April 2023

Bangladesh Development Update

Trade Reform: An Urgent Agenda

THE WORLD BANK
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Acknowledgements

This report was prepared by a team comprised of Bernard Haven (Senior Economist), Rangeet Ghosh (Senior Economist), Nora Carina Dihel (Senior Economist), Nazmus Sadat Khan (Economist), Zahid Hussain (Consultant), Sharmin Akter Jahan (Consultant), Rumana Islam (Consultant), and Bibhuti Chakma (Team Associate). Alexander Pankov (Lead Financial Sector Specialist), Anzhela Prygozhyna (Senior Financial Sector Specialist), and Sadia Afrin (Financial Sector Specialist) contributed to the analysis of the Financial Sector. Ayago Esmubancha Wambile (Senior Economist) contributed to the analysis of poverty trends. Yutaka Yoshino (Lead Country Economist) and Hoon Sahib Soh (Practice Manager) provided overall guidance under the leadership of Abdoulaye Seck (Country Director, Bangladesh and Bhutan) and Mathew Verghis (Regional Director, EFI).

Abbreviations

ABB	Association of Bangladesh Bankers
ADP	Annual Development Program
ADR	Advance-to-Deposit Ratio
APTA	Asia-Pacific Trade Agreement
ASEAN	Association of Southeast Asian Nations
AVE	Ad Valorem Equivalent
BAFEDA	Bangladesh Foreign Exchange Dealers' Association
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BCA	Bank Company Act
BDT	Bangladeshi Taka
BIDF	Bangladesh Infrastructure Development Fund
BoP	Balance of Payment
BPDB	Bangladesh Power Development Board
BPM6	Balance of Payments Manual 6
BSEC	Bangladesh Securities and Exchange Commission
CAD	Current Account Deficit
CAR	Capital Adequacy Ratio
CEM	Country Economic Memorandum
CY	Calendar Year
DSA	Debt Sustainability Analysis
DSE	Dhaka Stock Exchange
DSL	Debt Service Liabilities
EDF	Export Development Fund
EPZ	Export Promotion Zone
ERQ	Exporters' Retention Quota
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GSP	Generalized Scheme of Preferences
GTAP	Global Trade Analysis Project
GVA	Gross Value Added
GVC	Global Value Chains
IMF	International Monetary Fund
LC	Letters of Credit
LDC	Least Developed Country
LNG	Liquified Natural Gas
MLT	Medium and Long-Term
MPS	Monetary Policy Statement
MSCI	Morgan Stanley Capital International
MTDS	Medium-Term Debt Strategy
NBR	National Board of Revenue
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NPL	Non-Performing Loan
NSC	National Savings Certificate
NTB	Non-tariff barrier
NTM	Non-tariff measures
OMS	Open Market Sale
PCB	Private Commercial Banks
PPP	Purchasing Power Parity
PTA	Preferential Trade Arrangement
QLFS	Quarterly Labour Force Survey
R&D	Research and Development
RCEP	Regional Comprehensive Economic Partnership
RMG	Ready-made garments
SCB	State-owned Commercial Banks
SOE	State-owned Enterprises
SPS	Sanitary and Phytosanitary
TFA	Trade Facilitation Agreement
TRIST	Tariff Reform Impact Simulation Tool
VAT	Value-added Tax
WRI	Wage Rate Index
WTO	World Trade Organization

Executive Summary

Bangladesh navigated the COVID-19 pandemic with prudent macroeconomic policies, and real GDP growth rebounded to 7.1 percent in FY22. The recovery benefited from containment of the COVID-19 pandemic, resurgence of external and domestic demand, and policy support from the government. Real GDP growth is expected to decelerate to 5.2 percent in FY23 due to rising inflation, a revenue shortfall, energy shortages and slower global growth.

Inflation accelerated from an average of 6.1 percent in FY22 to an average of 8.7 percent in the first eight months of FY23 as international commodity prices rose and the taka depreciated. An accommodative monetary policy stance was tightened towards the end of FY22 and in the first half of FY23. Private sector credit growth rose modestly in FY22 and early FY23, supported by refinancing schemes. Banking sector liquidity declined as a result of Bangladesh Bank (BB) dollar sales and a decline in deposit growth, in the context of negative real deposit rates. Financial sector vulnerabilities deepened, with a rise in non-performing loans, weak capital buffers, and bank governance challenges.

External sector pressure led to a substantial balance of payments (BoP) deficit driven by the current account in FY22 and the financial account in FY23. The current account deficit in FY22 had widened to 4.0 percent of GDP due to a 35.5 percent surge in imports and a 15.1 percent decline in official remittance inflows. A moderate decline in import prices, import controls, and resilient export growth narrowed the trade deficit in the first half of FY23. However, a sharp contraction in trade credit and lower medium and long-term lending contributed to a financial account and BoP deficit. As a result, foreign exchange reserves continued to decline, driven also by BB interventions in the foreign exchange market to support the taka. The exchange rate depreciated despite the interventions, and in response a complex multiple exchange rate regime was introduced.

The fiscal deficit is estimated to have widened to 4.3 percent of GDP in FY22, as expenditure growth outpaced revenue growth. Tax revenue remained among the lowest in the world at an estimated 7.6 percent of GDP in FY22. Expenditure growth accelerated to 10.9 percent in FY22, led by a 23.4 percent increase in transfers and subsidies. Capital expenditure rose by 19.8 percent in FY22 led by infrastructure megaprojects, before being rationalized in the first half of FY23 to contain the budget deficit. Public debt as a share of GDP increased modestly but remained sustainable at 33.1 percent of GDP, excluding guarantees.

Real GDP growth is expected to decelerate to 5.2 percent in FY23, weighed down by elevated inflation, tighter financial conditions, disruptive import restrictions, and global economic uncertainty. Growth is expected to accelerate in FY24 and converge to around 6.5 percent over the medium term, as inflationary pressure eases, external conditions improve, and reform implementation gains momentum. A gradual reduction in extreme poverty is expected, from an estimated 10.0 percent in CY23 to 9.5 percent in CY24 (using the international poverty line of US$ 2.15 in 2017 PPP).

Structural reforms are needed to support a faster pace of growth over the medium term. To achieve the vision of attaining upper middle-income status by 2031, Bangladesh needs to create jobs and employment opportunities by creating a competitive business environment, diversifying exports, increasing human capital, building efficient infrastructure, deepening the financial sector, and establishing an enabling policy environment that attracts private investment. At the same time, Bangladesh will need to implement coordinated policies and investments to address rising climate vulnerabilities.

The special focus section of this report discusses trade reforms. Bangladesh’s progress towards upper middle-income will require diversifying exports and increasing trade competitiveness. Recent years have seen a decline in trade performance and an overreliance on ready-made garment (RMG) exports, raising concerns about the sustainability of this growth model. Priority reforms to improve competitiveness include tariff modernization, reduced non-tariff barriers, services liberalization, and regional integration, particularly with South Asia and Southeast Asia.

Recent Developments

Context

Bangladesh navigated the pandemic shock with prudent macroeconomic policies but faces a significant BoP deficit, rising inflationary pressure, and persistent external challenges. Bangladesh maintained positive real GDP growth during the COVID-19 pandemic supported by an effective stimulus program and prudent pandemic management. Growth accelerated in FY21 as movement restrictions ended. However, elevated commodity prices and synchronous global policy tightening disrupted the post-pandemic recovery in the second half of FY22. Following a sharp decline in foreign exchange reserves, Bangladesh requested additional World Bank and IMF support for key policy reforms and rebuilding external buffers. Bangladesh is also preparing for graduation from the United Nations Least Developed Country (LDC) status in 2026, which will gradually result in reduced access to preferential external market access for its exports under declining concessional financing.

Table 1: Global Growth and Commodity Prices

Real GDP Growth (%)					
	2020	**2021**	**2022e**	**2023f**	**2024f**
World	-3.2	5.9	2.9	1.7	2.7
USA	-2.8	5.9	1.9	0.5	1.6
Euro Area	-6.1	5.3	3.3	0.0	1.6
Saudi Arabia	-4.1	3.2	8.3	3.7	2.3
Commodity Prices					
Crude Oil, Brent ($/bbl)	42.3	70.4	100.0	92.0	80.0
Coal, Australia ($/mt)	60.8	138.1	320.0	240.0	212.3
Liquified Natural gas, Japan ($/mmbtu)	8.3	10.8	18.4	17.0	15.9
Fertilizer, TSP ($/mt)	265	538	735	650	550
Cotton ($/kg)	1.6	2.2	3.0	2.9	2.9
Iron ore ($/dmt)	108.9	161.7	120.0	100.0	98.8
Soybean oil ($/mt)	838	1,385	1,675	1,550	1,537

Source: Global Economic Prospects (January 2023); and Commodity Markets Outlook (October 2022).

Real Sector

A strong post-pandemic rebound in real GDP growth is facing new headwinds. *On the supply side, the industrial production index showed strong growth in manufacturing in FY22. However, energy shortages disrupted industry in the first half of FY23. On the demand side, rapid private consumption and investment growth in FY22 slowed in the first half of FY23 as a result of rising inflation and growing uncertainty. A record trade deficit was driven by a surge of imports beginning in the second half of FY22. Inflation accelerated with rising global commodity prices and the resulting adjustment of domestic petroleum, gas, and electricity prices. After increasing marginally during the COVID-19 pandemic, the estimated poverty rate declined in CY22.*

Table 2: Contributions to Growth

	FY16	FY17	FY18	FY19	FY20	FY21	FY22
GDP Growth	**7.1**	**6.6**	**7.3**	**7.9**	**3.4**	**6.9**	**7.1**
Contribution of Production Sectors (%)							
Industry	4.2	2.6	3.2	3.8	1.2	3.5	3.4
Services	3.6	3.3	3.3	3.5	2.0	2.9	3.1
Agriculture	-0.9	0.4	0.5	0.4	0.4	0.4	0.4
Import duty	0.3	0.3	0.3	0.2	-0.2	0.2	0.2
Contribution of Expenditure Components (%)							
Consumption	**2.6**	**4.6**	**6.6**	**4.1**	**2.1**	**5.7**	**5.3**
Private consumption	2.1	4.2	6.3	3.3	2.0	5.3	5.0
Government consumption	0.5	0.4	0.3	0.8	0.1	0.4	0.4
Investment	**2.7**	**2.5**	**3.7**	**2.2**	**1.3**	**2.6**	**3.8**
Private Investment	2.4	1.4	3.4	2.2	0.1	1.9	2.9
Government Investment	0.3	1.2	0.3	0.0	1.2	0.7	0.8

Resource Balance	1.7	-1.2	-3.3	1.4	-0.2	-1.5	-2.2
Exports, goods & services	0.3	-0.3	0.8	1.5	-2.3	1.0	3.1
Imports, goods & services	-1.4	0.9	4.1	0.1	-2.1	2.4	5.3
Statistical discrepancy	0.1	0.6	0.3	0.2	0.3	0.1	0.2

Source: Bangladesh Bureau of Statistics (BBS).

Growth

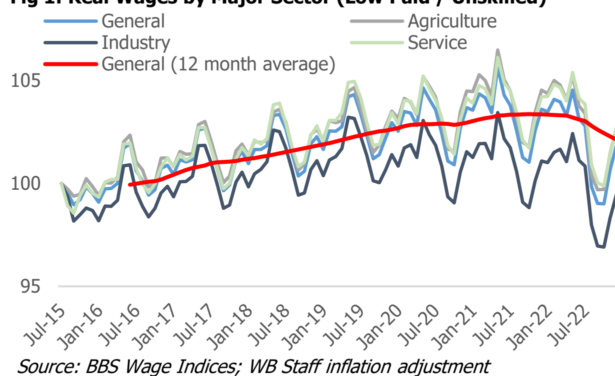
Global growth decelerated sharply amidst synchronized policy tightening, worsening financial conditions, and continued disruptions from Russia's invasion of Ukraine.[1] High inflation in advanced and emerging economies triggered unexpectedly rapid and synchronous monetary policy tightening around the world, which has in turn contributed to a significant worsening of global financial conditions. Global asset prices have fallen as investment growth slowed. Inflationary pressure was compounded by a surge in food and energy commodity prices in FY22 as a result of Russia's invasion of Ukraine. Inflation is weighing on private consumption, especially in low-income countries with high shares of food and fuel in their consumption.

In Bangladesh, a rapid recovery from the COVID-19 pandemic has been disrupted by a variety of demand and supply shocks, both internal and external. GDP growth rose to 7.1 percent in FY22, notwithstanding rising inflation and external pressure in the second half of the fiscal year. Faster implementation of a government stimulus package and an accommodative monetary policy supported the recovery. With almost two thirds of the population fully vaccinated, the impact of a new wave of COVID-19 cases in early 2022 was limited. However, challenging external conditions resulted in a significant BoP deficit beginning in the second half of FY22 and foreign reserves declined rapidly. A series of import suppression and foreign exchange (FX) rationing measures were adopted to slow the rising trade deficit, including restrictions on issuance of letters of credit (LC) for imported goods and rolling electricity blackouts to conserve energy.

On the supply side, manufacturing and services growth slowed in early FY23. The industrial sector grew by 9.9 percent in FY22 as resilient external demand for RMG supported strong manufacturing growth. However, gas and electricity shortages disrupted industrial production in the first half of FY23, including fertilizer, cement, and steel production. In addition to higher input costs, restrictions on issuance of LC to ration foreign exchange constrained access to key imported materials. In construction, higher cement and steel prices were partially offset by ongoing implementation of public infrastructure megaprojects. Growth in the agriculture sector decelerated to 3.1 percent in FY22 as the *boro* harvest was damaged by floods in eastern and northern regions of the country. Services growth of 6.3 percent in FY22 slowed in the first half of FY23, as consumer purchasing power declined with rising inflation.

On the demand side, private consumption and investment growth slowed in the first half of FY23. Private consumption grew by 7.5 percent in FY22, driven by pent up demand and normalization of economic activities post-pandemic and imports of consumer goods which surged by 35.5 percent. However, accelerating inflation weighed on consumer purchasing power in the first half of FY23 – imports of consumer goods declined by 1.5 percent (y-o-y) by January 2023. Adjusting the Wage Rate Index (WRI) for inflation illustrates the declining purchasing power of

Fig 1: Real Wages by Major Sector (Low Paid / Unskilled)



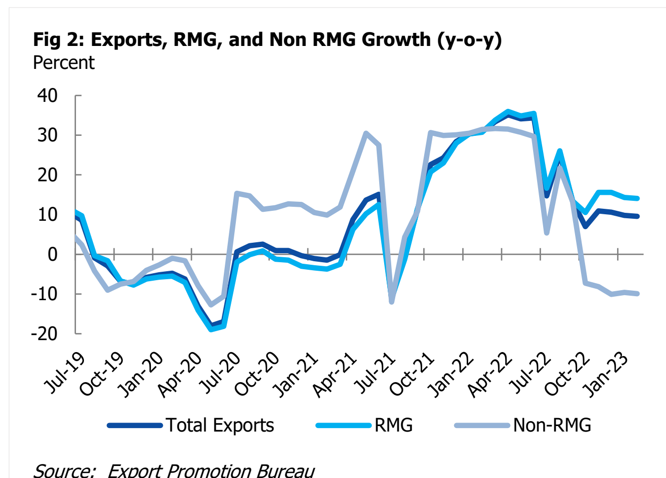
Source: BBS Wage Indices; WB Staff inflation adjustment

[1] World Bank, 2023. Global Economic Prospects, January 2023. http://hdl.handle.net/10986/38030

low paid skilled and unskilled labor (Figure 1).[2] Private investment grew by 11.8 percent in FY22 but slowed in the first half of FY23 as a result of rising uncertainty and foreign exchange rationing. Imports of capital goods declined by 8.2 percent (y-o-y) by January 2023. Government investment rose by 11.1 percent in FY22 led by infrastructure megaprojects and government consumption rose by a more modest 6.2 percent. Government spending growth slowed in the first half of FY23 as temporary austerity measures were imposed to narrow the deficit and conserve foreign exchange.

A surge in imports of intermediate goods outweighed higher export earnings in FY22. Merchandise exports rose by 33.4 percent in FY22 (Figure 2) supported by resilient global demand for RMG products and rising market share due to the diversion of orders from China. Exports remained highly concentrated, as RMG accounted for 81.8 percent of total merchandise exports. The United States (20.0 percent of exports) and the European Union (44.6 percent) remained the main export destinations. Among non-traditional markets, exports to India rose by 55.6 percent. However, a 33.6 percent surge in imports led to a record US$ 37.1 billion trade deficit. Higher commodity prices and supply chain disruptions due to Russia's invasion of Ukraine caused import payments to surge across all categories of consumer, intermediate, and capital goods (Box 1). A US$ 8 billion increase in RMG intermediate goods led to the rapid growth of imports.

Fig 2: Exports, RMG, and Non RMG Growth (y-o-y)



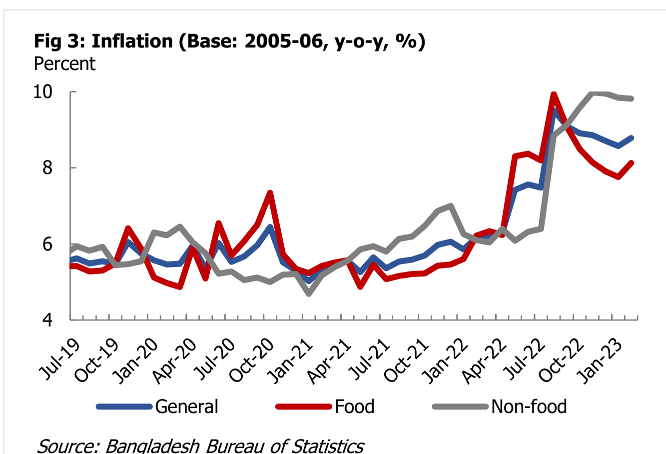
Source: Export Promotion Bureau

The trade deficit narrowed only modestly in the first half of FY23. The trade deficit remained elevated in the first seven months (July-Jan) of FY23. Exports grew by 9.6 percent (y-o-y) with resilient demand and growing market share in major export markets, and import growth declined to 5.7 percent as numerous import suppression measures were adopted, reducing the issuance of letters of credit.

Inflation

Inflation accelerated to 9.5 percent by August 2022 as commodity prices rose and the taka depreciated. Rising aggregate demand contributed to higher prices in the first half of FY22 with a strong rebound in growth. Significant administered price adjustments of energy and electricity coupled with exchange rate depreciation raised input costs in the second half of FY22, with knock-on effects that are still working through the economy. By February 2023, national inflation was measured at 8.8 percent (y-o-y).

Fig 3: Inflation (Base: 2005-06, y-o-y, %)



Source: Bangladesh Bureau of Statistics

[2] WRI measures the movement of nominal wages of low paid skilled and unskilled labor in different sectors of the economy with a base year of 2010-11. Figure 1 presents changes in inflation adjusted WRI from July 2015 onward.

Box 1: Drivers of Surging Imports in FY22

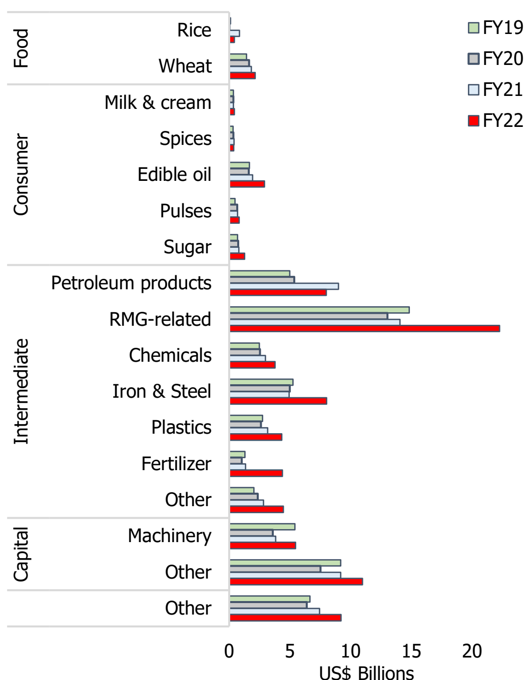
Merchandise import payments rose by a record 35.9 percent in FY22 (y-o-y) as commodity prices surged and freight costs rose. Imports grew in almost all categories in FY22 (Figure 4).

RMG intermediate goods: This category drove the surge in imports, rising by 42.1 percent (y-o-y). RMG-related inputs are the largest component of intermediate goods, with growth driven by both higher exports and an increase in global prices. Cotton import payments rose by 39.3 percent (y-o-y) as the price of cotton doubled in the international market. Similarly, imports of yarn, textile, and staple fibers also increased significantly.

Fertilizer: About two-thirds of total fertilizer consumption is imported, historically from Russia and Belarus. International fertilizer prices more than doubled following Russia's invasion of Ukraine. Energy shortages disrupted domestic fertilizer production, further increasing demand for imports. As domestic fertilizer is subsidized with a fixed price, demand remained insensitive to international price changes. Import payments for fertilizer spiked by 222.8 percent in FY22.

Capital goods and machinery: Capital goods and machinery import payments rose by 42.8 percent, and while iron and steel imports rose by 62.4 percent in FY22, as the implementation of infrastructure megaprojects accelerated.

Fig 4: Merchandise Imports by Fiscal Year



Source: Bangladesh Bank

Edible oil: More than 90 percent of Bangladesh's edible oil demand is met through imports. Edible oil price increased in the international market even before Russia's invasion of Ukraine. Price increases accelerated after a temporary restriction on exports from Indonesia. To limit the transmission of higher edible oil prices, VAT at import was reduced by ten percentage points. Edible oil import payments increased by 50.2 percent in FY22.

Higher import costs have contributed to food price increases. Rice prices remained elevated, despite a reduction in VAT on imports. Sugar prices also rose significantly after India restricted sugar exports, and wheat price increased after imports from Russia and Ukraine were disrupted. Temporary export restrictions on edible oils in Indonesia contributed to higher prices. A resumption of exports and withdrawal of VAT on imports reduced edible oil prices in late FY22 and early FY23.

Non-food inflation was close to double digits. Pent up demand increased aggregate demand, and a rise in the price of imported goods and subsequent energy and transport price increases exacerbated the inflationary pressure on other items such as pharmaceuticals, clothing, furniture, and house rent. A series of adjustments to retail electricity tariffs increased prices by 15.7 percent from January to March 2023, and the price of piped gas was substantially increased for the power, industrial, and commercial sectors in February 2023, rising by more than 150 percent for large industries.

Poverty and welfare

After increasing marginally during the COVID-19 pandemic, the estimated extreme poverty rate (US$ 2.15 in 2017 PPP) declined to 10.44 percent in CY22 from 11.07 percent in CY21. Job losses and reduced earnings during the pandemic disproportionately affected the poor, especially among women. Spatial inequality widened with the reemergence of a welfare gap between eastern and western Bangladesh. In CY22, employment levels improved, but real earnings have not yet recovered to pre-pandemic levels. Improving labor market conditions were partially

offset by the loss of purchasing power. The poorest decile of households is most vulnerable to lost purchasing power, spending more than two-thirds of their income on food, housing, and utilities. Based on a provisional BBS report on the 2022 Quarterly Labour Force Survey (QLFS), labor force participation increased in the agricultural sector between FY17 and FY22, while it has declined in the industrial and service sectors. These findings indicate that more people have been employed in the agriculture sector during this period than in the industrial and service sectors. Female labor force participation has also increased from 36.3 per cent in 2016/17 to 42.7 in 2022.

Monetary and Financial Developments

An accommodative monetary policy stance was tightened towards the end of FY22 and in the first half of FY23 as inflationary pressure accelerated. BB's substantial FX sales led to a deceleration in reserve money and broad money growth. Private sector credit growth rose modestly in FY22 and early FY23. Liquidity in the banking system dwindled as a result of BB dollar sales and a decline in deposits in the face of negative real interest rates and weakening depositor confidence. Financial sector vulnerabilities deepened.

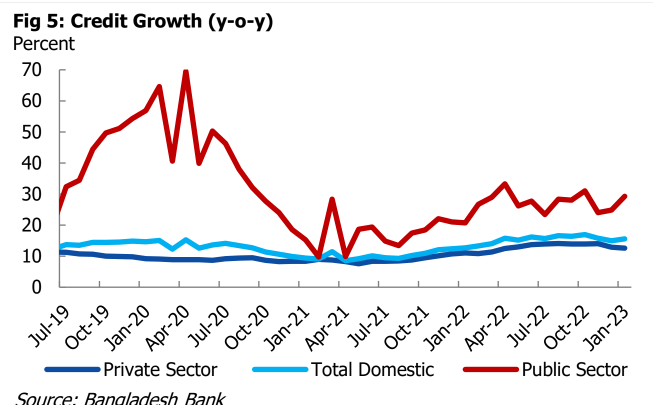
Table 3: Monetary Program Performance

	FY19	**FY20**	**FY21**	**FY22**	**FY 23**	
	Actual	Actual	Actual	Actual	Original (Jun-23)	Actual(p) (Dec-22)
Net Foreign Assets	2.1	10.2	27.7	-11.9	-2.1	-22.6
Net Domestic Assets	12.3	13.4	9.3	17.2	16.0	18.5
Domestic credit	12.4	13.7	10.4	16.2	18.2	15.1
Public Sector credit	21.7	53.4	21.7	29.1	36.0	26.6
Private Sector credit	11.3	8.6	8.3	13.7	14.1	12.8
Broad Money	9.9	12.7	13.6	9.4	12.1	8.4
Reserve Money	5.3	15.7	22.4	-0.3	9.0	17.4
Inflation (end of period average)	5.5	5.6	5.6	6.1	7.5	7.7
Growth	7.9	3.4	6.9	7.1	6.5	-

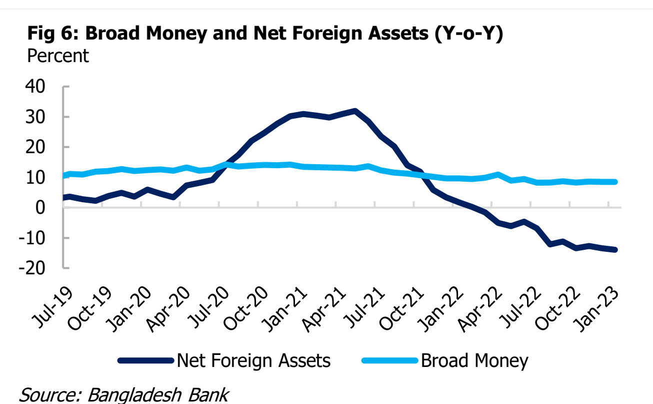
Source: Bangladesh Bank and Bangladesh Bureau of Statistics.

A decline in net foreign assets drove monetary tightening in late FY22 as inflation accelerated. An expansionary monetary policy adopted during the COVID-19 pandemic remained unchanged for most of FY22. To respond to rising inflationary pressure, BB increased the repo rate four times between May 2022 and January 2023 by a total of 125 basis points. The reverse repo rate was also raised by 25 basis points to 4.25 percent. However, the transmission of monetary policy was impaired as a result of an ongoing interest rate cap of 9 percent for the industrial sector lending. A Monetary Policy Statement Update in January 2023 increased the lending rate cap for consumer credit to 12 percent and removed caps on credit card loans. However, these categories represent only about 20 percent of overall private sector credit. A BB deposit rate peg to a three-month moving average of inflation was abandoned, following an acceleration in inflation.

Private sector credit growth rose moderately in FY22 and in early FY23. Private sector credit growth reached a three year high of 15.8 percent in November 2022, before slowing to 12.6 percent in January 2023. Higher growth partially reflects rising import costs due to the depreciation of the taka and increased margin requirements for LC issuance for some types of goods. Additionally, credit growth was supported by a series of subsidized lending schemes. The overall advance-to-deposit ratio (ADR)[3] stood at 79 percent in December 2022, well below the regulatory limit of 87 percent. This largely reflected the impact of interest rate caps on lending, which have constrained banks' ability to adequately price credit risks.



Monetary growth slowed. Substantial BB net FX sales led to a 4.7 percent decline in Net Foreign Assets (NFA) at the end of FY22. This, in turn, resulted in a negative reserve money growth for the first time in two and a half years. Broad money growth decelerated to 9.4 percent in FY22, below the BB's target of 10 percent. Despite a decline in NFA, the growth of net domestic assets (NDA) increased on the back of rising credit to the public and private sectors. NDA growth accelerated to 15.1 percent in the first seven months of FY23. Broad money growth slowed to 8.5 percent over the same period, as FX sales accelerated. BB reduced its broad money growth target by 0.6 percentage points to 11.5 percent for the second half of FY23.



Liquidity in the banking system declined. Record BB FX sales and falling deposit growth on the back of negative real deposit rates constrained liquidity in the banking system. A series of large-scale fraud allegations in the banking sector impaired public confidence, further weighing on deposit growth. Liquid assets to total assets stood at 16.2 percent in September 2022 from 20.4 percent one year before. The liquidity coverage ratio fell to 153.9 percent in December 2022 from 193.6 in December 2021. BB has introduced liquidity support facilities to address liquidity stress. Interest rates in the call money and inter-bank repo market rose, reflecting tighter liquidity conditions in the banking sector. The interbank overnight lending rate rose to 7.5 percent as of March 20, 2023, compared to 5.25 percent in March 2022. Yields on government securities also rose.

Financial soundness indicators deteriorated. The capital adequacy ratio (CAR) marginally increased to 11.8 percent in December 2022, compared to 11.1 percent a year ago, remaining below the minimum 12.5 percent regulatory requirement.[4] The aggregate CAR of state-owned commercial banks (SCBs) increased to 6.3 percent in December 2022 from 3.7 percent one year earlier. The aggregate CAR of private commercial banks (PCBs) remained almost unchanged at 13.8 percent in December 2022 from 13.7 percent one year earlier. Gross non-performing loans (NPLs) increased to 8.2 percent in December 2022 from 7.9 percent one year earlier, and provisions-to-NPLs decreased to 60.6 percent from 64.5 percent over the same period.

[3] A measurement of loans as a percentage of deposits.
[4] The 12.5 percent requirement is comprised of a minimum capital requirement of 10 percent and capital conservation buffer of 2.5 percent.

Financial soundness indicators likely understate vulnerabilities. The extent of troubled assets is obscured by lax regulatory definitions and reporting standards, extended forbearance, as well as weak supervisory enforcement. Published NPL statistics do not reflect internationally accepted definitions (90 days past due) of non-performing exposures. The loan rescheduling and restructuring policy for defaulted loans was substantially relaxed in FY23. The repayment period for defaulted loans was increased to eight years from two years. The down payment requirement for rescheduling was lowered to as little as 2.5 percent. NPLs can be rescheduled up to four times.

Investor confidence in equity markets remained low. The introduction of a price floor by the Bangladesh Securities and Exchange Commission (BSEC) in July 2022 led to a sharp decline in market liquidity. Morgan Stanley Capital International (MSCI) has applied special treatment for Bangladesh in its equity indexes as a result, excluding stock market performance in Bangladesh from its frontier markets index. In the fixed income segment, secondary market trading of government securities was introduced in the Dhaka Stock Exchange (DSE) in October 2022 on an experimental basis.

External Sector

A surge in imports and decline in official remittance inflows widened the current account deficit (CAD) in FY22, resulting in a BoP deficit. The CAD narrowed in the first half of FY23 following a series of import restrictions, supported by resilient export growth. However, a financial account deficit widened the BoP deficit in the first half of FY23, as trade credit and medium- and long-term borrowing declined. BB continued selling FX reserves to slow the depreciation of the taka. The introduction of a complex multiple exchange rate disincentivized export and remittance inflows.

Table 4: Balance of Payments

US$ million

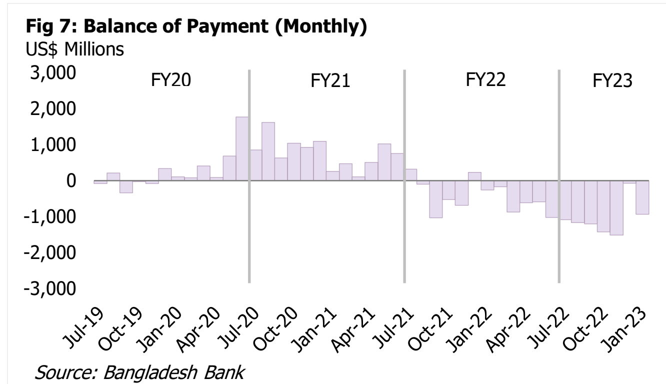
	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23 (to Jan)
Overall Balance	**5,050**	**3,169**	**-857**	**179**	**2,925**	**9,274**	**-5,380**	**-7,388**
Current account balance	**4,262**	**-1,331**	**-9,567**	**-4,490**	**-4,723**	**-4,575**	**-18,697**	**-5,037**
Trade balance	-6,460	-9,472	-18,178	-15,835	-17,858	-23,778	-33,249	-13,387
Merchandise export f.o.b. (inc. EPZ)	33,441	34,019	36,285	39,604	32,832	36,903	49,246	25,418
Merchandise import f.o.b. (inc. EPZ)	-39,901	-43,491	-54,463	-55,439	-50,690	-60,681	-82,495	-44,031
Services	-2,708	-3,288	-4,201	-3,176	-2,541	-3,020	-3,870	-2,242
Income	-1,915	-1,870	-2,641	-2,382	-3,106	-3,172	-3,299	-2,251
Current transfers	15,345	13,299	15,453	16,903	18,782	25,395	21,721	12,843
Official	67	59	51	41	19	51	16	38
Private	15,278	13,240	15,402	16,862	18,763	25,344	21,705	12,805
o/w Workers' remittance	14,717	12,769	14,982	16,420	18,205	24,778	21,032	12,452
Capital account	**478**	**400**	**331**	**239**	**256**	**458**	**181**	**174**
Financial account	**944**	**4,247**	**9,011**	**5,130**	**7,537**	**14,067**	**13,666**	**-1,196**
Foreign direct investment (net)	1,285	1,653	1,778	2,628	1,271.3	1,355	2,179	1,343
Portfolio investment (net)	139	457	349	171	44	-269	-158	-43
MLT loans (excludes suppliers' credit)	3,033	3,218	5,987	6,263	6,222	7,449	9,811	4,048
MLT amortization payments	-849	-895	-1,113	-1,202	-1,257	-1,417	-1,527	-915
Other long-term loans (net)	-110	-153	141	302	438	1,684	1,404	-150
Other short-term loans (net)	-435	1,030	1,508	272	931	2,064	2,333	-771
Trade Credit (net)	-2,101	-1,185	-1,270	-3,493	-616	3,749	-1,561	-2,840
Commercial Bank	-18	122	1,631	189	-270	-548	1,185	-1,868
Errors and omissions	**-634**	**-147**	**-632**	**-700**	**-145**	**-676**	**-530**	**-1,329**

Source: Bangladesh Bank.

The BoP moved from a surplus in FY21 to a deficit in FY22, as imports surged and official remittance inflows declined (Figure 7). The surge in imports was led by a 42.1 percent increase in intermediate goods imports (Box 1), the result of both quantity and price effects. Robust export demand contributed to the quantity of intermediate

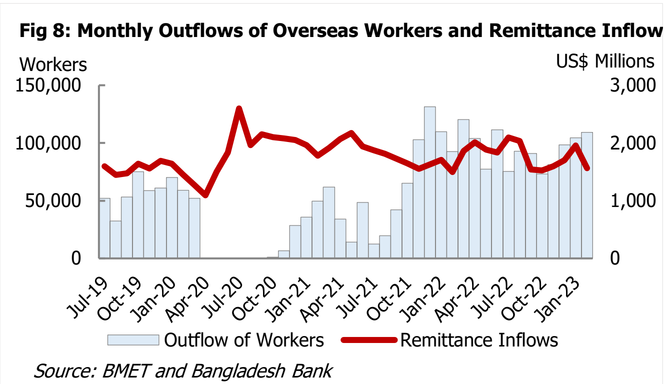
goods imports and surging global commodity prices contributed to rising input costs. Import growth was only partially offset by a 33.4 percent increase in merchandise exports in FY22, and the trade deficit widened to a record US$ 37.1 billion. Remittances through official channels had unexpectedly surged in FY21 as a result of pandemic travel restrictions that impeded the informal hundi market. As these restrictions were lifted, remittance flows through official channels returned to historical trend levels and official remittance inflows declined by 15.1 percent in FY22. As a result, the CAD rose to US$18.5 billion in FY22 compared to US$ 4.6 billion in FY21. Higher public external borrowing supported a US$ 13.8 billion financial account surplus in FY22 as medium- and long-term loan disbursement rose by 31.7 percent. Foreign Direct Investment (FDI) and portfolio flows remained modest.[5] The overall BoP deficit moved from a US$ 9.3 billion surplus in FY21 to a US$ 5.3 billion deficit in FY22.

Fig 7: Balance of Payment (Monthly)



Source: Bangladesh Bank

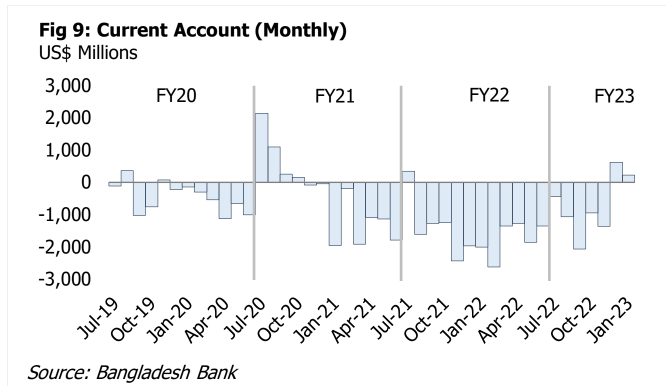
Fig 8: Monthly Outflows of Overseas Workers and Remittance Inflow



Source: BMET and Bangladesh Bank

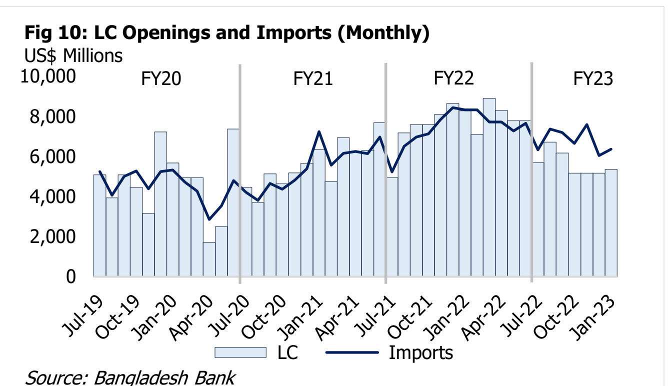
The CAD narrowed in the first half of FY23 as imports declined. A series of import suppression measures were introduced to narrow the CAD (Box 2). LC issuance declined sharply, and imports declined modestly (Figure 10) in the first half of FY23. Resilient export growth in the first seven months of FY23 (10.0 percent, y-o-y) helped narrow the trade deficit. Official remittance inflows grew by 4.3 percent in the seven months of FY23 but failed to keep pace with a high outflow of workers,[6] as new exchange rate policies disincentivized the use of formal channels. The CAD narrowed to US$ 5.0 billion in the first seven months of FY23, compared to US$10.3 billion over the same period of the previous year (Figure 9).

Fig 9: Current Account (Monthly)



Source: Bangladesh Bank

Fig 10: LC Openings and Imports (Monthly)



Source: Bangladesh Bank

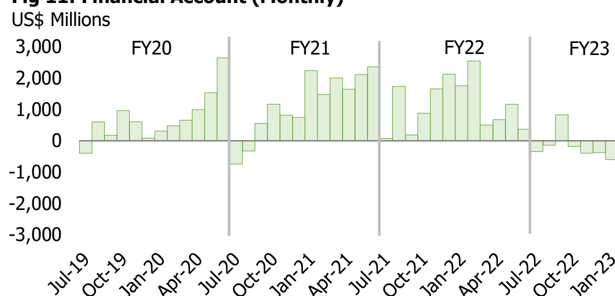
[5] As in previous years, the FDI inflow was driven by reinvested earnings by the foreign firms, though the share of equity investment rose compared to last year.

[6] BMET data shows that migrant worker outflows totaled 674,932 in FY19; 513,485 in FY20; 280,258 in FY21; and 988,920 in FY22.

Box 2: Selected Policies to Reduce Net FX Outflows
Selected policies to reduce FX outflows • Import LCs – BB increased margin requirements (higher requirements for non-essential goods), required higher advance payment, and required BB pre-authorization of LCs over US$ 3 million. • Liquified Natural Gas (LNG) imports from the spot market were deferred in the first half of FY23. • Public procurement of vehicles, ships, and aircraft has been deferred or halted. • Domestically financed public investment projects with substantial imported materials have been deferred. • Rolling electricity blackouts were temporarily implemented in the first half of FY23 to limit energy use. • Overseas travel of government officials related to study tours and training purposes was temporarily restricted. **Selected policies to augment FX inflows** • A ceiling on fund transfers through internet banking was withdrawn for remittances. • An interest rate ceiling on non-resident foreign currency deposits has been withdrawn. • The provision for showing the source of income for remittances of more than US$ 5,000 has been withdrawn. • Domestic banks were allowed to borrow from offshore operations to settle certain import payments, while importers were allowed to extend guarantees and maturity of suppliers/buyers' credit. • Banks have been asked to encash 50 percent of the balance held in exporter retention quota (ERQ) accounts.

A financial account deficit in the first half of FY23 widened the BoP deficit. Net trade credit declined sharply as a result of both a decline in imports and a contraction in the supply of trade credit amidst tighter global credit conditions. Medium- and long-term borrowing declined over the same period, as authorities sought to limit borrowing at higher interest rates. The financial account deficit reached US$ 1.2 billion in the first seven months of FY23, compared to a surplus of US$ 8.7 billion in FY22. As a result, the overall BoP deficit rose to US$ 7.4 billion in the first seven months (Jul-Jan) of FY23, compared to a deficit of US$ 2.1 billion during the same period of the previous year.

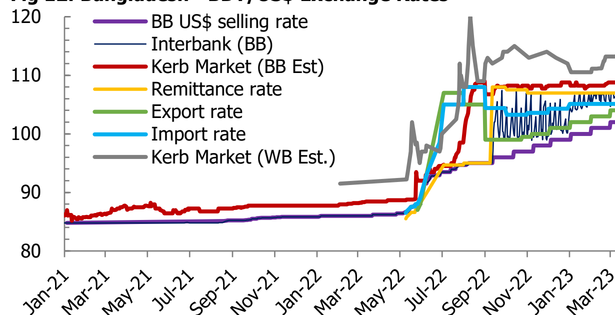
Fig 11: Financial Account (Monthly)



Source: Bangladesh Bank

The exchange rate depreciated. BB began selling FX in June 2021 to limit depreciation of the taka. Facing a sustained decrease in FX reserves, BB announced that the exchange rate would float freely in early June 2022. However, the floating exchange rate was reversed within two weeks as depreciation accelerated. In August 2022, the gap between official and unofficial exchange rates widened. BB maintained an interbank exchange rate cap of 95 BDT/US$, but unofficial exchange rates rose as high as 120 BDT/US$. Consequently, the interbank market became dysfunctional as dealers were unwilling to sell at the BB rate.

Fig 12: Bangladesh - BDT/US$ Exchange Rates



Source: Bangladesh Bank, Staff estimates of kerb market rates

In September 2022, a multiple exchange rate regime was introduced that set different exchange rates for exporters, importers and interbank transactions. To address a growing dollar liquidity challenge in the domestic

banking system, BB requested the Association of Bangladesh Bankers (ABB) and the Bangladesh Foreign Exchange Dealers Association (BAFEDA) to determine a new system of exchange rates (Box 3). This approach can be considered unusual, as ABB and BAFEDA have historically played an advocacy and policy dialogue role as industry associations. The institutional arrangements for enforcement of the exchange rate regime is also unclear. BAFEDA has indicated that deviations from this system of rates will be addressed by regulatory authorities.

The multiple exchange rate regime contributed to BoP pressure. The cap on remittance rates has incentivized the use of informal exchange channels offering higher rates. Exporters receiving lower-than-market exchange rates have deferred repatriation of net proceeds, and incentives for import over-invoicing have risen. Administered rates are not market clearing, and FX liquidity in domestic banks is negative. Firms are unable to access sufficient FX for imports or dividend repatriation and a wide gap between official and parallel rates has persisted. Uncertainty about FX policy can impact foreign investor confidence.

BB has committed to phase out multiple exchange rates in its updated Monetary Policy Statement (MPS). BB committed to unify official rates within a 2 percent variation by the end of FY23 in an MPS update published in January 2023. Additionally, the use of a market determined exchange rate for official forex transactions on behalf of the government will be a structural benchmark for the first IMF program review in June 2023. Authorities have committed to monitor exchange rate market conditions (in both the official and parallel channels) to adjust policies as needed, supported by an ongoing IMF program.

Box 3: Exchange Rate Updates

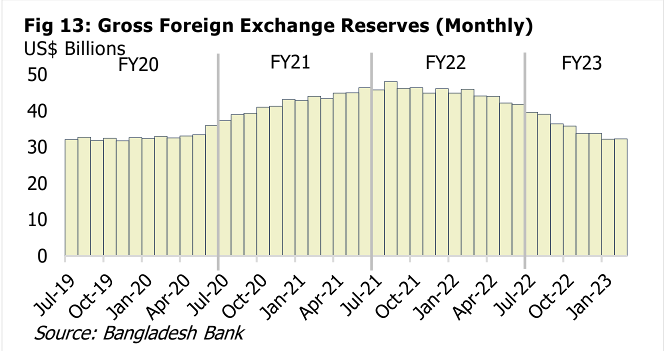
Based on a September 11, 2022 BAFEDA circular and subsequent updates (as of mid-March 2023), all authorized dealers are required to implement the following caps on BDT/US$ exchange transactions:

- **Exporters** – Export proceeds will be purchased by banks at a fixed rate of BDT 104/US$.
- **Remittances** – Remittances from exchange houses and banks will be bought by banks at a rate not higher than 107 BDT/US$.
- **Letters of credit / import bills and outward remittances** – Banks will charge a maximum of BDT 1 spread over the 5-day weighted average buying cost of export proceeds and remittances.
- **Interbank rate** - While the interbank rate is a market rate, it reflects the weighted average of the exchange rate caps of each bank.

As of March 2023, the estimated kerb market exchange rate remained at approximately 113 to 114 BDT/US$.

Gross FX reserves declined rapidly as the BoP moved into deficit and BB sold reserves to support the value of the taka. Gross FX reserves declined to US$ 31.3 billion as of March 15, 2023, down from US$ 44.2 billion one year prior. BB sold a record US$ 7.6 billion in FY22 and an additional US$ 9.9 billion in the first seven months of FY23. Without a market clearing exchange rate, BB FX sales are the primary source of dollar liquidity in the banking system.

Fig 13: Gross Foreign Exchange Reserves (Monthly)



Source: Bangladesh Bank

FX reserves have also been committed to non-monetary uses. To support the manufacturing sector, BB expanded the Export Development Fund (EDF) from US$ 3.5 billion in April 2021 to US$ 6 billion as of January 2023, stimulating trade finance.[7] A US$ 2 billion Bangladesh Infrastructure Development Fund (BIDF) was created to finance capital-intensive public works programs. At the same time, BB entered into swap arrangements with Sri

[7] BB increased the size of the EDF to US$ 7 billion during the COVID-19 pandemic but reduced it by US$ 1 billion in January 2023.

Lanka. Under its IMF program, BB is expected to adopt Balance of Payments Manual 6 (BPM6) definitions of reserves, removing these items from estimation of gross and net reserves.

Fiscal Trends and Debt Sustainability

The estimated fiscal deficit widened in FY22 to 4.3 percent of GDP from 3.7 percent of GDP in FY21, as expenditure growth outpaced revenue growth. Nominal tax revenues increased, primarily supported by trade-related taxes on rising imports. Expenditure growth was led by subsidies (fertilizer, food, fuel) and incentive payments (on exports and remittances). The reliance on the banking sector to finance the deficit increased as the net sales of National Savings Certificates (NSCs) declined following a reduction in NSC interest rates and enforcement of stringent regulations. Public debt as a share of GDP increased modestly but remained sustainable.

Nominal tax revenues remained below target in FY22 and declined in the first half of FY23. Estimated nominal tax collection rose by 11.6 percent in FY22, supported by trade-related taxes on surging imports and rising income tax revenue in the context of a post-pandemic economic recovery. Revenues collected by the National Board of Revenue (NBR) reached BDT 2.9 trillion in FY22, below the BDT 3.3 trillion budget target. Tax revenue growth of 11.6 percent was below 12.5 percent nominal GDP growth. In the first half of FY23, nominal tax revenue declined by 3.3 percent as imports fell, reaching only 37.3 percent of the full year target. Import duty and VAT declined in the first half of FY23, compared to the same period of FY22.

Table 5: Fiscal Outcomes (% of GDP)

	FY17	FY18	FY19	FY20	FY21	FY22
Total revenue 1/	8.7	7.3	8.5	8.4	9.3	8.4
Tax revenue	7.7	6.6	7.7	7.0	7.6	7.6
Total expenditure	11.6	10.9	13.3	13.3	13.0	12.8
Current expenditure	7.1	6.1	7.4	7.4	7.5	7.4
Capital expenditures	3.7	4.2	5.2	5.1	4.7	5.0
Deficit 1/	-2.9	-3.6	-4.7	-4.8	-3.7	-4.3
Net external financing	0.5	0.9	1.1	1.3	1.3	1.7
Net domestic financing	2.4	2.7	3.6	3.4	2.3	2.6
General government debt stock	26.3	27.2	28.5	31.7	32.4	33.1
External	9.6	9.3	10.8	11.8	11.9	12.3
Domestic	16.7	15.0	18.1	19.9	20.5	20.8

Source: Ministry of Finance.
1/Excluding grant

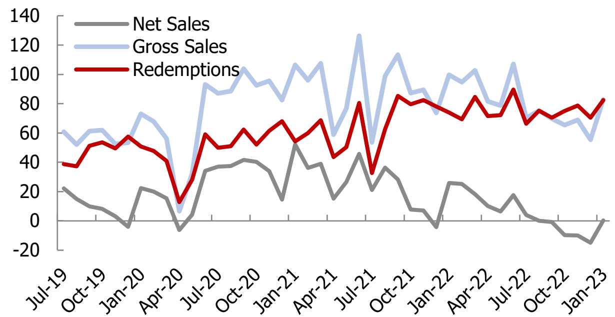
Expenditure rose by an estimated 10.9 percent in FY22. A 7.4 percent increase in current expenditure was driven by a 23.4 percent increase in subsidies, incentives, and current transfers. Capital expenditure growth accelerated by an estimated 19.8 percent in FY22 as project implementation accelerated and pandemic related restrictions were removed. Total expenditure reached 85.8 percent of the original budget allocation for FY22 reflecting persistent challenges in revenue collection and budget execution. In the first half of FY23, total expenditure grew by 1.3 percent (y-o-y). Current expenditure was driven by a 15.0 percent increase in subsidies, incentives, and current transfers. Development expenditure declined by 3.3 percent as project implementation was delayed to conserve foreign exchange. The FY23 budget is concentrated on large infrastructure projects, with 31.2 percent of the Annual Development Plan (ADP) allocated to the 20 largest projects.

Several major infrastructure projects have been completed, with others in various stages of implementation. The Padma Bridge was inaugurated for public use in June 2022. The bridge connects the southeastern region of Bangladesh with the capital and is expected to contribute significantly to the growth of the region. The first segment of the first metro rail system was launched in Dhaka in December 2022, with additional stations on the same line expected to take an additional year to complete. The Bangabandhu Sheikh Mujibur Rahman Tunnel under the Karnaphuli river in the second largest city of Chattogram is nearing completion, although the opening

has been deferred several times. Similarly, the production from the Rooppur Nuclear Power Plant may miss its December 2023 deadline. Four other fast-tracked projects have completion rates between 60 to 90 percent.[8]

The fiscal deficit widened in FY22, with higher financing from domestic banks. The fiscal deficit rose to an estimated 4.3 percent of GDP in FY22. As in previous years, deficit financing relied primarily on domestic borrowing (60.1 percent) but foreign borrowing was also significant. Net borrowing from the banking sector increased by 55.7 percent (y-o-y) in FY22 while National Savings Certificate (NSC) borrowing declined by 39.1 percent (y-o-y). Net foreign financing increased by 54.4 percent with higher disbursement of foreign loans.

Fig 14: National Saving Certificates - Net Sales



Source: Bangladesh Bank

With a sharp decline in revenues, the budget deficit widened in the first half of FY23. In the first six months of FY23, the deficit reached BDT 101.8 billion, compared to BDT 30.0 billion in the same period of FY22. Net sales of NSCs declined by 14.9 percent (y-o-y) in the first half of FY23 due to reduced NSC interest rates and additional purchase regulations, including a requirement to submit tax return confirmations to buy new bonds. NSC redemptions also accelerated as some households faced declining real wages. Borrowing from the banking sector (including BB) increased by more than 100 percent (y-o-y) over the first half of FY23. Net foreign financing has declined during this period and the government has requested increased budget support from development partners for FY23.

Estimated public debt (excluding guarantees) rose to 33.6 percent of GDP in FY22, from 32.4 percent in FY21, but the risk of debt distress remains low. External debt amounted to 11.8 percent of GDP, or just over a third of the total debt stock. External debt is mostly owed to multilateral creditors (53.8 percent of total external debt), although their share in overall external debt has been declining in recent years with increased borrowing from bilateral creditors to finance large infrastructure projects. The January 2023 joint World Bank-IMF Debt Sustainability Analysis (DSA) assessed that Bangladesh remained at low risk of debt distress. The Ministry of Finance published a Medium-Term Debt Strategy (MTDS) in June 2022 with technical support from the World Bank and the IMF and adopted the Public Debt Act 2022, replacing the Public Debt Act 1944. The new Act includes clauses related to sovereign bonds, Shariah-compliant securities, national savings certificates, and the state's guarantee against debts.

Explicit and implicit contingent liabilities from state-owned enterprises (SOEs) are rising. Guarantees to the largest 49 SOEs covered by a Ministry of Finance SOE Monitoring Cell stood at BDT 1,259.8 billion (approximately US$ 8.7 billion) as of May 2022, increasing by 18.1 percent (y-o-y). The power sector (53.5 percent) accounted for the largest share of outstanding contingent liabilities, followed by Bangladesh Biman Airlines (8.4 percent) and Bangladesh Chemical Industries Corporations (7.4 percent). The Bangladesh Power Development Board (BPDB) made the highest net loss in FY22 of BDT 18.9 billion. Based on data from 120 SOEs and local governments, the total Debt Service Liabilities (DSL) of these institutions stood at BDT 1,607.5 billion (approximately US$ 18.5 billion or 4 percent of FY22 GDP) as of May 2022.

[8] These projects include Maitree Super Thermal Power Project at Rampal, Payra Deep Seaport project, Padma Bridge Rail Link Project, Single Line Dual Gauge Railway Track from Dohazari to Cox's Bazar.

Outlook and Risks

GDP growth is expected to decelerate in FY23 to 5.2 percent before returning to its long-term trend. Inflation is projected to remain above the BB's 5.5 percent target in the near and medium term. External and fiscal sustainability will be stressed by elevated global commodity prices, with the pace of recovery contingent on policy reform implementation. The fiscal deficit is expected to widen in FY23 as subsidy expenditures rise, moderating over the medium term. Downside risks include slowing demand in Bangladesh's major export markets and unresolved financial sector vulnerabilities.

Table 6: Selected Macroeconomic Indicators
(annual percentage change, unless indicated otherwise)

	FY20	FY21	FY22	FY23f	FY24f	FY25f
Real GDP growth, at constant market prices	3.4	6.9	7.1	5.2	6.2	6.4
Private Consumption	3.0	8.0	7.5	3.9	4.8	5.3
Government Consumption	2.0	6.9	6.2	11.3	10.8	9.1
Gross Fixed Capital Investment	3.9	8.1	11.7	2.4	6.4	7.4
Exports, Goods, and Services	-17.5	9.2	29.4	9.4	7.5	6.5
Imports, Goods, and Services	-11.4	15.3	31.2	-0.5	4.5	5.2
Real GDP growth, at constant factor prices	3.8	7.0	7.2	5.2	6.2	6.5
Agriculture	3.4	3.2	3.1	3.3	3.3	3.4
Industry	3.6	10.3	9.9	6.5	7.2	7.8
Services	3.9	5.7	6.3	4.7	6.1	6.2
Inflation (Consumer Price Index)	5.6	5.6	6.1	8.6	6.5	5.7
Current Account Balance (% of GDP)	-1.5	-1.1	-4.0	-2.1	-1.5	-1.4
Financial Account Balance (% of GDP)	2.3	3.4	3.0	-0.1	1.9	2.2
Fiscal Balance (% of GDP) 1/	-4.8	-3.7	-4.3	-4.4	-4.0	-3.8
Debt (% of GDP)	31.7	32.4	33.1	33.8	34.1	34.2
Primary Balance (% of GDP) 1/	-2.9	-1.7	-2.5	-2.5	-2.1	-2.0

Source: Bangladesh Bureau of Statistics; Ministry of Finance; Staff Estimates.
1/ including grants

Near and Medium-Term Outlook

Real GDP growth is expected to decelerate to 5.2 percent in FY23 before returning to its higher long-term trend. High inflation relative to Bangladesh's own history and the current global average is likely to weigh on aggregate demand in the near term. Consumer spending growth appears to have passed the post-pandemic peak and growth would be expected to slow due to falling real wages and declining household savings, particularly for low- and middle-income households. Fragile demand across many sectors combined with global uncertainties and higher prices of capital goods have dampened investment growth.

Protracted global and domestic uncertainties are expected to weigh on investment growth, although the completion of the Padma Bridge offers high potential opportunities. Private investment had been stagnant at around 23 to 24 percent of GDP for about a decade before the pandemic, as a shortage of skilled labor, opaque regulations, and limited credit availability outweighed discretionary government incentives. The incentive to defer investment has increased with rising global uncertainty, higher capital goods prices, an unpredictable domestic FX regime, energy shortages, and political uncertainty ahead of upcoming elections. However, the completion of the Padma Bridge in 2022 has the potential to spur new investments due to its immediate impact on transport and inter-district trade. It has breathed new life into economic activities in the Khulna and Barishal regions, including boosting export-import through the Mongla port.

Inflation is likely to taper after reaching an eleven year high of 9.5 percent in August 2022. Exchange rate depreciation, energy and electricity price increases, and increased duties on many imported consumer items have

raised inflationary expectations.[9] Higher inflation puts poverty gains at risk. Lower income households, already impacted by the two years of pandemic, are struggling to make ends meet, as evident from the long queues formed when the Open Market Sales (OMS) trucks are on the street to distribute low-priced essentials. Inflation momentum may ease with favorable base effects from the first half of FY24 and some cooling in international commodity prices with slower growth in advanced economies.

Export growth is likely to moderate. The export boom of the last two years has benefited from the pent up demand globally as countries eased COVID-19 policy restrictions. However, the global economy is slowing, particularly with challenging financial sector conditions in Europe and the United States. The rising risk of a global growth recession[10] would exert downward pressure on Bangladesh's exports. Bangladesh benefited from a diversion of export orders from China, particularly in the European market. Going forward, upsides are contingent on Bangladesh's ability to maintain export market share and take advantage of recession induced shifts in preferences in advanced economies towards low-value apparels, electronics, and light engineering products.

Official remittance flows are vulnerable to administered exchange rate policies and illicit capital outflows. A surge in labor migration and a substantial depreciation of the taka have so far not made a visible impact on the monthly size and variability in formal remittance inflows. Formal remittances suffered a setback with the introduction of the complex multiple exchange rate regime in mid-September 2022. A persistent gap between official and parallel market rates has disincentivized the use of official channels. On the other hand, demand for dollars in the informal markets has regained momentum.[11] Capital flight can result in higher demand for informal remittance flows, in the context of formal sector capital restrictions.

External pressure is expected to remain elevated in FY23. The current account deficit is expected to narrow to 2.1 percent of GDP in FY23 from 4.0 percent of GDP in FY22, as imports normalize with the moderation of commodity prices and exports grow modestly. Short-term financing flows have contracted. Together with delays in the repatriation of export earnings and lower medium- and long-term government borrowing, this has limited financial account inflows, although disbursements are expected to rise in the last quarter of FY23 with budget support from development partners. Remittance inflows are expected to rise, underpinned by a higher outflow of workers and resilient demand for workers in the gulf region buoyed by elevated oil prices.

The fiscal deficit is projected to rise to 4.4 percent of GDP FY23, narrowing over the medium term. In the near-term, revenue growth is expected to remain tepid as a result of declining imports. Over the medium term, revenues will rise with increasing trade, improving domestic economic activity, higher incomes, and ongoing efforts to strengthen tax administration. Public expenditure is expected to match the rapid pace of GDP growth. Subsidy expenditure is expected to rise in the near term, modestly widening the deficit in FY23. Over the medium term, growth in subsidy expenditures will be contained by pricing reforms. Capital expenditure on infrastructure megaprojects is expected to keep pace with GDP growth. Over the longer term, rising public expenditure requirements to meet infrastructure needs, mitigate climate vulnerabilities, and accelerate human capital will require additional domestic revenues. Total revenues are expected to remain at 8.5 percent of GDP in FY23. Although revenues are expected to gradually increase, this ratio remains among the lowest in the world.

Downside risks have deepened. Geopolitical tensions, which rose markedly after Russia's invasion of Ukraine, could increase further, encompassing a larger set of countries. At the same time, risks identified in recent global

[9] The BB Monetary Policy Statement 2022-23 also cites business survey data showing rising inflationary expectations.
[10] Defined as a contraction in annual global per capita income.
[11] "Intel finds money laundering 'almost unstoppable'," The Business Standard, February 28, 2023.

forecasts have materialized over recent weeks, with a series of bank failures in the United States and Europe.[12] In this context, Bangladesh is facing near-term risks in sustaining economic growth, reining in inflation, and reducing the CAD without being disruptive to the supply side. Relatively low external indebtedness and vaccination success enabled the economy to restart swiftly. However, the policy responses to mitigate external imbalances have so far been inadequate. The uncertain availability of FX is an impediment to business development, as much as the price of FX and the level of interest rates. These may compound the effect of costlier imports and weaken the taka further. Contingent liabilities from high NPLs and insufficient capital in state-owned banks, as well as any recapitalization of or facilitation of resolution processes for privately-owned financial institutions, could result in higher domestic debt. Finally, the fiscal deficit could rise unexpectedly in the run-up to the general election in January 2024 if additional spending measures are adopted or policy reform implementation is deferred.

Policy directions and structural reforms

Bangladesh faces difficult policy tradeoffs. The demand and supply side austerity measures introduced in response to a widening BoP deficit slowed growth in attempting to relieve pressure on FX reserves and the exchange rate. Tariff hikes and import controls are blunt instruments with costly unintended consequences for investments, exports, and GDP growth. A better approach would be to minimize reliance on price and quantitative controls and instead use market-based monetary, fiscal, and structural policy instruments. An orderly approach is a prerequisite to avoid unnecessary adjustment costs that risk continuity along the long-term growth path.

Enhancing monetary policy would enable inflation targeting and support financial stability. Monetary policy needs to be fully dedicated to reining in inflation through the interest rate channels. The continued use of a lending interest rate cap introduced in April 2020 has impaired the effectiveness of policy rates. The introduction of a benchmark lending rate or reference rate for commercial banks could provide a transition path from rate caps toward market determined rates. This policy could see a shift from reserve money-based monetary policy transmission towards a policy rate-based transmission mechanism. The reference rate could be anchored on the treasury rates of government securities or interbank rates.

Addressing banking sector vulnerabilities could strengthen financial intermediation. As a result of lending rate caps, the spread between deposit and lending rates is constrained, complicating management of net interest margins in banks. The average spread between deposit and lending rates has declined below 3 percent for the banking sector, with several commercial banks experiencing negative spread and net interest margins in the wake of recent liquidity stress in the banking sector. Depositors took a flight to quality in the last quarter of 2022, as reported loan irregularities shook confidence. Despite BB liquidity support, the overall deposit trend was negative. Planned amendments to the Bank Company Act (BCA) incorporating international good practices would provide an opportunity to strengthen supervision and bank governance to address these vulnerabilities and should be given a high priority.

Adoption of a market determined single, flexible exchange rate would reduce distortions and strengthen the external position. BB is expected to unify official market exchange rates within a 2 percent variance by June 2023. The multiple rate regime offers windfall profits from privileged access to FX at the official exchange rate. BB's dollar selling rate has gradually been depreciated to converge with the interbank market rate, where transaction volume has been minimal for months. However, multiple exchange rates may continue to be applied within this

[12] The World Bank's Global Economic Prospects noted in January, "The combination of slowing growth, persistently high inflation, and tightening financial conditions amid high levels of debt increases the risks of stagflation, financial strains, continued fiscal pressures, and weak investment in many countries."

narrower band of rates. Adopting a single market clearing exchange rate would reduce these distortions and support external balance.

Fiscal policy can be adjusted to support macroeconomic stabilization. Adherence to fiscal austerity measures announced in July 2022 has waned, and the fiscal deficit in the first half of FY23 has widened. Domestic financing of the deficit has increasingly been monetized, which is incompatible with inflation reduction objectives. The foreign financing target has been revised down in an effort to limit external borrowing at higher interest rates. A reduced foreign financing target is contributing to the financial account deficit and pressure on demand for dollars. In this context, there is an opportunity to adjust fiscal policy to support macroeconomic stabilization objectives, while protecting social protection expenditure for low-income households.

Over the medium term, business climate and trade policy reforms can support competitiveness. An improved business environment would help attract FDI, including a predictable regulatory environment and reliable utilities and logistical services. There has been some progress in the preparation of a National Tariff Policy formulation to set reform objectives for tariffs, supplementary duties, and access to bonded warehouses. However, a clear timeline and implementation plan to adopt lower tariffs and reduce non-tariff barriers remains outstanding. Development of export infrastructure and negotiation of free trade agreements with main trading partners to provide a sustainable boost to exports of goods and services should be accompanied by further investment regime liberalization and a reduction in tariffs.

The special focus of this edition of the Bangladesh Development Update illustrates how trade reform can accelerate economic growth. The report highlights Bangladesh's declining competitiveness and analyzes the primary contributing factors. It proposes a set of comprehensive reforms that go beyond tariff modernization and involve broad-based liberalization and regional integration, particularly with South Asia and Southeast Asia. Achieving these objectives will require policy action to remove non-tariff barriers, reduce trade related costs, and simplify trade in services.

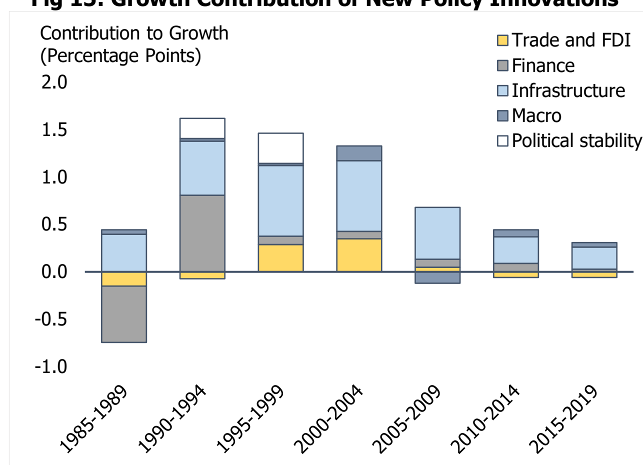
Trade Reform in Bangladesh: An Urgent Agenda

Trade has been a driving force behind Bangladesh's economic growth, job creation, and poverty reduction in recent decades. However, recent years have seen a decline in trade performance and an overreliance on ready-made garment exports, raising concerns about the sustainability of this growth model. The erosion of competitiveness based on low wages and the impending loss of trade preferences due to the expected graduation from LDC status are challenging the status quo. Factors such as high import taxes and non-tariff barriers have protected domestic industries at the expense of emerging exports. Bangladesh's progress towards upper middle-income may waver without diversifying exports by increasing trade competitiveness. This chapter explores the key factors leading to Bangladesh's declining competitiveness and proposes reforms to address it. These reforms go beyond tariff modernization and include comprehensive market liberalization and regional integration, particularly with South Asia and Southeast Asia. This will require policy actions to remove non-tariff barriers, reduce trade costs, and ease bottlenecks to trade in services.

1.1 Trade and Growth

Openness to trade and Foreign Direct Investment (FDI) has been an important contributor to the acceleration of growth in Bangladesh since the late 1990s. Trade openness contributed to surging RMG exports.[13] The easing of FDI regulations and introduction of back-to-back letters of credit were complemented by the creation of new export processing zones. The specialization in labor-intensive RMG exports created new and productive manufacturing jobs, many of which were taken up by women. Exports, led by RMG, doubled from 10 percent of GDP in the mid-1990s to a peak of over 20 percent of GDP in 2012. Novel policy interventions, including trade and FDI reforms contributed significantly to growth in per-capita income over 1995-2004 (Figure 15). The contribution of these categories was second only to infrastructure development over this period.

Fig 15: Growth Contribution of New Policy Innovations

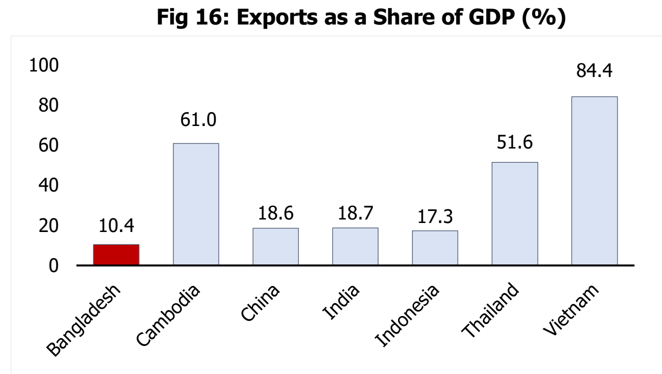


Source: World Bank (2022).
Note: Trade includes trade openness (measured as the sum of exports and imports over GDP, export diversification and terms of trade changes. For more details refer to Beyer and Wacker (2022).

[13] The rise to prominence of the RMG sector in exports started with a collaboration between a Korean company and a Bangladeshi company, that led to key knowledge and skills transfers into Bangladesh. Moreover, the government encouraged and directed investments in RMG and adjusted trade policy, so that low wages and the absence of import quotas allowed for a rapid expansion of the sector.

Trade reform has slowed in recent years. With trade preferences eroding,[14] the overreliance on RMG exports challenges the sustainability of Bangladesh's increasingly inward-oriented growth model. At around 10 percent of GDP in 2020, exports are low compared with the country's peers (Figure 16). The current export basket remains heavily dependent on RMG. The lack of export diversification can be partly attributed to the country's protective trade regime. Average tariffs more than double if para-tariffs are included, making Bangladesh an outlier among countries at a similar income level. A strong reform scenario, involving tariff modernization, removal of non-tariff barriers, trade facilitation (including regional and multilateral integration), services and FDI liberalization, can lead to growth increasing above 7 percent on average over the next 15 years, compared to a baseline of below 6 percent on average under the "business as usual" scenario (World Bank, 2022).

Fig 16: Exports as a Share of GDP (%)

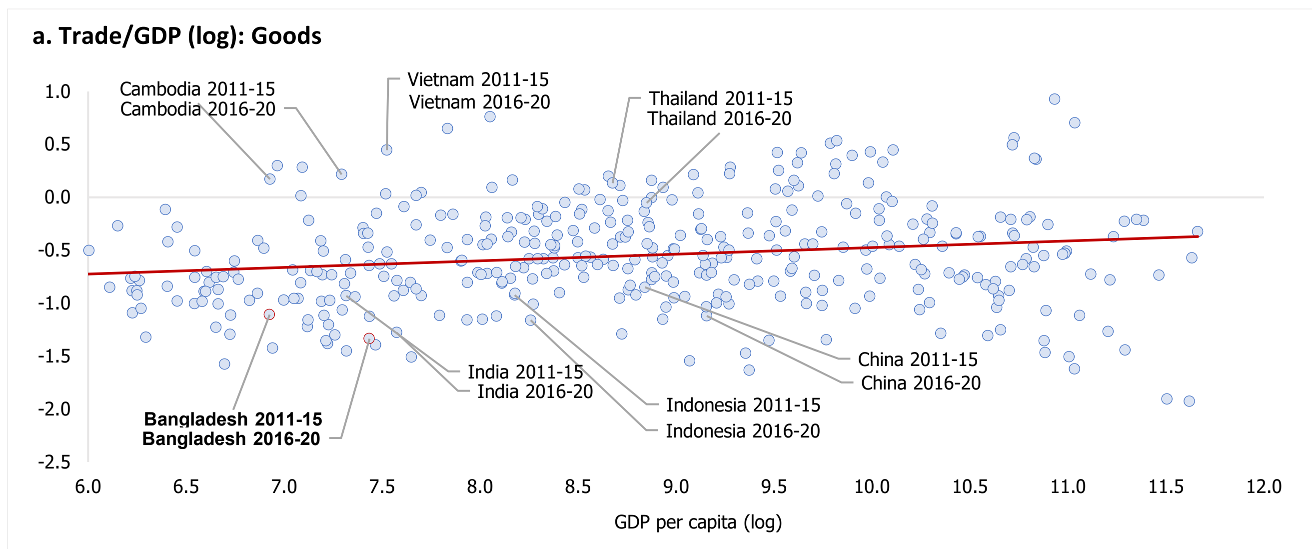


Source: World Development Indicators (2022).

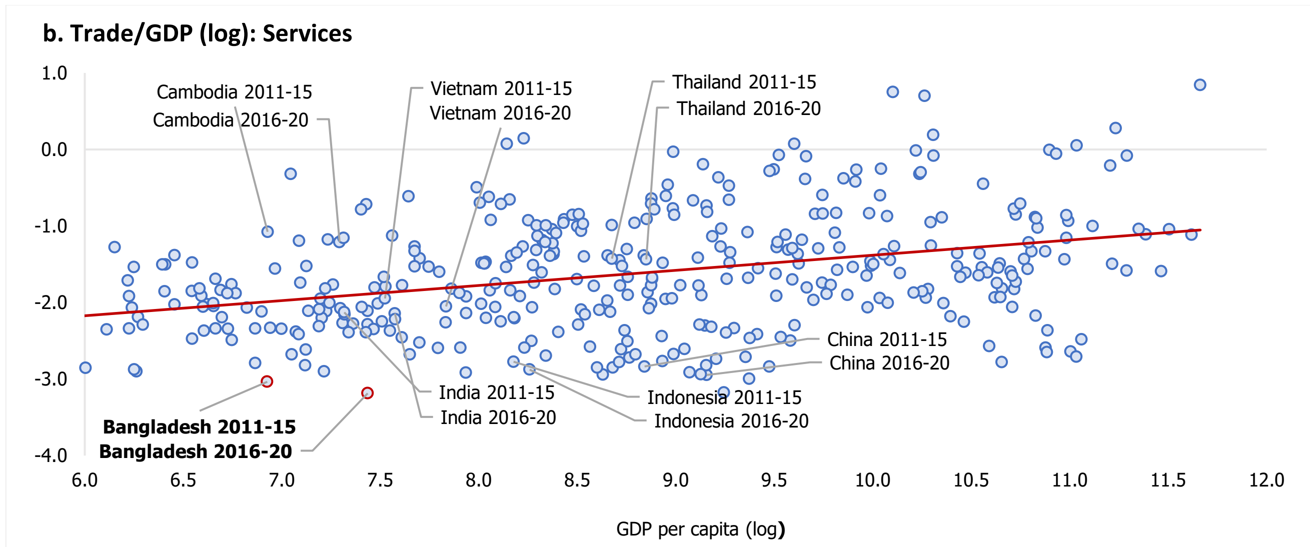
1.2 Eroding Trade Competitiveness

Trade performance in Bangladesh has been on a downward trend since 2011, both in comparison to the country's historical performance and overall economic growth. The country's trade activity remains heavily focused on goods, with manufacturing exports and employment generation driven by preferential access to advanced economies' markets and low labor costs. However, the contribution of manufacturing exports to growth has been decreasing over the past five years, even before the COVID-19 pandemic. Both goods and services trade as a percentage of GDP have been decreasing since 2011, remaining well below the levels of other countries at similar levels of development (Figure 17a and 17b). Although services contributed more than 50 percent of gross value added (GVA) and 40 percent of employment, services trade as a percentage of GDP is only 5.2 percent, which is lower than other comparable countries.

Fig 17: Bangladesh's Trade Openness in Goods and Services



[14] Graduation from least developed country (LDC) status in 2026 will trigger a three-year transition period after which Bangladesh will graduate from the Everything but Arms initiative and face changes in its preferential market access to the European Union and the United Kingdom, including changes in the rules of origin for apparel exports.

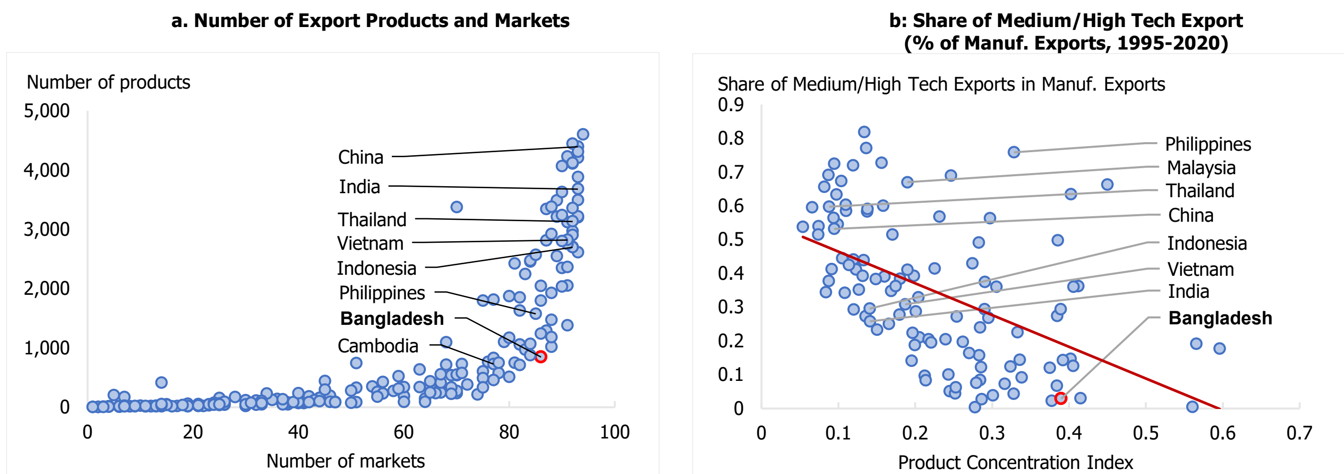


Source: World Development Indicators (WDI), 2022.
Note: Log of openness to trade (services) plotted against log of gross domestic product per capita, controlling for population size. The sample contains all countries in the WDI for 2011–20 (the graph shows period averages for 2011/15 and 2016/20)

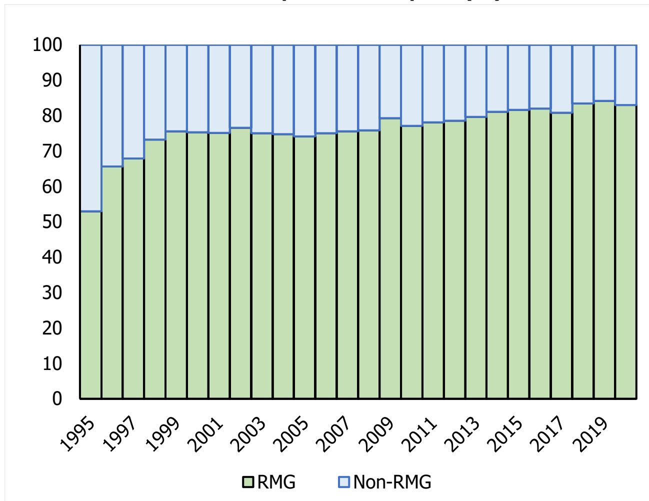
Exports are concentrated in the RMG sector, making up 83.6 percent of total merchandise exports in 2022, similar to previous years. This concentration is reflected in both the export products and markets (Figure 18a and Figure 18c). This limited diversification explains the relatively low level of goods exports as a share of GDP in 2020 and 2021 (9 percent) compared to the average export-to-GDP ratio of low and middle-income countries (25 percent) and comparators such as Vietnam (95 percent). The protection of import-substituting industries has limited the growth and development of emerging export industries, resulting in a lack of diffusion of technology for the production of exports. This is evident in the low share of medium and high technology exports in total manufacturing exports, standing at just 2.9 percent, which is one of the lowest in the world (Figure 18b).

Imports are more diversified, but the share of capital goods is declining. Even though the import basket is more diversified in comparison to exports, the share of capital and intermediate goods in the import basket has been decreasing. The share of the two categories combined in total imports stands at 32 percent in 2020 compared to 43 percent in 2005. The share of consumer and other goods imports, in contrast, has steadily increased over the same period (Figure 18d) despite high protective barriers.

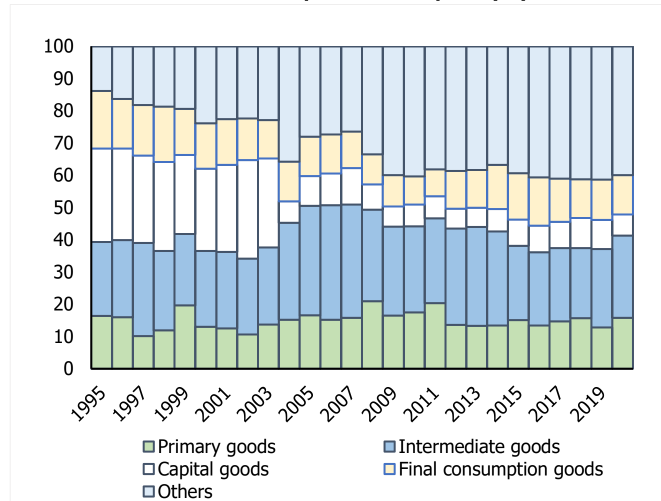
Fig 18: Bangladesh's Export Diversification in a Comparative Perspective and the Structure of Exports and Imports



c. Composition of Exports (%)



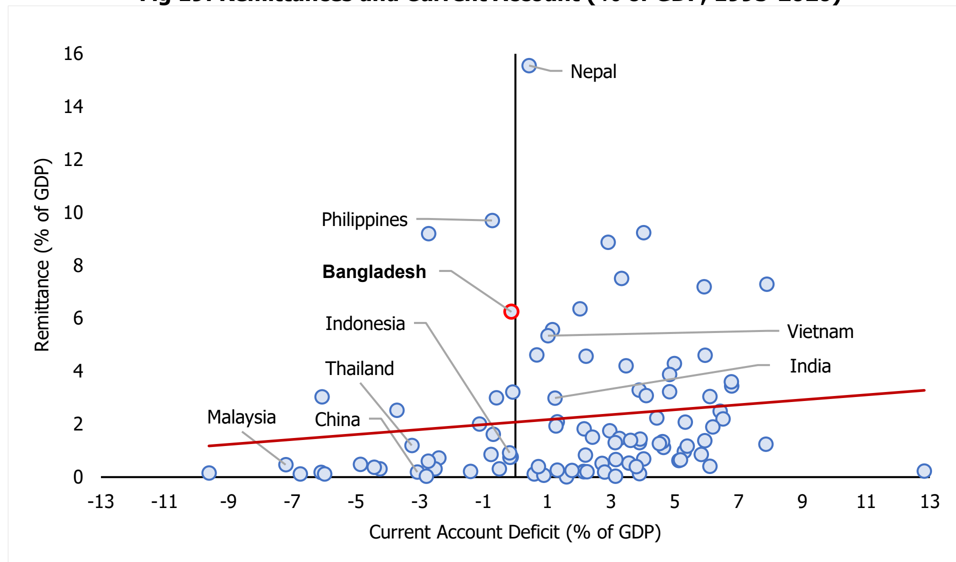
d. Composition of Imports (%)



Source: WDI 2022.

Remittances have partly mitigated the risk to FX earnings due to the lack of export diversification. Over the past decades, Bangladesh has run a modest current account surplus on average, helped by a rising share of remittances in GDP up to 2012. The reliance on remittances remains higher than many of its peers like Vietnam, Indonesia, and Malaysia, but lower compared to Philippines or Nepal (Figure 19). With eroding competitiveness and a generally declining share of remittances in GDP in recent years, diversification of exports earnings to newer markets and products can lend robustness to the current account by boosting export earnings.

Fig 19: Remittances and Current Account (% of GDP, 1995-2020)



Source: WDI, 2022.

Bangladesh lacks export superstars, other than garments, and the survival of new entrants is relatively low. Firm-level data confirm that at 24 percent, the share of superstar export firms in Bangladesh is lower than the 36 percent average recorded in South Asia (Figure 20a). The survival of new entrants is largely comparable to other regions, but relatively lower compared to India and the East Asia and Pacific region (Figure 20b). Empirical evidence for Bangladesh, India, and China suggests that access to imported inputs helps promote product scope

and the productivity of domestic firms (Kee, Forero, and Fernandes 2021). Such policies include tariff and value-added tax reductions and duty drawbacks on imported materials, improvements in financing, and reduction in credit constraints for small exporting firms. The firm-level analysis shows that participation in Global Value Chains (GVCs) and Research and Development (R&D) increases the survival rates of export firms (Table A1 in Annex 1).

Fig 20a: Share of Top 1 % of Exporters

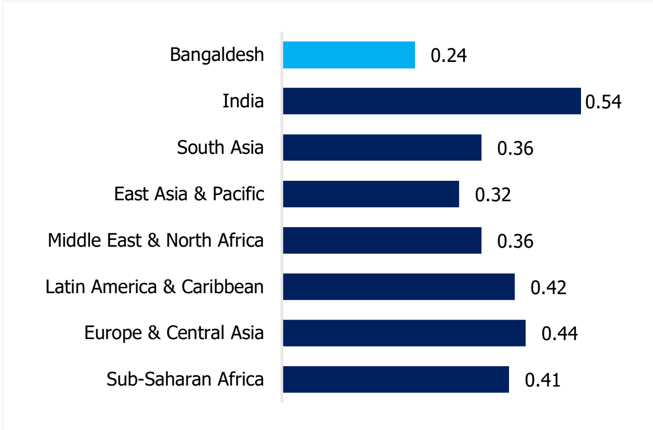
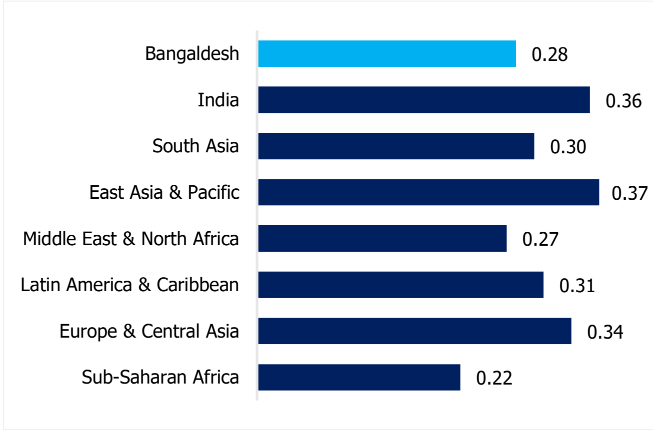


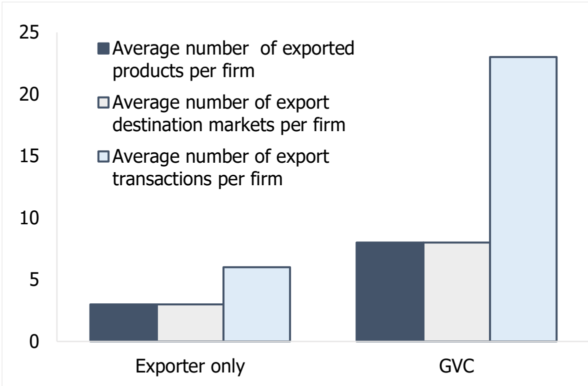
Fig 20b: Survival Rate of Exporters



Source: Calculations using Updates to Exporter Dynamics Database (described in Fernandes, Freund, and Pierola 2016). For more details, see World Bank (2022).

Bangladesh's participation in global value chains (GVCs) is mixed. An in-depth analysis of the domestic value added of exports, based on the customs export and import transactions data of the World Bank Exporter Dynamics Database for 2005–16, shows that exports from Bangladesh have high import content (Kee and Ferrero Rojas 2022). Therefore, Bangladesh is relatively well integrated into selected GVCs, especially in textiles and apparel, footwear, and transport. Analysis of firm-level customs transactions data reveals that GVC participants perform better than non-GVC exporters in terms of the number of exported products, export transactions, and destination markets (Figure 21). To increase the export survival of firms, the government needs to facilitate participation in GVCs and adoption of modern technologies and deepen regional linkages.

Fig 21: Performance of Bangladeshi Exporters and GVC Participants, 2005–16



Source: Bangladesh Customs data, 2005–16.

1.3 Key Reasons for Eroding Competitiveness

Bangladesh has a protective trade regime. Bangladesh has six ad-valorem tariff rates, but non-transparent para-tariffs such as regulatory and supplementary duties add additional import charges and increase the complexity of the tariff structure[15]. Para-tariffs increase the number of tariff rates from six to fifty and double the average nominal protection rate on imports from 14.7 percent to 28.8 percent. The average tariff rate on intermediate goods is more than double the rate in China (7.4 percent) and nearly double the rate in Thailand and Vietnam (9.6 percent). Bangladesh has a nearly 30 percentage point difference in tariffs for consumer and intermediate goods

[15] Ad valorem tariff rates range from zero to 25 percent, with almost 53 percent of the tariff lines subject to rates of 10 percent or less. Rates of 25 percent apply to about 45 percent of the tariff items.

and the highest tariff escalation among the comparators (Figure 22a and 22b). The export dynamics analysis shows that high protection levels reduce the export survival probabilities of exporters and GVC participants. The effect is more pronounced for GVC firms, thus negating the positive impact of GVC participation on the probability of survival for exporters (Table A1, Annex 1).

Fig22a: Nominal Protection Rate (%)

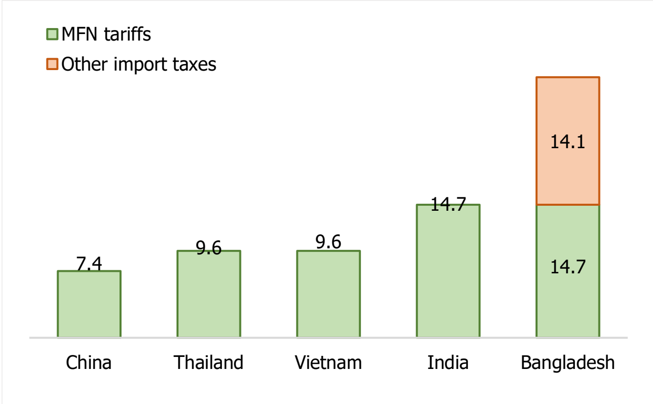
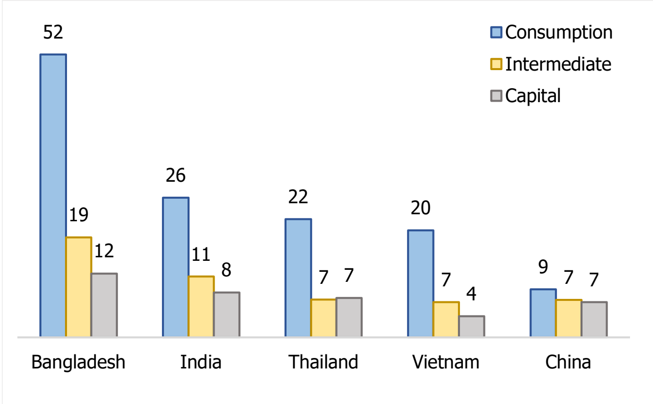


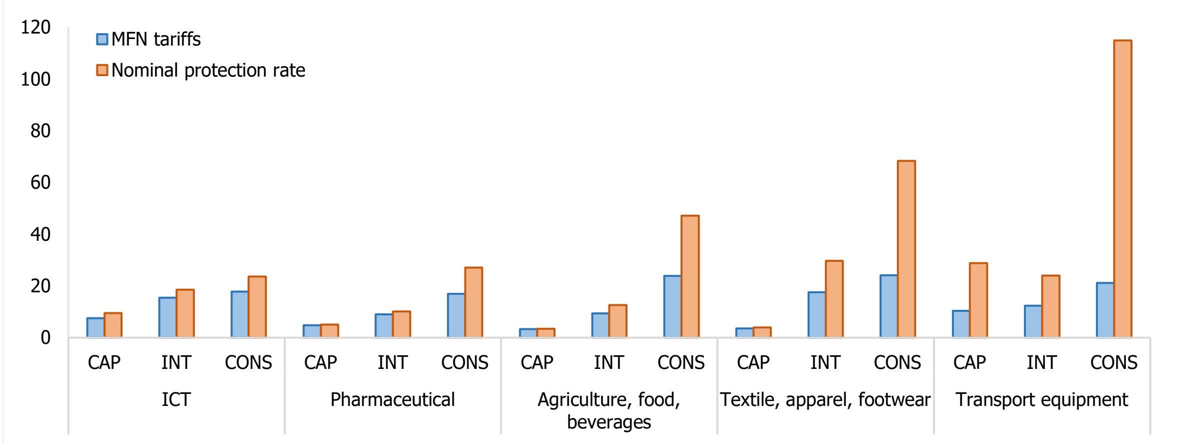
Figure 22b: Nominal Protection Rate (%)



Source: Calculations using data from Bangladesh Customs and WTO 2022.

The prevalence of para-tariffs incentivizes import substitution and deepens anti-export bias. With the exception of a free trade regime in the RMG sector with a special bonded warehouse facility enabling duty-free access to imported raw materials and components, the trade policy stance perpetuates a high degree of protection of domestic (import substituting) industries at the expense of emerging and potential export industries. This is a key reason for the country's high export concentration in the RMG sector. An additional issue is tariff escalation. The difference between tariffs on inputs and outputs has increased over time, leading to a high degree of protection, primarily for domestically produced consumer goods. Para-tariffs substantially increase tariff escalation in some sectors, like transport equipment and textiles, where average nominal protection for final goods is five to ten times higher, respectively, than for intermediate goods (Figure 23).

Fig23: Tariff Escalation (%, 2019-20)



Source: Calculations based on Customs data. Note: MFN tariff is one that WTO member countries promise to impose all of their WTO trading partners; nominal protection rate is the percentage tariff imposed on a product as it enters the country. We include the paratariffs in the calculation of Bangladesh's nominal protection rate.

Competitiveness will erode further with expected graduation from Least Developed Country (LDC) status in 2026. The UN General Assembly adopted a November 2021 resolution that provides an extended five-year preparatory period for Bangladesh's graduation in 2026. LDC graduation will trigger an additional three-year

transition period after which Bangladesh will graduate from the Everything but Arms initiative, under which the European Union provides duty-free and quota-free market access to LDCs. Bangladesh will face additional changes in its preferential market access to the European Union and the United Kingdom, including changes in the rules of origin for apparel exports which will require a higher share of domestic value addition.

Changes in the external trade environment due to LDC graduation vary by destination market. In the European Union (EU), Bangladesh will face a tariff increase of about 10 percent for most clothing products. The country will also face changes in markets such as Canada, Japan, and China (Table 7). Tariff increases for Canada will be between 16 to 18 percent for 10 of the top 12 export products, and around 8 to 11 percent in the Japanese market. No increase in effective tariffs is expected in markets such as the United States, India and Australia. Under the Asia-Pacific Trade Agreement (APTA), Bangladesh will continue to benefit from preferential market access in China (Figure 24). However, these preferences have so far not produced any major improvement of Bangladesh's exports to China.

The LDC graduation could impact clothing exports significantly. According to the World Trade Organization (WTO), clothing is expected to account for the bulk of the reduction in Bangladesh's exports as a result of LDC graduation. As a share of initial exports, exports to Canada (42.8 percent), Japan (32.3 percent), and the Republic of Korea (32.3 percent) are expected to be significantly affected. Bangladesh is currently negotiating a special incentive arrangement for sustainable development and good governance with the EU (the Generalized Scheme of Preferences Plus (GSP+)) that would allow the country to retain tariff preferences conditional on committing to strong sustainability standards[16]. Under the GSP+ scheme, minimal losses are expected.

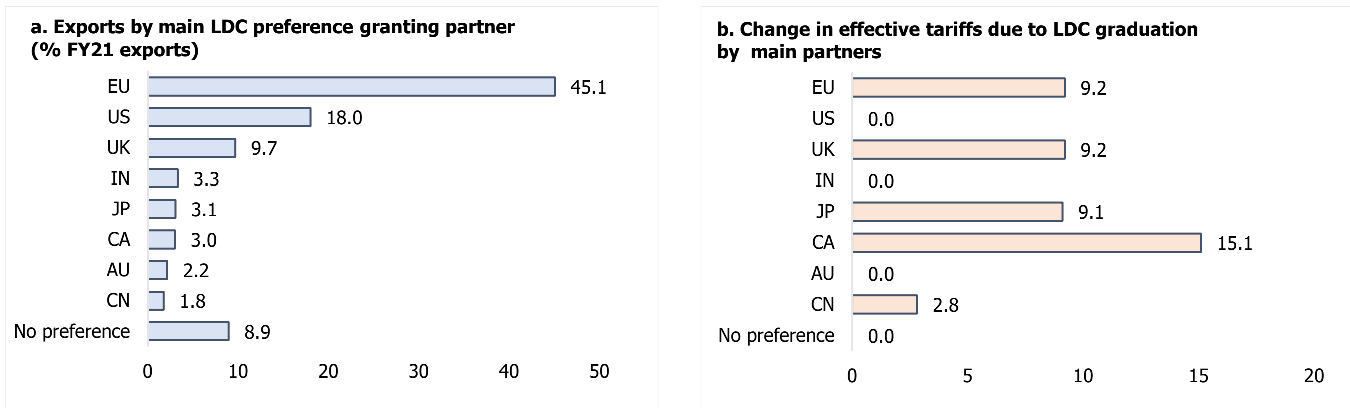
Table 7: Implications of LDC Graduation

Destination	LDC tariffs	Graduation tariffs	LDC ROOs	Graduation ROOs
EU	EBA, duty free for all products except arms	Standard GSP, possibly GSP+	70% value-added can be imported Single transformation for apparel	50% value-added can be imported Double transformation for apparel
United States	GSP+, no preferences currently apply due to suspension in 2013	Standard GSP	35% domestic content requirement + other LDCs	35% domestic content requirement only
Canada	LDC GSP, duty free for all products except dairy, poultry, and egg products	Standard GSP	60% value-added can be imported	40% value-added can be imported
Japan	Special preferential treatment for LDCs	Standard GSP	No specific rules of origin	No specific rules of origin
China	LDC GSP, duty free for 61% of tariff lines	APTA or MFN	Specific criteria for substantial transformation	N.A.

Source: World Bank (2022). Note: N.A. = not available; ROOs = rules of origin.

[16] The European Commission adopted the legislative proposal for the new EU GSP for 2024–34 in September 2021. The Commission is proposing to improve the scheme to respond to the evolving challenges of GSP countries and reinforce social, labor, environmental, and climate dimensions. The new proposal further improves the current scheme by ensuring a smooth transition for all countries set to graduate from LDC status in the next decade. They will be able to apply for GSP+ if they commit to strong sustainability standards related to human rights, labor rights, protection of the environment, and good governance to strengthen enforcement and make withdrawal and suspensions easier.

Fig 24: Expected Tariff Changes by Main LDC Granting Partner (%, 2019-20)



Source: Panel a: Export Promotion Bureau 2022; panel b: WTO 2020.

Non-tariff barriers (NTBs) significantly exceed tariff barriers. The restrictiveness of NTBs in Bangladesh, at an average ad valorem equivalent (AVE) close to 200 percent, exceeds that of tariffs (figure 25a). Non-tariff measures (NTMs) such as sanitary and phytosanitary (SPS) requirements, technical barriers to trade, pre-shipment inspection, discretionary licensing requirements, and price control measures significantly increase Bangladesh's trade restrictiveness. While some NTMs aim to protect human health and environmental safety, many such measures are a significant deterrent to trade and detrimental to firms' competitiveness.

Inefficiencies in border processes increase overall trade costs. Border and documentary compliance requirements lead to major delays for exporters. Such compliance requirements in Bangladesh result in delays of about 300 hours, more than 10 times the time required to comply in China and 5 times that required in India (Figure 25b). The implementation of Bangladesh's commitments under the WTO Trade Facilitation Agreement has been lagging and stands at about 36 percent, an implementation rate that is much lower than in comparators such as Cambodia, Indonesia, or India.

Significant barriers hamper trade in services. Ad valorem equivalents (AVEs) of services barriers are high relative to tariff rates for goods in all examined sectors. AVEs are highest in the telecom sector, at 52 percent on average. In the other sectors, the averages are lower: 18 percent in finance, 22 percent in transport, and 26 percent in distribution. Bangladesh does better than many peers, having less restrictive policies particularly in the transport and telecom sectors (Figure 25c). The main horizontal restrictions in Bangladesh are in visa processing. Bangladesh also has policy restrictions related to land acquisition and some data transfer restrictions.

Fig 25a: Non-Tariff Barriers (%)

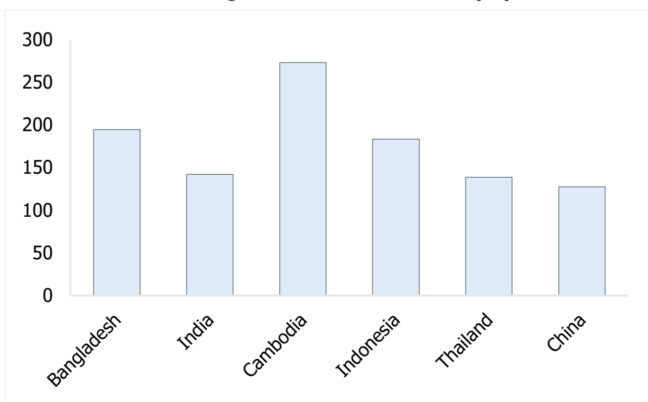


Fig 25b: Time to Export

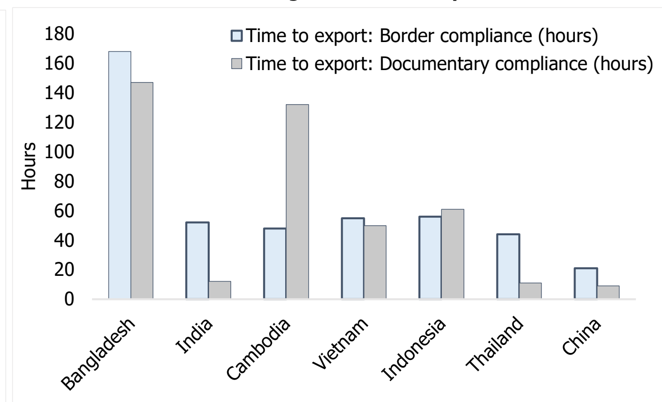
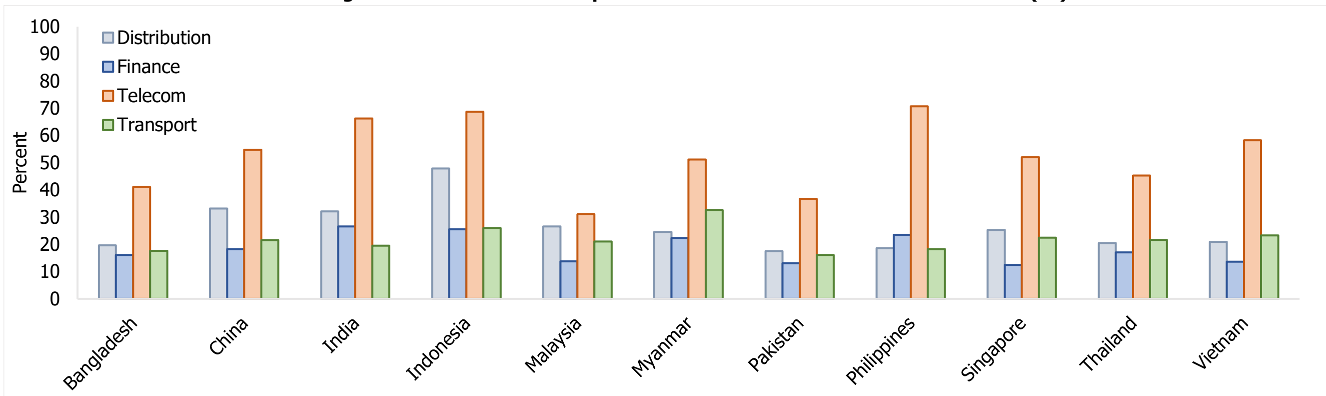


Fig 25c: Ad Valorem Tariff Equivalents of the Services Trade Policies Index (%)



Source: World Bank (2022).
Note: The AVEs were quantified using machine learning techniques and a gravity model estimation (World Bank, 2022). Estimates use data from Hoekman and Shepherd 2021.

1.4 The Way Forward to Restore Competitiveness

Reducing the level of protection is crucial to boost competitiveness. Elevated levels of protection of domestically produced consumer and intermediate goods have generated skewed incentives in favor of production for the domestic market. There is an inherent contradiction between protecting domestic markets and export promotion. A policy focused on import protection (domestic market-oriented industrialization) could be a path toward a middle-income trap. LDC graduation in 2026 will tighten compliance with WTO rules on import tariffs and subsidies. Policies that help exporting firms access imported intermediates can promote exporters' performance, make exports globally competitive and facilitate better integration into GVCs by moving up the technology ladder.

Modernization of the tariff regime is an important first step to incentivize export diversification. Moving toward low and uniform tariffs and adopting a single rate for similar goods irrespective of origin can be a game changer. Para-tariffs that protect domestic producers from imports eventually need to be eliminated. Bangladesh's 8th Five-Year Plan identifies the need to reduce the nominal protection rate by 3-5 percent every year until 2025. It will be important to accelerate the preparation and implementation of the new National Tariff Policy, which will provide a strategy to reform tariffs to promote investment and increase competitiveness. The National Tariff Policy will need to lay out a time path of import tariff and export subsidy reduction so that the markets can adjust to reduction of protection of the domestic market.

Tariff rationalization must be accompanied by simultaneous tax reforms to compensate for the expected revenue loss. Simulations in the recently published Bangladesh Country Economic Memorandum (CEM) (World Bank, 2022) were conducted on various tariff adjustments of tariffs, customs duties and para-tariffs, in line with the tariff profile formulated in Bangladesh Vision 2041.

The results show that concerns over revenue loss are legitimate. Reductions of customs duties and other taxes to the level of other middle-income countries, such as China, India, or Vietnam, would result in tariff revenue losses between 18 and 41 percent (Table 8). Higher revenues from other taxes are needed to compensate for the

loss of revenue from rationalizing existing tariffs and para-tariffs (Bangladesh Public Expenditure Review 2023).[17] Compensating for lost tariff revenues is critical because total revenue collection in Bangladesh was only 8.4 percent of GDP in FY22, quite low compared to most other countries.

Table 8: Tariff Modernization Scenario Results (BDT Millions)

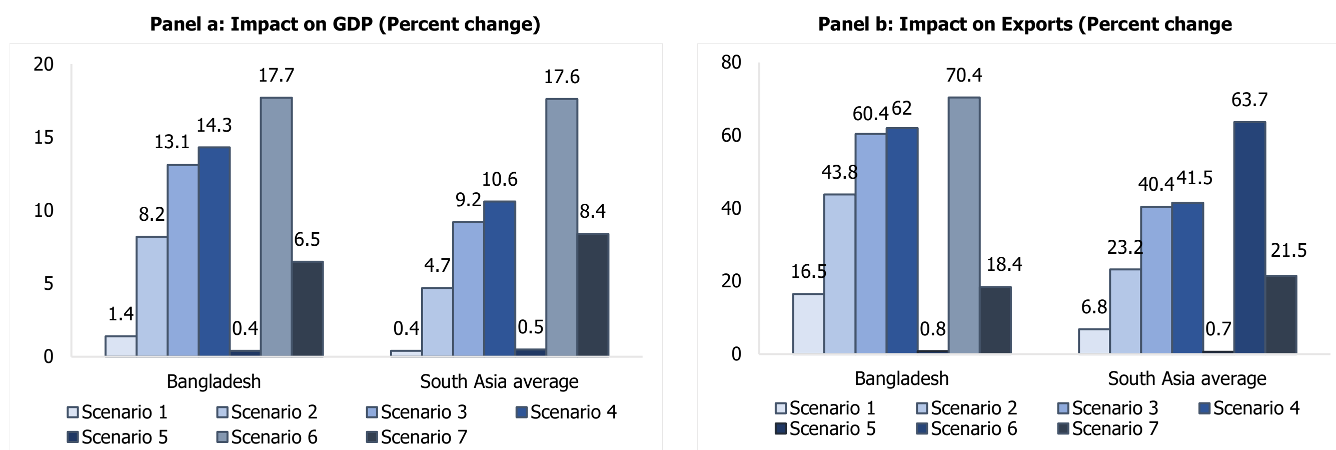
	SCENARIOS						
	1.1	1.2	1.3	1.4	2.1	2.2	2.3
	Set CD to MIN CD of India, China and Vietnam	Set CD to India levels (if India CD is lower)	Set CD to China levels (if China CD is lower)	Set CD to Vietnam levels (if Vietnam CD is lower)	Reduce CD 25% to 22.5%	Reduce CD 25% to 22.5%, SD cap 20%	25% cut in CD
Impact on imports							
Imports pre	4,668,160	4,668,160	4,668,160	4,668,160	4,668,160	4,668,160	4,668,160
Imports post	4,863,123	4,727,998	4,826,210	4,794,115	4,678,499	4,699,105	4,755,687
Change in imports	194,963	59,838	158,050	125,955	10,339	30,945	87,528
Change in imports (%)	4.2	1.3	3.4	2.7	0.2	0.7	1.9
Impact on tariff revenue							
Tariff revenue pre	252,174	252,174	252,174	252,174	252,174	252,174	252,174
Tariff revenue post	115,652	206,754	148,380	153,898	245,146	248,688	198,428
Change in tariff revenue	-136,522	-45,420	-103,794	-98,276	-7,028	-3,487	-53,746
Change in tariff revenue (%)	-54.1	-18.0	-41.2	-39.0	-2.8	-1.4	-21.3
Impact on total tax revenues on imports							
Import tax revenue pre	980,234	980,234	980,234	980,234	980,234	980,234	980,234
Import tax revenue post	860,827	940,757	891,907	890,398	974,852	962,680	936,392
Change in import tax revenue	-119,407	-39,477	-88,327	-89,835	-5,381	-17,554	-43,842
Change in import tax rev. (%)	-12.2	-4.0	-9.0	-9.2	-0.5	-1.8	-4.5

Source: World Bank (2022). CD: Customs Duties; SD: Supplementary Duty.
Note: The simulations were carried out using the World Bank Tariff Reform Impact Simulation Tool (TRIST) that a partial equilibrium spreadsheet tool. The tool provides estimates of the impacts of changes in tariffs on government revenues, imports, protection, and prices, using detailed data on actual revenues from trade, including all taxes levied and shows the change in trade tax revenues, which is more relevant than the change in tariff revenues alone. A more sophisticated economywide model is used in the next step to assess whether a particular policy change is beneficial.

Beyond tariffs, the government could consider NTB liberalization and services reforms to diversify exports. The CEM estimates that the impact on economic growth from comprehensively reforming tariff barriers and NTBs, trade facilitation, and services and investment can be more than 10 times higher compared with liberalization efforts relying solely on tariff cuts. For example, Bangladesh's GDP gains from deep regional integration with South Asia and Southeast Asia would increase to 14.3 percent compared to 1.4 percent from a shallow regional integration scenario. Exports would also increase from 6.8 to 41.5 percent (figure 26). While tariff liberalization will facilitate "trade creation" between Bangladesh and other trading partners, improved access to South Asian and Southeast Asian markets through deep regional integration would provide new trading opportunities and catalyze the participation of exporters in GVCs. Also, access to cheaper imports of intermediates goods will reduce input costs and generate efficiency gains. The various scenarios are detailed in Annex 2.

[17] As envisioned in the 8th Five-Year Plan, the current VAT law should be aligned with the original version that had a single VAT rate. Unjustified exceptions and truncated VAT rates could be removed. The reliance should shift from indirect to direct tax taxes. The new direct tax laws should be finalized quickly, in line with internationally accepted good practices. A tax structure more aligned with its competitors, coupled with an improved business climate, can gradually reduce the necessity of maintaining large tax expenditures to attract investment. A modern tax administration characterized by greater integration, technical capabilities, and automation can expedite the domestic resource mobilization efforts. It needs to move away from the existing system that is largely manual and characterized by high levels of discretion.

Fig 26: Impacts of Regional and Multilateral Liberalization



Source: World Bank (2022)

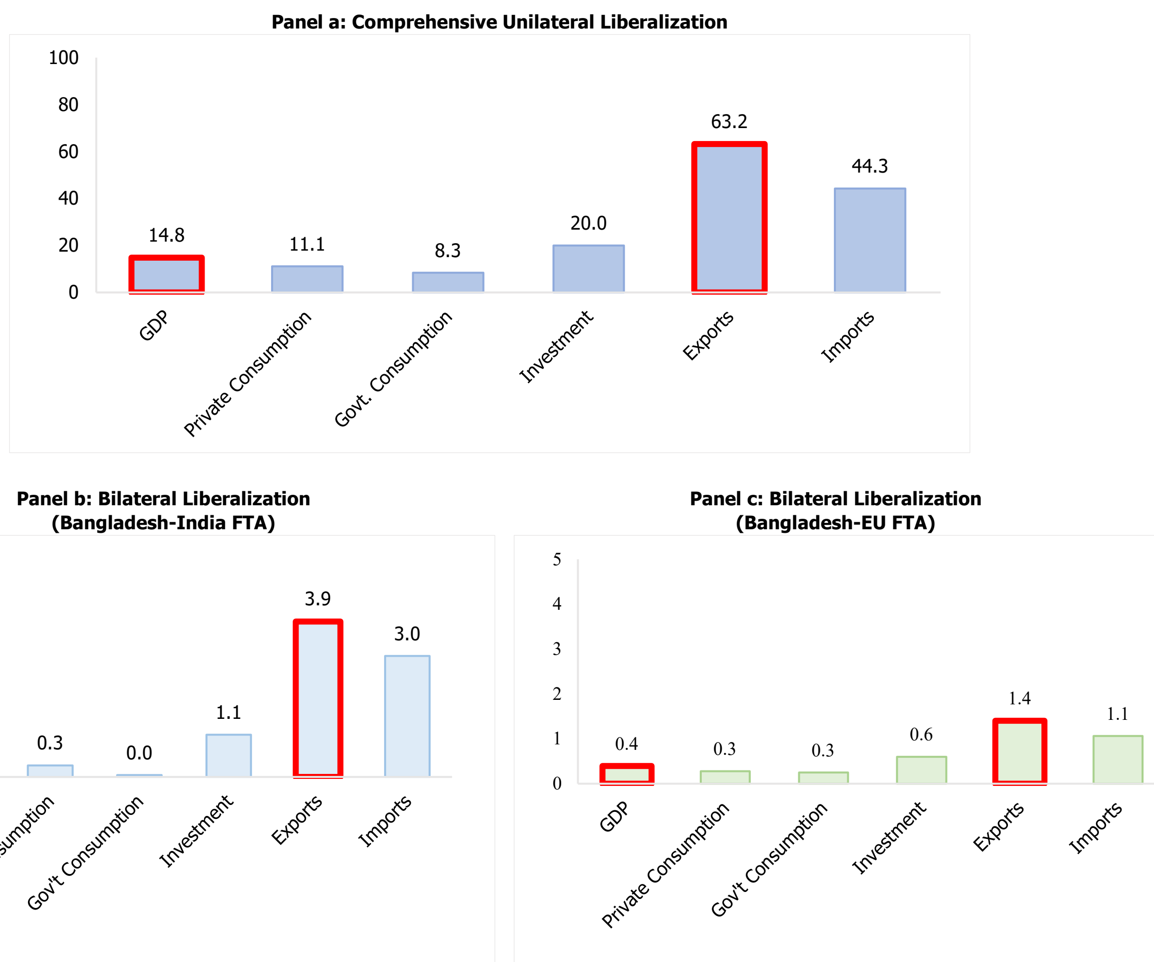
How to Liberalize

Unilateral liberalization generates the highest gains. The gains from unilateral liberalization of barriers to trade and investment could boost Bangladesh's GDP, investment, and exports by 14.8, 20, and 63.2 percent, respectively (Figure 27a). Unilateral reforms would not lead to improved market access, but the reforms would reduce trade costs and expand access to cheaper and better-quality imported inputs, which would boost domestic firms' competitiveness, output, and exports. Domestic industries such as apparel, retail trade, and transportation services would benefit (World Bank, 2022).

Gains from bilateral liberalization and regional integration are smaller compared to broader unilateral liberalization. However, pursuing such integration initiatives through comprehensive reforms that cover tariffs, NTBs, trade facilitation, and FDI can improve market access and boost competitiveness.

Comprehensive bilateral Free Trade Agreements (FTAs) with the EU and India could boost Bangladesh's GDP by 0.4 and 0.5 percent, respectively, and exports by 1.4 and 3.9 percent, respectively (Figure 27b and Figure 27c). The impact of a preferential trade agreement between Bangladesh and India is estimated to be higher, with export gains more than double the benefits of an agreement with the EU. This is partially due to existing preferences on exports to EU markets. Overall, the bilateral agreements are expected to boost exports across the board and contribute to diversification into higher value-added manufacturing and services.

Fig 27: Economy-wide Impacts of Trade Liberalization (Impact in Percent)



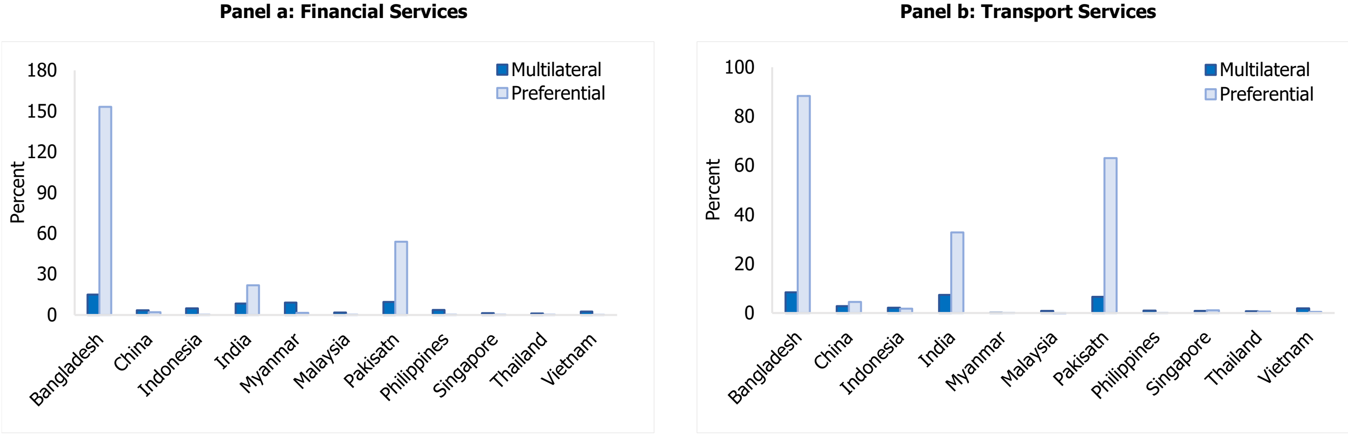
Source: World Bank (2022). World Bank–UNESCAP trade costs database.
Note: The model underlying the simulations is the Global Trade Analysis Project (GTAP) FDI model—a multi-region, multi- sector, and multi-factor computable general equilibrium model (Lakatos and Fukui 2014; Hertel 1997). The model is calibrated using the GTAP 11 database representing the global economy in 2017 (Aguiar, et al. 2019) and endogenously updated to 2021 to capture latest macroeconomic developments. To capture FDI and multinational linkages, the GTAP database was complemented with an explicit breakdown of FDI stocks and cross-border operations of MNCs. For details, please refer to World Bank (2022), chapter 3.

Preferential liberalization with South Asia and Southeast Asia would boost Bangladesh's services economy. The cost of restrictive services policies is much higher than the applied rates of tariff protection in goods. Simulations using a structural gravity model involving Bangladesh and selected South Asian and Southeast Asian countries show that the gains from preferential liberalization are huge compared to that of multilateral liberalization[18]. Figure 28 (panels a and b) show the results of these simulations, expressed as counterfactual percentage changes in exports relative to the model baseline, for the two sectors in which the gains are expected to be the largest—financial services and transport. The gains for Bangladesh are significantly higher than other countries because the complete network of trade agreements considered in the preferential liberalization scenario includes preferential liberalization between Bangladesh and countries such as India. In fact, for the other countries, the

[18] The preferential liberalization scenario refers to a case where countries sign a complete network of preferential trade agreements among themselves but keep their multilateral Services Policy Index scores constant. A multilateral liberalization scenario is when selected Asian countries reduce their Services Policy Index scores by 10 percent on a multilateral basis, with all other countries maintaining their baseline policies. For further details please refer to World Bank (2022).

changes in exports due to multilateral liberalization are typically stronger than from further preferential integration. These results indicate that liberalizing services policies between Bangladesh and South Asian and Southeast Asian countries can help boost the services economy.[19]

Fig 28: Impacts on Exports from Multilateral and Preferential Services Liberalization (Percent over baseline)



Source: World Bank (2022)

1.5 Conclusion

Tariff modernization is central to Bangladesh's trade policy reforms. The reform agenda will involve moving toward low and uniform tariffs, adopting a single rate for similar goods irrespective of origin, and gradually eliminating para-tariffs. This is a crucial first step towards ending the anti-export bias inherent in the current trade policy regime. Given that substantial tariff-related revenue losses will be involved, tariff reforms need to be complemented by simultaneous revenue mobilization efforts.

Beyond tariff modernization, complementary reforms would further promote export diversification and GVC participation. Although a wholesale trade reform that covers goods and services in Bangladesh's current environment does not seem feasible, several steps could usefully be taken to increase economic efficiency and support the country's development objectives:

(a) **NTB liberalization and trade facilitation reforms.**
High trade costs are generated by the costs of complying with numerous behind the border measures that include non-tariff regulatory measures, documentation requirements, and lengthy administrative procedures. Customs reforms to enhance efficiency at the borders would encourage firms to rely more on imported inputs that are necessary to compete in export markets.

(b) **Services as a source of export-led growth.**
Services reforms needs to feature on the policy agenda. Reforming key strategic sectors, such as digital services or key services inputs such as telecom or business services that accelerate spillovers for development and productivity, could be a good entry point.

[19] These simulations do not account for trade under the General Agreement on Trade in Services Mode 3 (sales by foreign affiliates) and capture the other modes of supply imperfectly. Also, given that there is more to international trade in services than is captured in standard data from the BoP, these estimates should be considered as lower bounds of the likely true effects of policy liberalization.

Unilateral liberalization generates the highest gains. These could be complemented with bilateral, regional, or multilateral trade liberalization options. Based on the evidence from the computable general equilibrium and gravity simulations discussed earlier, the policy implications are as follows:

(a) The largest economic gains for Bangladesh come from nondiscriminatory policy reforms. While these reforms—covering goods, services, and investment—are consistent with the aims of the multilateral trading system, they do not strictly require multilateral negotiations to be feasible: individual countries are always free to liberalize autonomously, on a *de facto* most favored nation basis. Given the difficulty of moving forward on multilateral negotiations, this route holds appeal for Bangladesh, especially in the case of investment and services.

(b) Trade and investment linkages between Bangladesh and South Asia are still constrained by high tariffs and NTBs, and costly customs procedures. Bangladesh can focus on regional integration strategies that go beyond South Asia to include a broader group of countries. Bangladeshi policymakers may consider joining existing regional groupings such as ASEAN or the Regional Comprehensive Economic Partnership (RCEP). Deeper regulatory cooperation can be pursued as part of FTAs or other regional mechanisms. Of course, regional integration is not straightforward given the political landscape at home and abroad. The size of the gains from preferential integration should not overshadow the more general finding that multilateral liberalization, including when undertaken unilaterally, can bring significant economic gains to Bangladesh.

Annex 1: Determinants of Export Survival

Table A1: Determinants of Export Survival: Key Results from the Cox Proportional Hazards Model

Group	Variables	+ Increase Exports Survival - Reduce Exports Survival
Spell characteristics	Exports at the beginning of spell	+***
	Number of destinations at the beginning of spell	+***
Product characteristicsTariffs	R&D intensity	+***
	Weighted average imports tariff (at firm level)	-***
Firm characteristics	Firm exports to and imports from the same region	+***
	Firm exports to the same region	+
	R&D intensity of exports	+
	R&D intensity of imports	+***
Firm type	GVC (exporter-importer)	+***
	Backward GVC	+***
	Forward GVC	+***
	GVC x weighted average import tariff	-***

Source: Dihel and Kukenova 2022.

Annex 2: General Equilibrium Modeling Scenarios

The scenarios and the assumptions are as below:

The Unilateral Liberalization Scenario. A uniform 90 percent cut in tariffs, a 50 percent reduction in NTBs, improvement in trade facilitation implying a 15.5 percent reduction in trade costs, and FDI liberalization.

Bilateral Preferential Trade Arrangements (PTA) between Bangladesh and the European Union and India, respectively. A uniform 90 percent cut in bilateral tariffs, a 50 percent reduction in bilateral NTBs, improvement in trade facilitation implying a 15.5 percent reduction in bilateral trade costs, and FDI liberalization, closing half the gap in bilateral FDI.

Regional Integration between Bangladesh and South Asia and Southeast Asia.

- **Scenario 1** (Shallow Integration). A uniform 90 percent cut in bilateral tariffs between Bangladesh and South Asian and Southeast Asian countries across all sectors.
- **Scenario 2.** Scenario 1 plus a 50 percent reduction in bilateral NTBs between Bangladesh and South Asian and Southeast Asian countries. It is assumed that 50 percent of the total non-tariff trade costs are actionable (possible to be affected by policy measures), and 50 percent of these actionable barriers are liberalized – a conservative assumption for potential integration scenarios. The assumption of 50 percent liberalization is aligned with Wignaraja et al. (2014) and others in the literature who assume that only about half of the NTMs are actionable.
- **Scenario 3.** Scenario 2 plus improvement in trade facilitation implying a 15.5 percent reduction in trade costs between South Asia and Southeast Asia. According to Moïsé and Sorescu (2013), implementing the WTO Trade Facilitation Agreement (TFA) could reduce trade costs by up to 15.5 percent. Bilateral trade costs come from the United Nations Economic and Social Commission for Asia and the Pacific–World Bank trade costs database.
- **Scenario 4** (Deep Integration) Scenario 3 plus South Asia–Southeast Asia FDI liberalization, closing half the gap in bilateral FDI.

Multilateral Liberalization

- **Scenario 5.** Sustained US-China trade tensions – as specified in Petri and Plummer (2020), this scenario assumes an increase in US-China tariffs in place by December 2019, 10 percent increase in agricultural and manufacturing US-China NTBs, 50 percent increase in US-China services NTBs, and US-China FDI barriers double.
- **Scenario 6.** Open regionalism – Bangladesh integrates with an open South Asia and Southeast Asia region that extends the same liberalization to the rest of the world and regionally within South Asia and Southeast Asia.
- **Scenario 7.** Bangladesh integrates with South Asia and Southeast Asia region without intraregional South-South- east Asia integration.

Source: Lakatos (2021).

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