIVE AND TAX POLICY ISSUES

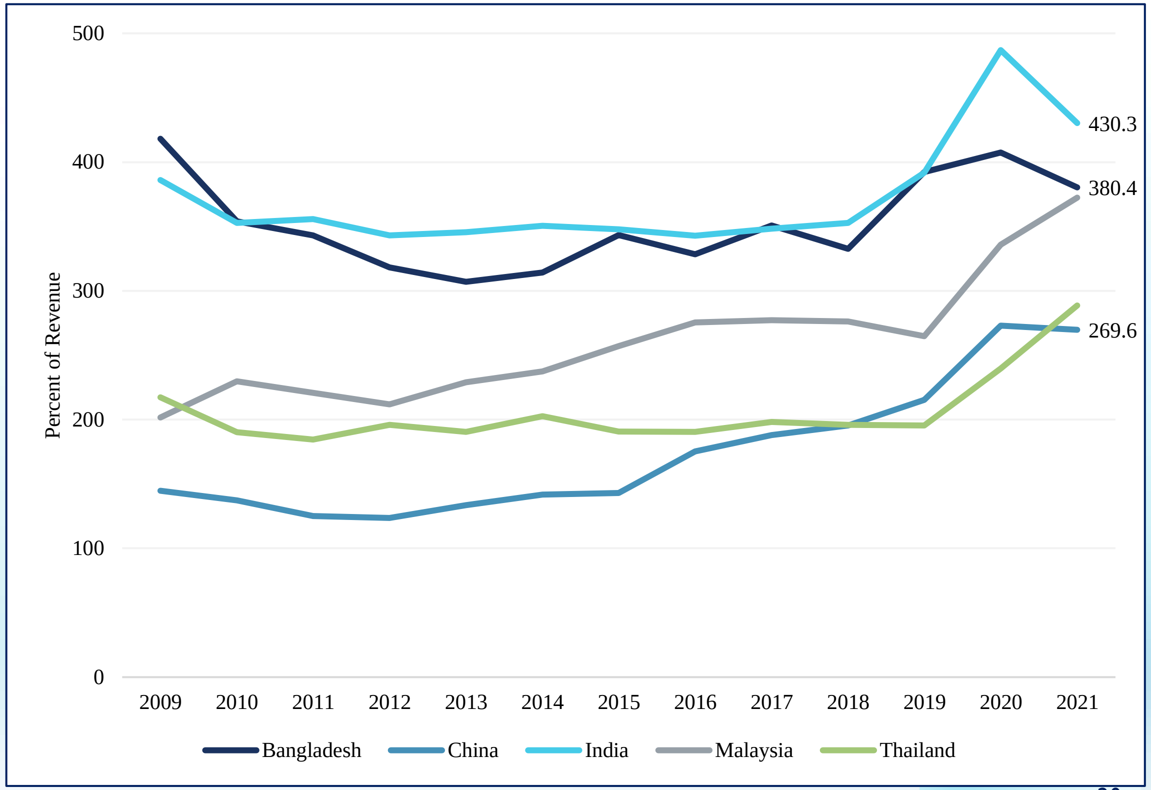
- Despite the secular decline in the tax/GDP ratio over more than one decade, there was no political pressure for bringing about the necessary changes. Now this has come to the point that it cannot wait anymore. Government is suffering from liquidity shortages in both foreign and domestic currency.
- The debt/GDP ratio may look favorable, but in terms of capacity to service debt—measured more appropriately in terms of debt/revenue ratio—Bangladesh's debt burden is one of the highest in the world. Bangladesh once was considered to be HIPC countries (based on IMF criteria) because of its debt/revenue ratio close to 400%, a threshold for HIPC eligibility.
- The agenda for reforms are well understood and I will not go into details. I will simply underscore that focus should be on fundamental tax administration and policy reforms, with emphasis on international best practices and automation.

BANGLADESH ALSO HAS A PUBLIC DEBT PROBLEM

Ratio of Public Debt to GDP, 2018 – 2022 (%)



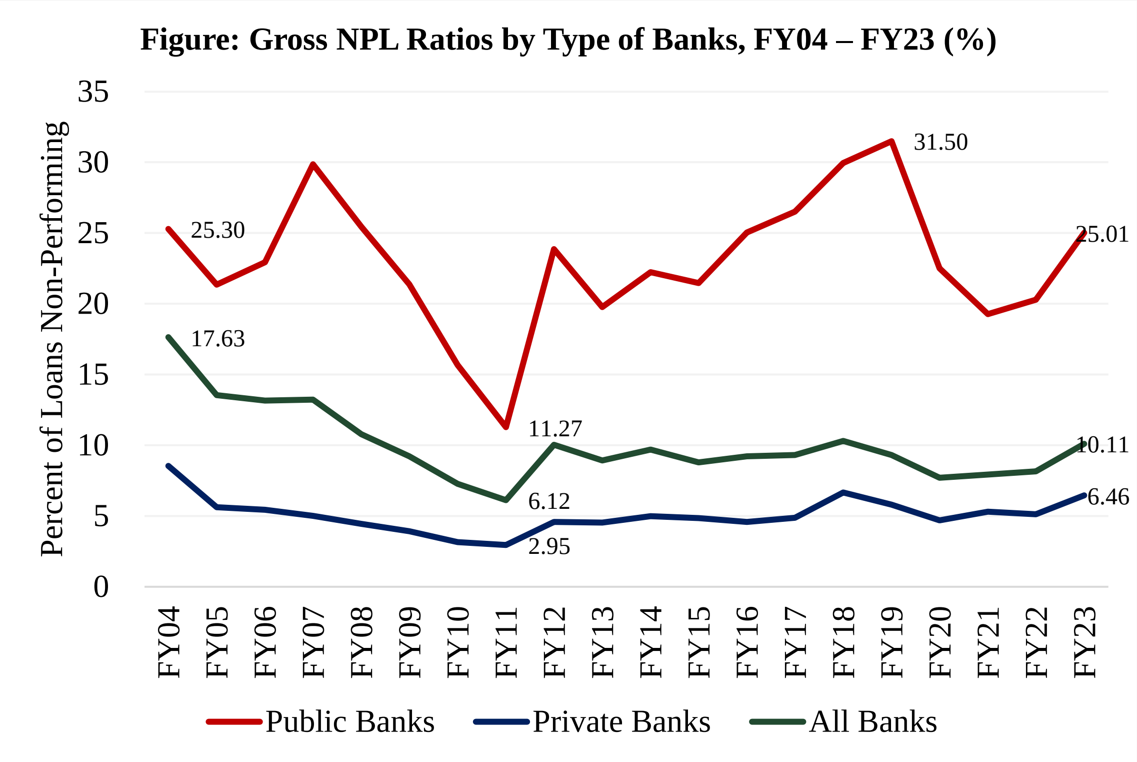
Ratio of Debt to Revenue, 2009 – 2021 (%)



FINANCIAL SECTOR IS THE OTHER MAJOR AREA WHICH NEEDS MASSIVE OVERHAUL IN THE POST-ELECTION PERIOD

- Financial sector in Bangladesh is in a very poor state and needs overhaul. Banking sector is the largest component and better managed part of the financial sector, but that is also in a very bad shape.
- Banking system is suffering from a huge burden nonperforming loans, slowdown in deposit growth, and low profitability.
- Some banks are also suffering from chronic liquidity crisis, but being bailed out by Bangladesh Bank by extending liquidity support. The bailouts are happening without much accountability.
- The state of the banking sector is being demonstrated in the following slides:

NON-PERFORMING LOANS ARE WORSENING

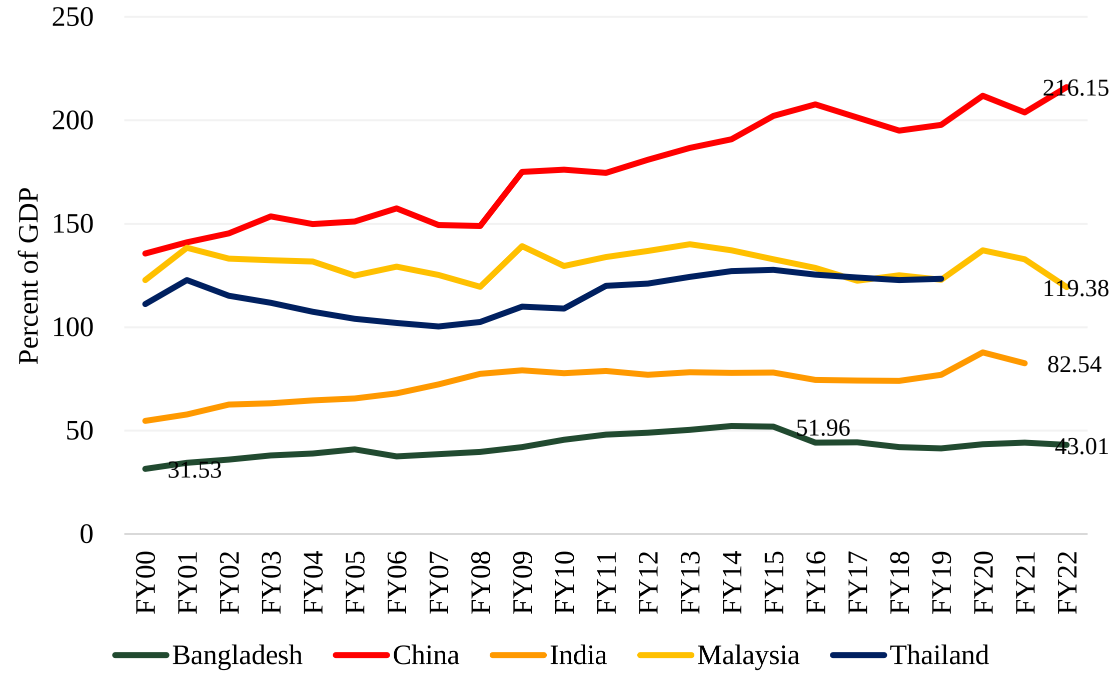


- Following a period of steady decrease in non-performing loans due to financial sector reform program initiated in early 2000s, the situation started to deteriorate after FY11.
- NPLs of both public and private banks improved significantly until FY11.
- Thereafter, with the deteriorating governance, the NPLs started to increase once again and exceeded more than 10% in FY23.
- **The true picture is much worse.** After including the rescheduled nonperforming loans and the loans stuck in the court system for a very long time, the actual level is believed to be about 25% of total loans.

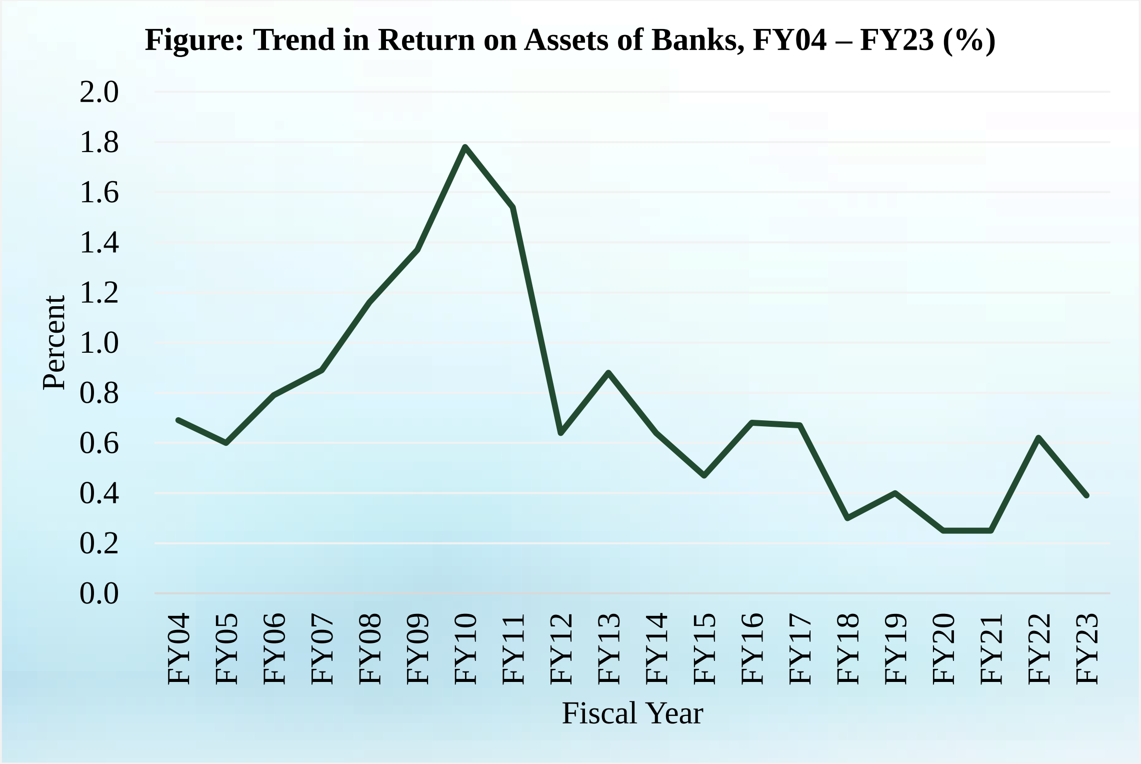
BANGLADESH'S FINANCIAL SECTOR IS EXTREMELY SHALLOW

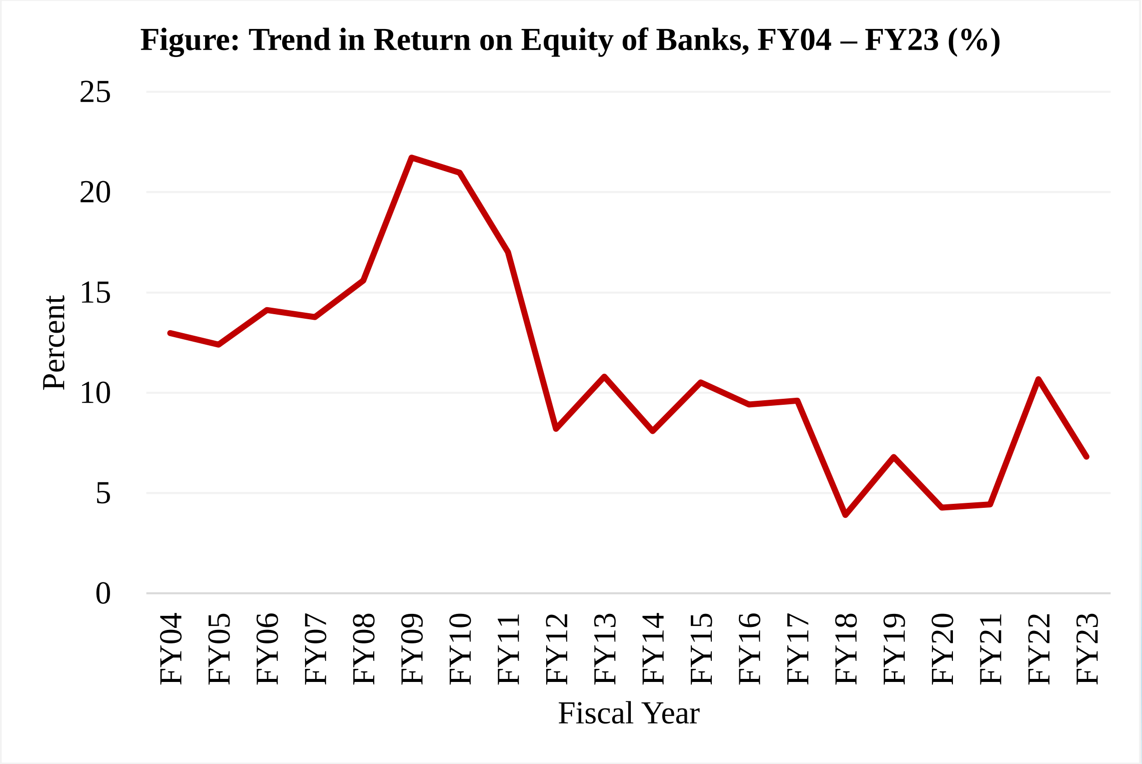
- The depth of the financial sector may be measured in terms of the ratio of broad money (M2) over GDP.
- After increasing by 20 percentage points to 52% over the period FY00-FY15, the ratio started to decline in line with the general deterioration of the financial sector in Bangladesh.
- Currently at only 43%, the ratio is almost half of the level of India, and well below East Asian countries (more than 100%) and China (more than 200%).

Figure: Ratio of Broad Money to GDP, FY00 – FY22 (%)

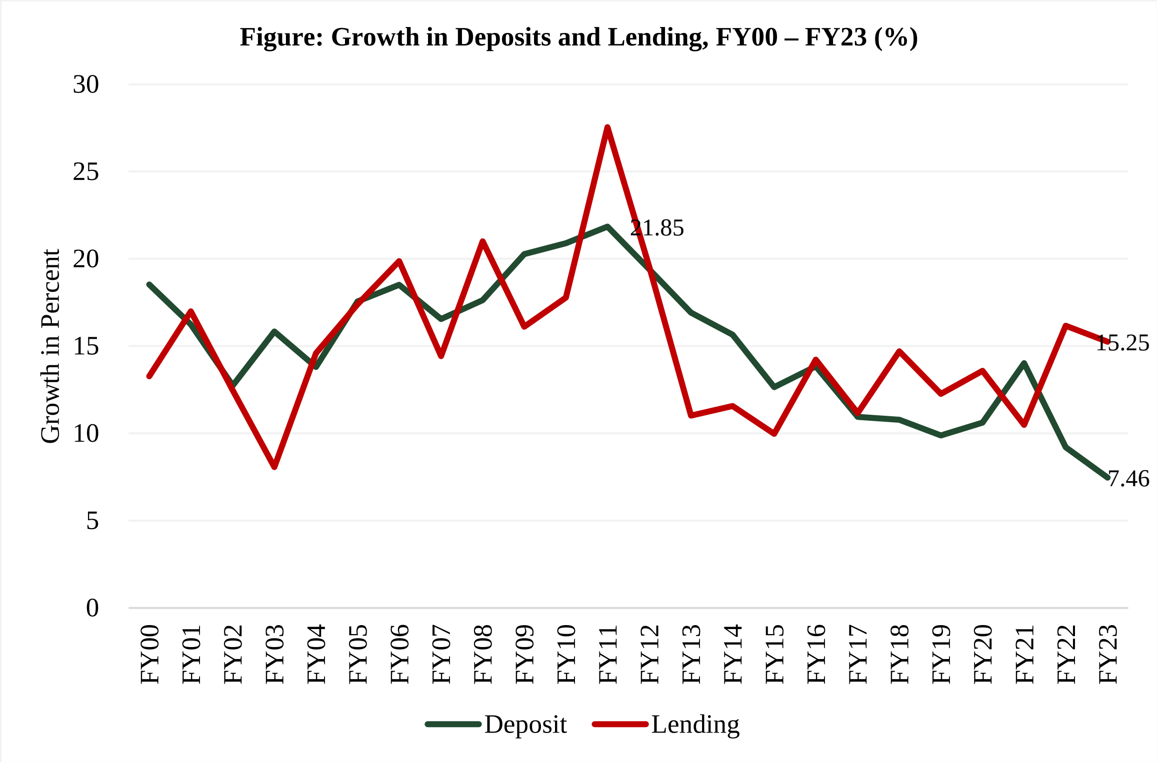


REFLECTING POOR PERFORMANCE THE RETURN ON ASSETS AND RETURN ON EQUITY OF BANKS HAVE DETERIORATED SHARPLY



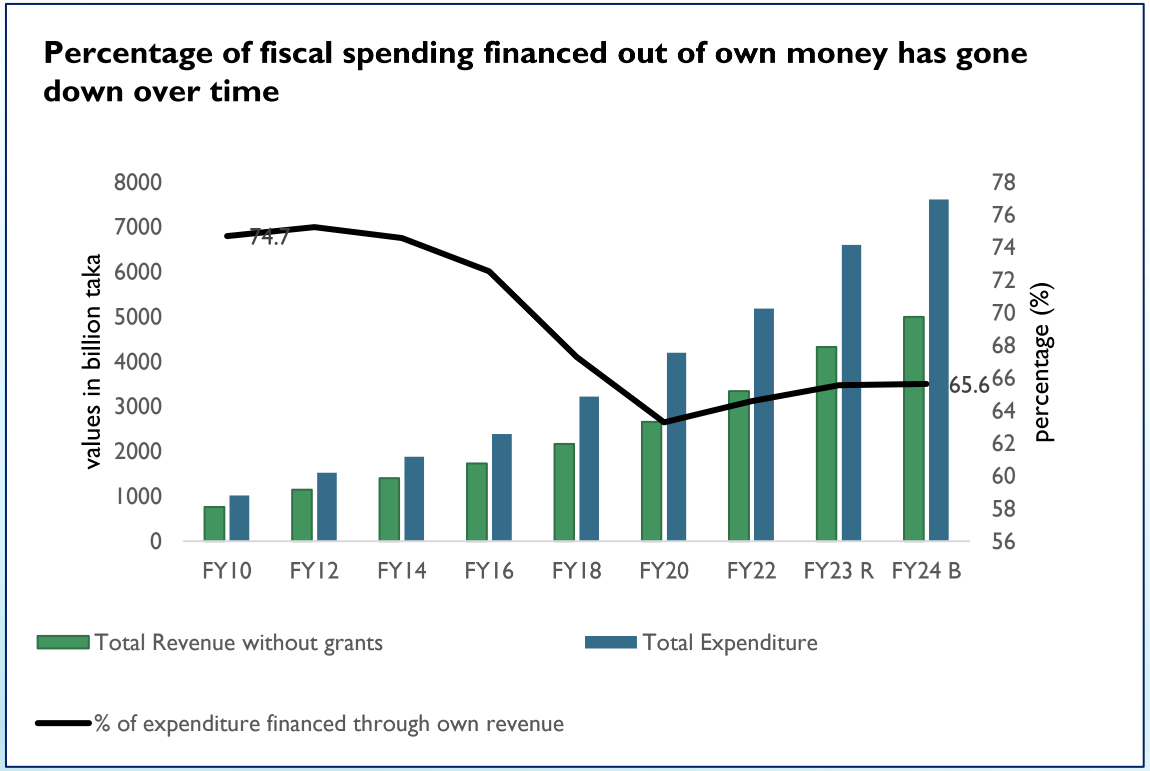


THE RAPID DECLINE IN THE GROWTH OF SAVINGS AT BANKS IS TROUBLING



- Growth of savings at commercial banks, which used to be 16-18 percent range plummeted to 7.5% level in FY23
- This reflects lack of confidence in banks and also poor return on savings accounts for a long time under the 9-6 percent policy caps.
- The prevailing high inflation rate also made savings in banks much less attractive with negative real rate of return.

RELIANCE OF THE BUDGET ON BORROWING IS INCREASING



The proportion of expenditure covered by revenue is declining over time, the banking sector is weakening further.

This creates problems for budget financing, sometimes leading to money creation by the central bank.

CONCLUDING OBSERVATIONS

- Bangladesh is facing multiple challenges on the macroeconomic front.
- Bringing down inflation, restoring exchange rate stability, preserving and then rebuilding foreign exchange reserves to much higher levels, and managing the fiscal situation despite revenue shortfalls will be extremely challenging.
- The short-term problems have also been compounded by the long-term structural problems associated with the structure of BOP, the extremely vulnerable banking sector, and the poor state of revenue administration.
- While not much can be done before the forthcoming national elections, preparations must be taken to roll out major reforms to ensure market based interest rates, proper management of the exchange market to ensure unified market based exchange rate along with exchange rate stability, and regularize or restructure the overdue payments to the international creditors.

CONCLUDING OBSERVATIONS

- Restructuring the banking and the broader financial sector and the improving the elasticity of the tax system will require comprehensive medium-term reform programs. International expertise and financial support from the multi-lateral organizations may help in preparing the right strategy and reducing the financing requirements through additional supports under new programs. External technical and financial support were never problems in initiating reforms in these areas in the past, and will not be in future. But **what is really needed is the political will to undertake real and not superficial reforms**.
- Notwithstanding the challenges, the situation can be stabilized and turned to a positive direction.
- However, for that to happen, the **post-election political leadership of the economic team should be credible and with strong political mandate**. The current narrative of the government must change to prepare public for some of the short-term difficulties and pains that are likely to be associated with any strong reform strategy. **Business as usual is not an option.**