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Navigating the Global Financial Storm: Challenges for Bangladesh

November 2008

**Policy Analysis Unit
Bangladesh Bank**

Navigating the Global Financial Storm: Challenges for Bangladesh

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Executive Summary

The collapse of the US subprime mortgage market and its repercussions on the US financial system transmitted shockwaves throughout the global financial markets leading to the present financial turmoil and international crisis of confidence. Commodity prices have eased from recent highs, large exchange rate alignments are taking place, and the global economy is experiencing a major downturn. The developed countries are now forced to tighten their belts and reorganize their financial systems. Although the developing countries did not participate in the binge preceding the crisis, the crisis is likely to have big impacts on the poor countries.

The triggers of the present global financial crisis were in the US subprime mortgage market the collapse of which engulfed the global financial markets leading to a painful recession of the world economy.

Recent developments indicate that global growth prospects have deteriorated significantly over the last few months. The global growth slowdown is mainly due to significant downturn in economic activities in the advanced economies where output is projected to grow at only 1.4 percent in 2008, more than one percentage point lower than in 2007. The year 2009 is projected to be worse, when output is forecast to contract in advanced countries. Three major factors may pave the way toward gradual recovery starting in late 2009. First, likely stability of world commodity prices leading to the start of an unwinding process of adverse terms of trade effects especially in oil importing countries. Second, end of the intense drag on US growth by the housing sector with positive effect on the world economy. Third, high resilience and relatively unaffected status of the emerging economies providing the momentum to recovery for the global economy.

The Bangladesh economy is largely shielded from the most immediate and direct effects of the financial crisis. However, Bangladesh's exposure to real economy effects of the financial crisis is likely to be greater through exports, remittances, and foreign capital inflow channels. The major sources are the projected slowdown in growth in the advanced economies which may lead to decline in exports (especially of readymade garments) since nearly 87 percent of Bangladesh's exports are destined to markets in advanced countries, remittances may ease as the source economies face lower growth and challenging times, aid inflow may reduce, and Bangladesh's macroeconomic stability and growth prospects may suffer.

Although Bangladesh's financial sector remains largely immune to the global financial crisis, the country's exposure to real economy effects is likely to be greater through exports, remittances, and foreign capital inflow channels.

Bangladesh's financial sector maintains a relatively good health underpinned by prudent regulation and sound management due to past reforms and is highly insulated from foreign markets. The non performing loans are declining; the capital base is relatively comfortable; foreign exchange reserves remain well managed with no holding of any corporate bond; the capital account remains nonconvertible with few private transactions permitted such as foreign direct investment and portfolio investment; private debt transactions are limited and strictly monitored by Bangladesh Bank; current account balance is positive that reduces the risks

emanating from short run fluctuations in the exchange rate and foreign reserve situation; financial institutions are not exposed to complex securitization instruments; and Bangladesh Bank pursues pro-active monetary and exchange rate management. External debts are low and reserves are comfortable. In addition, a reasonably high domestic savings rate (around 20 percent of GDP) provides added cushion. The main downside risk on the financial sector is a reduction in foreign capital flows, including for the government. Overall, the current global financial crisis is not likely to have any significant effect on the country's financial sector.

The low level of global integration has shielded the Bangladesh economy from the current financial turmoil. Bangladesh's financial sector maintains a relatively good health and the current global crisis is not likely to have any significant effect on the financial sector.

For Bangladesh, the composition of exports makes export sector the most vital transmission channel of the effects of recent global financial developments. Two features contribute significantly toward increasing the export sector vulnerability: first, high dominance of RMGs in total export earnings; and second, almost entire reliance of Bangladesh's RMG exports on US and EU markets. A number of factors would determine the net impact on exports. First, given the overwhelming dominance, impact on RMGs would set the effects on Bangladesh's exports. Second, since Bangladesh's RMG exports mainly cater to the low-price segment of the apparel market, the current slowdown may create less impact on the country's RMG exports. With incomes falling, even some diversion of demand from high-end garment segment to low-end segment may take place. Third, in the export sector, new dimensions are likely to creep into price negotiations especially if the major purchasers of RMG products move to take advantage of the market situation. Fourth, in view of the country specific changes due to the crisis and other developments, it is likely that RMG importers in advanced economies may introduce adjustments in sources of procuring apparel products which may compensate Bangladesh's negative effects on RMG exports by enabling it to capture greater market shares in these countries. Thus, opposing forces are likely to work in RMGs export sector and the net impact would determine the final outcome.

The relative insulation of the country's capital market and limited role of foreign portfolio investment supported by reasonably strong macroeconomic fundamentals and strengthened policy and management frameworks have ensured resilience of the Bangladesh economy.

In the case of imports, the prospects are likely to favor Bangladesh through lowering the growth of import bill. In the international market, prices of commodities for which Bangladesh is a net importer (especially food, oil, fertilizer, and other essential products) have experienced significant decline in recent months. The settlement of LCs for consumer goods declined by more than 29 percent during July-September 2008. The opening of new LCs for consumer goods during the period declined more sharply showing improved domestic supply conditions (especially of rice) and benefits of global price declines.

The country's banking sector is free from exotic or toxic derivatives and the off balance sheet items comprise mostly basic swap contracts with no risk of sustaining unexpected losses.

The overall remittance inflow is unlikely to be much affected since the bulk (63 percent) of the remittances originates in the Gulf region where growth prospects are mostly unchanged in 2008

and projected to lower marginally in 2009. Remittances from advanced economies could be adversely affected if the recession prolongs and job cuts persist. It is difficult to predict the net impact since the low-skilled jobs in which Bangladeshi migrant labor is mostly concentrated are likely to be less affected from the growth slowdown. Moreover, the resilience shown by remittance inflows to Bangladesh to past changes in economic growth in major remittance sending countries gives some hope of optimism.

Although remittances are not likely to be affected in the short term, some pressure on remittance inflows may arise if the recession deepens and persists for a longer period in the advanced economies and the Middle Eastern economies slowdown due to decline in oil revenues.

The aid budget in advanced economies is under pressure due to their reduced ability to sustain recent levels of foreign aid resulting from debt overhang and weak fiscal positions created by the financial crisis and slow growth. This would particularly affect the flow of bilateral aid to recipient countries. Bangladesh's aid mostly comes from multilateral sources (nearly 80 percent of the total). However, the country's prospects of expected large increase in aid in FY09 may be weakened.

Tighter global credit markets have raised the cost of capital in the international market and are likely to reduce foreign direct investment (FDI) in developing countries. Bangladesh has little FDIs. Since most FDIs in Bangladesh are longer term in nature, the current financial crisis is unlikely to have an immediate impact. The full impact would only be clear when investors begin to assess longer term investment decisions depending on global growth prospects and price developments.

Aid inflows are likely to remain unaffected in the short run although the promises of significant aid increase may not materialize up to the expected level.

The potential impact of the global financial crisis calls for action in a number of areas including sound economic management. The export sector could be strengthened through several measures such as providing pre- and post-shipment credits for longer periods and allowing rescheduling of loans especially for RMGs; enhancing the efficiency of customs, ports, and infrastructure as producers/exporters need cost-cutting measures to stay competitive; installing and strengthening safety net programs for garment workers; diversifying the export basket, adding more value added products to export items, and exploring new markets. For the RMG sector, it is critical to ensure smooth and production friendly environment and uninterrupted access to power and other inputs to retain competitiveness. The sector should also avail the opportunity created by the just-started process of diverting fresh apparel orders from US and EU importers who earlier sourced apparels to China and other countries in order to enhance Bangladesh's market share and overcome any depressing effects. A comprehensive export (including export of services) promotion program needs to be adopted to expedite the implementation of short and medium/long term export promotion measures employing a product and country specific approach. The newly elected US President's economic agenda of tagging labor and environmental standards with trade, although unlikely to affect the volume of transactions in the near term, is an area of concern for Bangladesh. Bangladesh needs to be well prepared to adopt

The major source of vulnerability is the export sector and its (especially of RMGs) very high dependence on markets of advanced economies.

Several actions are needed to strengthen the export sector and face the likely consequences of the global crisis.

appropriate strategy since the issue, though dropped from the ongoing Doha negotiations within the WTO, is likely to be brought back by US when the current round concludes.

The Bangladesh Bank needs to pursue its present prudent monetary policy measures keeping in view the rising downside risk of slowing economic activity. In this context, a major concern would be to ensure that high inflation does not enter into the medium/long term expectations of economic agents and become a permanent feature of the economy. The priority should be to correct the short term debt yield curve and 'plan for tomorrow' especially in terms of dampening inflation expectations and ensuring price stability. The current policy of providing adequate credit support to agriculture, small and medium enterprises (SMEs), and other productive sectors which are primary sources of job expansion should be continued along with measures to ensure improved functioning of the credit markets and payment systems.

The situation calls for pursuit of present prudent monetary policy measures and ensure that high inflation does not enter into the medium/long term expectations of economic agents.

In adopting appropriate foreign exchange policy, Bangladesh needs to take into account a number of considerations including (i) direction of trade covering both origin of imports and destination of exports; (ii) industry composition of trade flows; and (iii) origin of capital inflows especially remittances. It would be important for Bangladesh to confront the challenging tradeoff between keeping inflation down and achieving better competitiveness through exchange rate management. Any improper exchange rate adjustment can harm even the exporters, if this raises costs through increasing domestic prices of imported raw materials. The present circumstances and the current state of macroeconomic fundamentals do not provide enough justification of pursuing any policy of letting the exchange rate to depreciate to any significant extent. With priority to reducing inflation expectations and inflation rate from its double digit level, this will help evade any dilution of the pass through of declining global commodity prices to domestic prices and strengthen the depressing effect on inflationary pressures.

It is important for Bangladesh to confront the challenging tradeoff between keeping inflation down and achieving better competitiveness through proper exchange rate management.

The fiscal sector has significant pressure for public funds in the FY09 budget. It would be prudent to prepare an action plan to create some fiscal space to respond to any downturn in economic activities or external shocks due to the ongoing global crisis. This is necessary in order to accommodate, if required, additional fiscal support to expand safety nets and provide assistance to the exporters especially RMG exporters. As a sensible and quick response, low priority expenditure may be trimmed and revenue collections improved to help protect fiscal positions and the government's ability to respond when needed.

It would be prudent to prepare an action plan to create some fiscal space to respond to any downturn in economic activities or external shocks due to the ongoing global crisis. As a sensible and quick response, low priority expenditures may be trimmed and revenue collections improved to help protect fiscal positions and the government's ability to respond when needed.

Although protected from the direct effects, Bangladesh's banking sector would probably face more pressure over time. The loan quality may deteriorate and liquidity may reduce if economic

growth slows. The Bangladesh Bank should carefully monitor liquidity conditions and other financial developments to take appropriate actions. Obviously, the longer term concern for Bangladesh would be to move toward a macro-prudential and regulatory architecture that is effectively integrated and involves needed coordination among all concerned agents.

Financial sector surveillance could be refreshed and financial management revisited.

Several short term measures may be adopted to address the potential concerns such as close monitoring of the possibility of rising default on borrowings by importers against stocks of essential products imported at higher prices earlier due to anticipated loss on their stocks by falling world prices; regular monitoring of the trend in non-performing assets of banks since such assets might rise due to lower profitability of firms especially producing for the export sector due to decline in prices in the global market causing value crash of their current stocks and leading to liquidity problems for the financing banks because of repayment defaults; strengthening existing supervisory mechanism of the financial institutions and regularly monitor the key financial sector indicators and take remedial measures as required; putting in place backstops at Bangladesh Bank that can be applied quickly and flexibly in the event of system-wide pressures; quality improvement of the output of credit rating agencies to avoid mispricing of risk particularly in credit markets; and pursuing structural reform to lessen the downside of crisis, carry out adjustment to food and oil prices which are likely to remain at historically high levels, improve rural productivity, and strengthen the supportive environment for private sector led growth and the economy's resilience to external events.

It is important to reinvigorate structural and institutional reforms in order to strengthen supportive environment for private sector led growth and enhance the economy's resilience to external events.

The present global financial crisis shows that there is no substitute of prudent government intervention and careful regulation even when market determined incentive structures operate. The pursuit of free financial sector nostrums does not guarantee against moral hazard, adverse selection, and the financial institutions to cause systemic distress. This does not mean that the financial sector should be administratively controlled and not be allowed the freedom to innovate, compete, and use market based incentives.

Bangladesh needs to ensure a liberalized, market based, and effectively supervised and regulated financial sector capable of generating quality information in order to promote and sustain rapid growth.

A liberalized, market based, and effectively supervised and regulated financial sector capable of generating quality information is necessary in order to promote and sustain rapid growth in Bangladesh. The important agenda for Bangladesh is to convert the current global crisis into an opportunity in order to move forward.

1. Introduction

The recent crisis in the global financial markets emerged as a consequence of poor lending practices in the US subprime mortgage market hurting the companies that held and sold mortgage-backed securities and credit derivatives. The stress spread rapidly to other financial institutions and the crisis deepened at alarming rates to include financial, credit, and currency markets as well as the real economy. The shockwaves of the collapse of US subprime mortgage market also engulfed the financial markets across countries in Europe and other regions making a prolonged and painful economic recession, especially in the US and Europe, a reality. In Bangladesh, even though the impact of the financial crisis has not been directly felt mainly due to shielding of the economy from the most immediate effects of the crisis, the looming economic conditions and financial market instability in the developed and several emerging economies can create adverse impacts on the Bangladesh economy.

The financial turmoil in the developed countries has forced these countries to tighten their belts and they now are in the process of re-organizing their financial systems. Although the developing countries did not participate much in the binge preceding the crisis, the crisis is likely to have big effects in many poor countries. No doubt it is difficult to predict how the financial crisis would affect the poor countries such as Bangladesh, but it is relatively safe to conclude that the effects are more likely to be indirect for Bangladesh since the country has little direct exposure to the failing financial institutions and toxic assets in the developed world.

Although declining commodity prices in the world market (especially of food and fuel), emanating mostly from depressed demand, has provided some relief for Bangladesh, the fall in demand also brings new concerns for Bangladesh. With growth falling in the developed countries, the country's exports (especially of readymade garments) may decline, remittances may ease as the source economies face lower growth and challenging times, aid inflows may reduce, and Bangladesh's growth prospects may decline adversely affecting the country's macroeconomic stability and development efforts.

The present paper analyzes the nature of the current global financial crisis keeping in view its implications on the Bangladesh economy and identifies major channels through which the effects of the financial crisis could be transmitted to Bangladesh. After this introduction, section 2 examines the current situation of the crisis and changes in global outlook that could affect the Bangladesh economy. Section 3 discusses the potential implications that Bangladesh could face through different transmission channels; while section 4 provides conclusions and identifies some key policy responses.

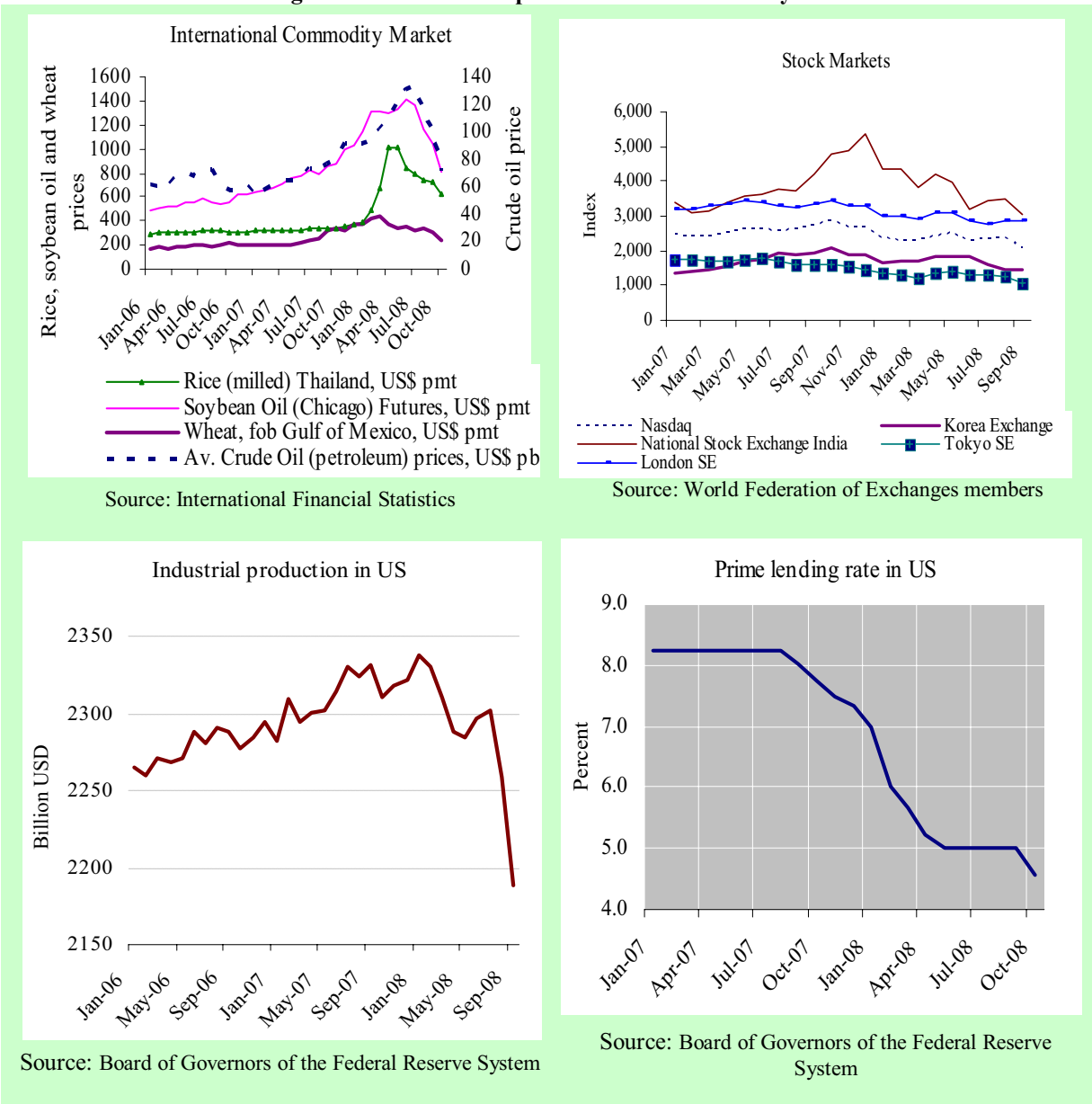
2. Global Financial Crisis: Current Situation and Direct Impacts

It is now well documented that the triggers of the present global financial crisis were in the US subprime mortgage market which was supported by expansionary monetary policy and encouraged borrowing for real estate.¹ Although the governments in many

¹ For details on the global financial crisis, see the International Monetary Fund (www.imf.org/) and the Board of Governors of the US Federal Reserve (www.federalreserve.gov/). Although companies involved in home construction and lending were the first affected, the problems spread quickly through the entire US

countries intervened to bail out banks and other institutions, the severity of the crisis fueled by eroded confidence has been overwhelming along with drastic fall in world stock markets in developed countries. The effects also transmitted quickly to emerging economies in view of the close links that exist in assets, trade, and financial product markets in the existing globalized environment. Thus, the financial crisis that started in the US has spread to European financial markets and is threatening the emerging economies as well.

Figure 1: Recent Developments in Global Economy



financial sector setting an international crisis of confidence and spreading the turmoil to financial markets in Europe and other countries.

Following the lead of the US, many European governments have stepped in to inject liquidity into the markets.² In general, the measures by the governments included four major components: (i) raising the amount of guaranteed deposits to prevent massive withdrawals and possible bank runs; (ii) providing capital to financial institutions in exchange for shares of equity; (iii) guaranteeing specific amounts of interbank loans; and (iv) taking illiquid mortgage backed securities from banks in exchange for Treasury bills that are easier to trade and have shorter maturities. On 8 October 2008, six central banks (US, Euro area, UK, Canada, Switzerland, and Sweden) announced their coordinated decision to cut official policy rates by 50 basis points. Similar measures were also announced by other central banks (e.g. China, Australia, Hong Kong, and Korea).

It is now apparent that the present financial crisis would pose a significant threat to economic growth worldwide. The projection of global growth has declined as a result of the turmoil, and weakening demand has started the inflationary pressures to subside.

World Economic Growth³

The present financial crisis came at a time when the global economy was slowing down due to high oil and commodity prices. In general, the crisis led to a fall in asset prices as well as confidence along with contraction in bank credit. These developments have started a process known as deleveraging, through which firms and consumers try to reduce their exposure to debt. The process, however, is lengthy and remains an ongoing drag on global growth.

As a result of government actions, some improvements in the global financial situation can be noticed of late. For example, credit default swap (CDS) spreads for commercial banks have come down considerably in the developed countries.⁴ Marginal success has also been achieved in increasing liquidity into the financial markets. However, as banks find it difficult to raise capital and deleverage, the nonfinancial sector would be adversely affected and the effects would also be felt in the real economy.

Due to the global nature of the financial crisis, growth is likely to be affected in most countries which are Bangladesh's export destinations and sources of remittance inflow (Table 1). In the case of Bangladesh's exports, more than 53 percent of the total was destined to Europe while another 29 percent to USA and Canada in FY08. It may be added that more than 76 percent of total exports of Bangladesh are readymade garments (RMGs) products.⁵ For remittances, the major source is the Gulf region providing nearly 63 percent of the total while 17 percent originates from USA and 12 percent from

² According to the Bank of England, global bailouts will amount to about 12 percent of global GDP which would be about USD 7.2 trillion of taxpayers' money. This will be spent on recapitalization of banks, buying out their toxic assets, state guarantees, and nationalization.

³ This assessment of global growth primarily focuses on countries/regions which are Bangladesh's major export destinations and sources of remittance inflow.

⁴ The CDS spreads measure the risk of an institution defaulting on a loan. In UK, for instance, when the rescue plan was announced, sovereign CDS spreads for the UK government rose as risk was transferred from individual banks to the government.

⁵ In FY08, more than 93 percent of Bangladesh's total exports to European countries and USA were RMG products.

Europe. The above shows that economic conditions in three regions (Euro, Gulf, and US) are important for Bangladesh's exports and remittances.

According to the latest update of IMF published in November 2008, world output, which grew at 5.0 percent in 2007, is expected to slow to 3.7 percent in 2008 and 2.2 percent in 2009 (IMF 2008a). The forecast for the developed countries is bleak with sharp downward revisions over earlier forecasts (Table 2). In the advanced economies, output is likely to grow by 1.4 percent in 2008 (compared with 2.6 percent in 2007) but would contract by 0.3 percent in 2009, the first annual contraction during the postwar period. The recovery is projected to start in late 2009. In 2008, all major advanced countries except Italy are likely to experience positive output growth, while the situation would reverse dramatically in 2009 when Canada alone is projected to have positive growth. The unemployment rates have also started to climb in these countries.⁶ Although developing Asia is not likely to hard hit in 2008, these countries are projected to grow at much slower rates in 2009 mainly due to demand slowdown in developed countries since they are heavily reliant on exports to fuel economic growth. In the Middle East, output growth is also projected to be slower in 2009.

Table 1: Bangladesh's Major Export Destinations and Remittance Sources

Export destinations (FY08)		Remittance sources (FY08)	
Country/region	Share (%)	Country/region	Share (%)
<u>Advanced Economies</u>	86.8	<u>Gulf Region</u>	62.8
Euro area	40.2	Saudi Arabia	29.4
Germany	15.4	UAE	14.3
France	6.8	Kuwait	10.9
Netherlands	4.6	Qatar	3.7
Spain	4.2	Oman	2.8
Italy	4.1	Bahrain	1.8
Belgium	3.5	<u>Europe</u>	11.7
USA	25.4	UK	11.3
UK	9.7	Germany	0.3
Canada	3.8	<u>Asia Pacific Region</u>	3.0
Japan	1.2	Singapore	1.6
<u>Developing Asia</u>	4.8	Malaysia	1.2
India	2.5	Japan	0.2
Hong Kong	1.1	<u>Rest of the World</u>	22.5
<u>Middle East</u>	1.7	USA	17.4
<u>Rest of the World</u>	6.7		

Source: Bangladesh Bank and Export Promotion Bureau

USA and euro region

Growth in the US economy appears to have slowed sharply in recent months. According to the advance estimate of Bureau of Economic Analysis (BEA) of the US Department of Commerce, real GDP in the US decreased at an annual rate of 0.3 percent from Q2 to Q3 of 2008. In Q2 2008, real GDP increased by 2.8 percent. The largest contributors to the decline in real GDP growth in Q3 were sharp downturn in personal consumption expenditures (PCE) for nondurable goods, larger decline in PCE for durable goods, smaller decrease in imports, and a deceleration in exports.⁷ Real PCE decreased 3.1 percent in Q3 in contrast to an increase of 1.2 percent in Q2; durable goods decreased

⁶ The US economy, for instance, seems to have entered a deep recession with the unemployment rate reaching 6.5 percent in October 2008, highest level since 1994. This signals that the economic slump may become deeper with the possibility of further lowering of the federal funds rate and bringing in more fiscal stimulus packages in future.

⁷ The continuing downturn in the housing market has created an unprecedented situation in which more than 10 million households owe more on their mortgages than the market value of their homes and the current anticipation is that the housing cycle will find a floor in 2009 after corrections.

14.1 percent (compared with a decrease of 2.8 percent in Q2) while nondurable goods decreased 6.4 percent in contrast to an increase of 3.9 percent in Q2. The IMF projections for US growth are (-) 0.7 in 2009 following a rise of 1.4 percent in 2008.

Although the US economy is likely to return to its potential growth only in 2010, it is anticipated that the US firms would be able to maintain their spending patterns better than expected despite financial strains thereby providing higher than anticipated support for household incomes. This positive expectation stems largely from major initiatives by the authorities to deal with threats to systemic stability and stabilize market conditions, and still-healthy profit margins of the firms. Thus, although obvious signs of weakness in household consumption are apparent, the recovery may set in earlier than expected depending upon how deep the downturn would be, when the recovery would get under way, and how strong would it become. Moreover, the stress on US households may be less severe than expected due both to the positive outcome of recent government initiatives and the possibility of easing the monetary policy further if the downturn continues. In Canada, growth is projected to come down to 0.6 percent in 2008 from 2.7 percent in 2007 and is expected to further slow down to 0.3 percent in 2009.

Table 2: Update on Global Growth Outlook

	2000-04	2005	2006	2007	Apr 08 proj.		Oct 08 proj.		Nov 08 proj.	
					2008	2009	2008	2009	2008	2009
World	3.6	4.4	5.1	5.0	3.7	3.8	3.9	3.0	3.7	2.2
Advanced Economies	2.4	2.6	3.0	2.6	1.3	1.3	1.5	0.5	1.4	-0.3
Euro area	1.9	1.6	2.8	2.6	1.4	1.2	1.3	0.2	1.2	-0.5
Germany	1.4	0.8	3.0	2.5	1.4	1.0	1.8	...	1.7	-0.8
France	2.1	1.9	2.2	2.2	1.4	1.2	0.8	0.2	0.8	-0.5
Italy	1.9	0.6	1.8	1.5	0.3	0.3	-0.1	-0.2	-0.2	-0.6
Spain	3.6	3.6	3.9	3.7	1.8	1.7	1.4	-0.2	1.4	-0.7
United States	2.4	2.9	2.8	2.0	0.5	0.6	1.6	0.1	1.4	-0.7
Japan	1.5	1.9	2.4	2.1	1.4	1.5	0.7	0.5	0.5	-0.2
United Kingdom	2.8	2.1	2.8	3.0	1.6	1.6	1.0	-0.1	0.8	-1.3
Canada	3.0	2.9	3.1	2.7	1.3	1.9	0.7	1.2	0.6	0.3
Developing Asia	7.3	9.0	9.8	10.0	8.2	8.4	8.4	7.7	8.3	7.1
China	9.2	10.4	11.6	11.9	9.3	9.5	9.7	9.3	9.7	8.5
India	5.8	9.1	9.8	9.3	7.9	8.0	7.9	6.9	7.8	6.3
Middle East	5.0	5.7	5.7	6.0	6.1	6.1	6.4	5.9	6.1	5.3

Source: IMF 2008a, 2008b

The euro area, in general, has been hit by major shocks leading to weakening economic activities. The slow economic growth resulted initially from rising oil prices and is now fed by tightening financial conditions and falling confidence. The recent projections envisage a significant slowdown in economic growth across Western Europe followed by gradual and slow recovery from the second half of 2009. Growth in euro area is expected to moderate from 2.6 percent in 2007 to 1.2 percent in 2008 and further decelerate to (-) 0.5 percent in 2009. In UK, real GDP growth would fall to 0.8 percent in 2008 from 3.0 percent in 2007 and is likely to decline further to (-) 1.3 percent in 2009. These forecasts, however, are subject to significant downside risks mainly due to accelerated deleveraging

in the financial sector, abrupt unwinding of global imbalances, and sharp appreciation of the euro. On the upside, prospects relate to buoyant employment that is still present in these economies which might lead to higher than expected consumption.

Gulf region

Remaining largely resilient to present international crisis and the downturn in developed countries, the oil exporting countries in the Gulf region are expected to grow at an average rate of 6.4 percent in 2008, same as in 2007, although it might decline slightly to 6.1 percent in 2009.⁸ Most of these countries are likely to have higher real GDP growth in 2008 than in 2007 (except United Arab Emirates) although several countries (including Saudi Arabia and United Arab Emirates) are likely face growth slowdown in 2009 (Table 3).⁹

On the other hand, consumer price inflation (CPI) in oil exporting countries is projected to rise to 15.7 percent in 2008 from 10.0 percent in 2007 and ease to 13.6 percent in 2009. All countries (except Iraq) has been experiencing higher inflation in 2008 especially Saudi Arabia (rising from 4.1 percent in 2007 to 11.5 percent in 2008), Kuwait (9.0 percent in 2008 compared with 5.5 percent in 2007), and United Arab Emirates (12.9 percent in 2008 compared with 11.1 percent in 2007). Inflation is likely to be 10.0 percent in Saudi Arabia, 7.5 percent in Kuwait, and 10.8 percent in United Arab Emirates in 2009.¹⁰

Despite some adverse impact of global credit crunch on financial markets (especially GCC stock markets)

and concerns about real estate markets (Dubai and Saudi Arabia), the banking sector in the region remains generally sound with strong fundamentals and little exposure to US credit markets.

Table 3: Real GDP Growth in Selected Gulf Countries
(percent)

	Average 2000-04	2005	2006	Est. 2007	Proj. 2008	Proj. 2009
Bahrain	5.6	7.9	6.5	6.0	6.3	6.0
Kuwait	13.4	11.4	6.3	4.6	5.9	5.8
Libya	3.1	10.3	6.7	6.8	7.1	8.1
Oman	4.6	6.0	6.8	6.4	7.4	6.0
Qatar	8.9	9.2	15.0	15.9	16.8	21.4
Saudi Arabia	3.7	5.6	3.0	3.5	5.9	4.3
United Arab Emirates	7.7	8.2	9.4	7.4	7.0	6.0
Oil exporters	5.8	6.6	6.3	6.4	6.4	6.1

Source: IMF 2008c

⁸ The oil exporters consist of 14 countries in the Middle East and Central Asia region including Saudi Arabia, Kuwait, Qatar, and UAE.

⁹ The November 2008 forecast by IMF puts the growth rate in the Middle East at 6.1 percent in 2008 and 5.3 percent in 2009 compared with 6.0 percent in 2007. See IMF 2008a.

¹⁰ The countries in the region have already resorted to a wide range of policy actions in order to contain inflation and minimize its social impacts. Depending on the country context, measures covered tax cuts, consumption subsidies, price controls, trade restrictions, social safety nets, and supply side interventions. Civil service wages have been increased in most countries during 2007-08. Since the exchange rates of most oil exporting countries are pegged to USD, their monetary policy has generally been guided by US policies. Most central banks lowered interest rates following the monetary easing in the US spurring strong private credit demand and forcing several central banks to raise reserve requirements and expand open market operations to mop up liquidity.

Overall, the economic outlook for Middle East oil exporting countries remains favorable with no deceleration in expected growth in 2008. In addition, large investments and strong private consumption are likely to support buoyant growth.

Asia Pacific region

Among the countries of advanced Asia, rising commodity prices, weakening external demand, and diminishing profit expectations have adversely affected the growth prospects in Japan and recent projections indicate substantial slowdown in economic growth from 1.5 percent in 2007 to 0.5 percent in 2008 and further to (-) 0.2 percent in 2009. The growth prospects in developing Asia have also been adversely affected with a decline in projected economic growth from 10.0 percent in 2007 to 8.3 percent in 2008 and to 7.1 percent in 2009. Economic growth in China is projected to slow down to below 10 percent in 2008 and 2009 (9.7 percent and 8.5 percent respectively), first time since 2002. India's growth is also projected to slow down in 2008 and 2009. Although investment and consumption growth has been somewhat steady, the countries in developing Asia are likely to face more weaknesses in response to slowing demand from advanced countries and growing strains on financial markets mainly due to increasing concerns about the global outlook and declining investor risk appetite.

Weakened global growth prospects

The recent developments thus indicate that global growth prospects have deteriorated over the past few months leading to downward revision of global growth rate in 2008 and substantial reduction in projected growth in 2009. Moreover, the global growth slowdown is mainly due to significant downturn in economic activities in the advanced economies where output is projected to grow at only 1.4 percent in 2008, more than one percentage point lower than in 2007. The year 2009 is projected to be worse, when output is forecast to contract in advanced countries. Since nearly 87 percent of Bangladesh's exports are destined to markets in advanced countries, such growth slowdown could have important implications on the demand for exports, especially that of RMGs, in these countries. Remittances, on the other hand, is likely to be less affected by adverse growth prospects since less than 30 percent of the remittances originate in advanced countries (mostly USA and Europe) while nearly 63 percent come from the Gulf region where growth prospects are likely to be slightly lower in 2008 and 2009 compared with 2007. Moreover, these forecasts are based on current policies. Ongoing and future global actions to support financial markets and provide further fiscal stimulus and monetary easing can help limit the decline in world growth. The sharp slowdown in global growth has already created visible effect on commodity prices including food, oil, and metals in the global market. The effect on a particular country, however, is complex. Bangladesh, for example, benefits from the drop in oil and food prices but is set to lose from any decline in the prices of exportable commodities especially RMGs and remittance inflows.

Recent Global Developments

In the backdrop of high inflation driven by a surge in commodity prices, the world economy is entering a major downturn resulting from the deep financial crisis that originated in the mature financial markets. Along with substantial growth slowdown, the global economic situation is highly uncertain and subject to considerable downside risks. A modest recovery is likely to begin in late 2009 but would be gradual when it comes.

At present, the weakening demand is causing inflationary pressures to decline in the world economy. The index of consumer prices in advanced economies is projected to rise by 3.6 percent in 2008 compared with 2.2 percent rise in 2007 but the rate would be 2.0 percent in 2009 (IMF 2008b). In emerging and developing economies, similar projections indicate a higher rise of 9.4 percent in 2008 relative to 6.4 percent in 2007 but a lower rate of 7.8 percent in 2009. The decline in commodity prices is most notable in energy prices, falling by more than 50 percent since the peak in July 2008 despite the decision by the Organization of Petroleum Exporting Countries (OPEC) to cut production.¹¹ Inflation has moderated in many countries since July 2008, in part reflecting falling, but still elevated, commodity and energy prices (Table 4).¹² However, high inflation risks are still present in many countries emerging mainly from local supply conditions, salary/wage adjustments, and high inflation expectations.

Table 4: Movement of Consumer Prices Inflation

	2000-04	2005	2006	2007	End period 2007	Oct 08 proj.	
						2008	2009
Advanced Economies	1.9	2.3	2.4	2.2	3.1	3.6	2.0
Euro area	2.2	2.2	2.2	2.1	3.1	3.5	1.9
Germany	1.5	1.9	1.8	2.3	3.1	2.9	1.4
France	2.0	1.9	1.9	1.6	2.8	3.4	1.6
Italy	2.5	2.2	2.2	2.0	1.8	3.4	1.9
Spain	3.2	3.4	3.6	2.8	4.3	4.5	2.6
United States	2.6	3.4	3.2	2.9	4.1	4.2	1.8
Japan	-0.7	-0.3	0.3	...	0.7	1.6	0.9
United Kingdom	1.2	2.0	2.3	2.3	2.0	3.8	2.9
Canada	2.4	2.2	2.0	2.1	2.4	2.5	2.1
Developing Asia	2.7	3.8	4.2	5.4	6.3	7.8	6.2
China	1.1	1.8	1.5	4.8	6.6	6.4	4.3
India	3.9	4.2	6.2	6.4	5.5	7.9	6.7
Middle East	5.3	6.2	7.0	10.6	11.4	15.8	14.4

Source: IMF 2008b

Nevertheless, several factors are likely to pave the way toward gradual recovery of the world economy starting in 2009:

- Likely stability of commodity prices in the world market, although at 20-year high levels, leading to the start of the unwinding process of adverse terms of trade effects especially in oil importing countries.

¹¹ The IMF, in its World Economic Outlook (WEO) Update published on 6 November 2008, has revised down the petroleum price projection for 2009 to USD 68 a barrel from USD 100 in WEO October 2008.

¹² In the US, appreciation of USD against major currencies like euro and pound is also helping to contain inflationary pressure. The Japanese yen is appreciating against USD. In recent times, USD and yen have been heavily borrowed against due to their low interest rates to buy higher yielding currencies. The appreciation of these two currencies have also been fuelled by the expectation that interest rates in Europe will be cut further in response to the emerging economic downturn.

- End of the intense drag on US growth by the housing sector present since 2006 leading to the start of the recovery cycle of the financial sector and creating positive effect on global financial system and world economy.
- High resilience and relatively unaffected status of the emerging economies providing the momentum to recovery for the global economy.

Developments in Bangladesh Economy

Despite adverse effects of recurrent floods and cyclone (Sidr) and negative price developments in the global market, most macroeconomic indicators of the Bangladesh economy remained stable in FY08 (Table 5). Real GDP grew at 6.2 percent and fiscal deficit was robust in terms of South Asian standards. Although the inflation rate was high, the overall outcome of the monetary policy was positive especially in ensuring adequate flow of credit to redress supply shortages in the economy and boost private sector activities. The money market and the foreign exchange market remained mostly stable. Despite a surge in trade deficit resulting mainly from a robust import growth, healthy growth in workers' remittances and higher external aid flows provided a cushion to the external balance and helped to maintain a comfortable international reserves position. The growth prospects in FY09 are reasonably good and analysis at the Policy Analysis Unit (PAU) of Bangladesh Bank shows that Bangladesh would achieve GDP growth in the range of 6.2 percent and 6.5 percent in FY09.

Bangladesh experienced an average inflation of 9.9 percent in FY08 and recent forecast by PAU shows that the inflation rate is likely to remain in the range of 8.5 percent and 9.0 percent in FY09. Although food inflation has eased, nonfood inflation has shown rising tendency in recent months. The present expectation is that food inflation would decline in the coming months, and with a weight of nearly 59 percent of food items in the consumption basket, this would generate significant moderating effect on the overall inflation pressure. At present, increase in costs seems to have fed into nonfood prices and passed along the supply chain driving up nonfood inflation. But so long as prices in the global market stabilize at their new higher levels, their direct impact on inflation should wash out after a year. In other words, by late 2009 these items would not be making much contribution to the rate of consumer price inflation. Nevertheless, inflation rates are likely to remain relatively high during the first half of FY09 due to non-monetary factors such as adjustments resulting from rise in administered fuel prices (although fuel prices have been reduced recently, these remain higher than previous levels), lagged effects of past global price hikes, domestic market adjustments to expected global shocks, and unexpected supply bottlenecks for specific commodities in the backdrop of tight and potentially volatile world market for food and other commodities.

Since reasonable price stability is one of the principle objectives of the country's monetary policy, the compulsion would be to bring inflation down further keeping in view the complexities of globally transmitted inflation and the need to conditioning perception of inflation in the range of 5.5 percent and 6.0 percent in the next 2/3 years so that an inflation rate of around 4.5 percent can emerge as the medium term objective. This is needed to ensure smooth integration of the domestic economy into the global economy and pursue the goal of sustained high growth over the medium term.

In the medium term, the real upside risks to inflation lie in high inflation expectations of financial markets, price setters, and households. Raising interest rates can in time bring inflation down even when expectations of future inflation are high. But the process is painful as it works through increased threat of lowering growth and rising unemployment. Thus the risk of inflation expectations drifting up is a central concern for monetary policy at present. Although the near term expectations of inflation might have risen this year, but this is inevitable given the country's inflation experience in the recent past. What matters now is the expectation of inflation over the medium term. The important concern for policy is to create a gap between people's perceptions of current inflation and their expectations of a year or more ahead so that medium term expectations fall back.

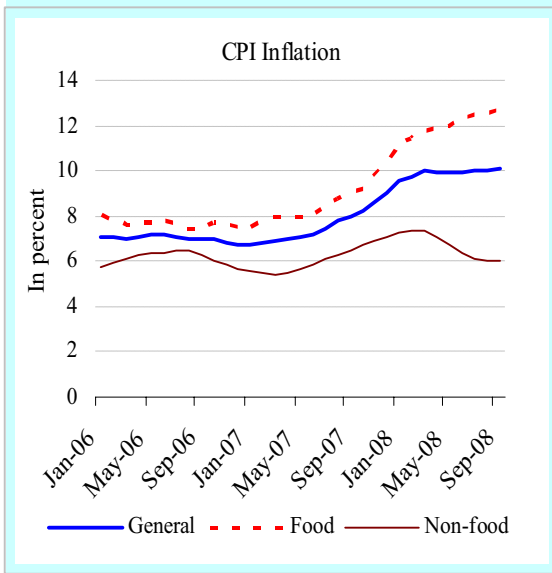
In the external sector, Bangladesh suffered significant loss of income from severe terms of trade shock mainly originating from higher food and petroleum prices. Between January 2003 and May 2008, the loss was 7.7 percent of GDP (food 3.1 percent; energy 2.6 percent) for all commodities compared with 9.5 percent for India, 11.3 percent for Pakistan, and 10.2 percent for Sri Lanka (WB 2008b). This large loss of income, however, was largely met by compensating growth in remittances and Bangladesh enjoyed a surplus in its current account balance.

Table 5: Trends in Major Macroeconomic Indicators

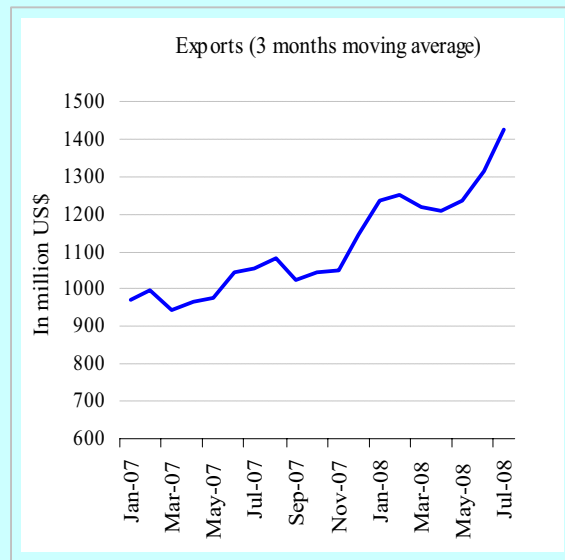
	FY06	FY07	FY08	FY09 target/proj.
<u>Growth (percent)</u>				
Real GDP	6.6	6.4	6.2	6.2-6.5
CPI Inflation (annual average)	7.2	7.2	9.9	8.5-9.0
Broad money (M2)	19.3	17.1	17.6	17.5
Private sector credit	18.9	15.8	24.9	18.5
Exports	21.6	15.7	15.9	15.5
Imports	12.1	16.4	26.1	21.0
Remittances	24.8	24.5	32.4	24.0
<u>As percent of GDP</u>				
Domestic savings	20.3	20.4	20.1	20.2
Domestic investment	24.7	24.5	24.2	24.4
Budget deficit (except grants)	3.9	3.6	4.9	5.0
Current account balance	1.3	1.4	0.9	0.7
<u>Exchange Rate</u>				
Nominal (BDT/USD)	69.7	68.8	68.5	68.5
REER (Base FY01=100)	83.9	86.6	86.2	...
<u>In billion USD</u>				
Remittances	4.8	6.0	7.9	9.5
Gross official reserves	3.5	5.1	6.1	6.0

Source: Bangladesh Bank, Bangladesh Bureau of Statistics, and Ministry of Finance

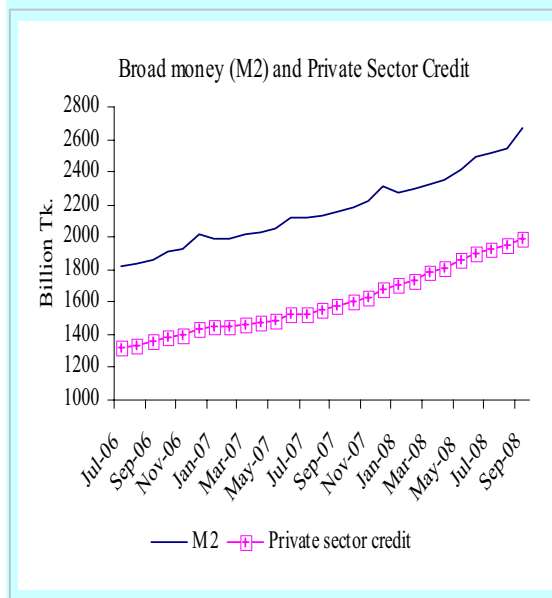
Figure 2: Developments in Bangladesh Economy



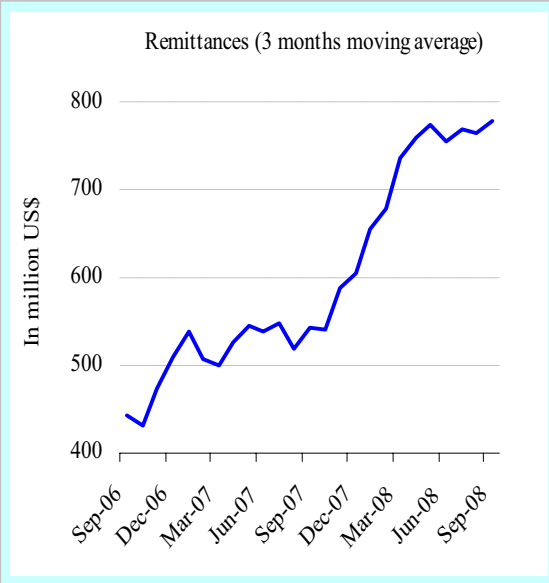
Source: Bangladesh Bureau of Statistics



Source: Export Promotion Bureau



Source: Bangladesh Bank



Source: Bangladesh Bank

Obviously, the easing of the adverse external environment emanating from global price developments has been clouded by the present global financial crisis posing downside risks to Bangladesh. The potential channels of transmission of these risks are multiple. The financial risks include the lower foreign capital flows including the inflow of foreign aid. In addition, a number of risks on the real sector emanate from global slowdown in growth covering adverse effect on exports, possible downward pressure on remittances, and slowdown in investments and growth.

3. Financial Crisis and Bangladesh Economy: Potential Implications

Bangladesh's exposure to the contagion effects of the global financial markets has been low. The country's financial sector has achieved reasonable resilience mainly due to the implementation of financial sector reforms since the 1990s. These reforms have led to significant improvement in the regulatory framework along with rapid development of financial sector activities and improved health of the financial system. For managing credit and liquidity risks in the financial market and promoting healthy competition and efficient performance, Bangladesh Bank has been providing prudential guidelines and implementing reforms for ensuring proper financial regulation and supervision.¹³ In the backdrop of continuous efforts that are being made toward promoting a robust financial sector, Bangladesh's financial sector remained largely immune to the recent global financial sector turmoil.

Moreover, capital control exists in Bangladesh which insulates the economy to a large extent from the risk of transmission of financial crisis from abroad. So far, the adverse effect on capital flows from portfolio and foreign direct investments has been minimal. Similarly, the exposure of domestic financial institutions to troubled international financial institutions is extremely limited. The increased volatility and losses in the stock market in recent weeks represent short term developments which have resulted mainly from shaken confidence of market participants and are mostly temporary in nature. Bangladesh Bank has been pursuing prudent policies to ensure effective exchange rate management and provide required liquidity to the financial sector.¹⁴ The financial risks are also low due to satisfactory macroeconomic performance, relatively good health of the financial sector, and its limited exposure to foreign capital markets.

Overall, Bangladesh's recent macroeconomic policies have been prudent toward ensuring a robust external sector. At present, the balance of payments is reasonably satisfactory which has been facilitated by rapidly rising remittances and prudent demand management. Over the July-September 2008 period, the nominal effective exchange rate (NEER) depreciated marginally while the real effective exchange rate (REER) index appreciated. The REER based exchange rate shows that Taka remained undervalued by around 10 percent during September 2008 against major trading partners (Table 6). The table shows that although REER based exchange rate rose in September 2008, the nominal effective exchange rate is still higher than REER based exchange rate indicating that Bangladesh enjoys some export competitiveness. In the present situation, proper management of the exchange rate is critical since any undue movement can harm the exporters through raising costs by increasing domestic prices of imported raw materials since the exporters (especially RMG exporters) have limited scope to increase prices in the presence of sharp competition.

¹³ Bangladesh Bank, for example, has taken steps for fulfilling the Basel II norms of capital adequacy in a time bound manner. For details, see Bangladesh Bank 2008a.

¹⁴ For details, see Bangladesh Bank 2008b.

Table 6: Recent Movements in Bangladesh's Nominal and Real Exchange Rates

Year	Month	Nominal exchange rate (Tk/USD)		REER index	REER based ER		Competitiveness		Percent of under/over valuation	
		Period avg	End period		Period avg	End period	Period avg	End period	Period avg	End period
2007	Mar 07	68.94	68.80	85.12	58.68	58.86	10.26	9.94	-14.88	-14.45
	Jun 07	68.94	68.80	86.55	59.67	59.55	9.27	9.25	-13.45	-13.44
	Sep 07	68.70	68.71	86.86	59.67	59.68	9.03	9.03	-13.14	-13.14
	Dec 07	68.58	68.57	85.37	58.55	58.54	10.03	10.03	-14.63	-14.63
2008	Mar 08	68.56	68.58	82.72	56.71	56.73	11.85	11.85	-17.28	-17.28
	June 08	68.52	68.53	86.22	59.08	59.09	9.44	9.44	-13.78	-13.77
	Sep 08	68.52	68.52	89.96	61.64	61.64	6.88	6.88	-10.04	-10.04

Source: Policy Analysis Unit and Monetary Policy Department, Bangladesh Bank.

During FY08, food prices made a bigger impact on inflation than fuel prices. As prices of most food items have declined in the international commodity market in recent months, some pass through impacts are observed in the domestic economy. However, high inflationary pressure still exists reflecting, in addition to supply side factors, the rise in inflation expectations and lagged effects of high prices of essential imports in the international market. The average rate of inflation stood at 10.1 percent in September 2008 compared with 9.9 percent in June 2008. Inflationary pressures, however, are coming down and inflation is likely to lower from its current level in the coming months. The fiscal deficit remains manageable. In July-August 2008, total deficit financing amounting to Tk. 16.4 billion was accommodated through Tk. 0.7 billion from domestic sources including bank financing of (-) Tk. 5.9 billion and non-bank financing of Tk. 6.6 billion and Tk.15.7 billion from foreign sources.

The financial sector has maintained a good health due to past reforms and is highly insulated from foreign markets. The non performing loans are declining, the capital base is relatively comfortable, and Bangladesh Bank continues to pursue pro-active monetary and exchange rate management. External debts are low and reserves are comfortable. In addition, a reasonably high domestic savings rate (around 20 percent of GDP) provides added cushion. However, the main downside risk on the financial sector is a reduction in foreign capital flows, including for the government. Overall, under the existing circumstances, the current global financial crisis is not likely to have any significant effect on the country's financial sector. In summary, the strengths and weaknesses of the financial transmission channel in relation to the global crisis are:

- Bangladesh's foreign exchange reserves (held by Bangladesh Bank and the commercial banks) have remained well managed; kept mostly in cash, US Treasury securities, accounts with central banks, and in sovereign bonds.¹⁵ Thus with very limited exposure to the securities markets and commercial banks,

¹⁵ On 13 November 2008, BB's foreign exchange reserve holding was about USD 5.1 billion. The commercial banks together had about USD 400 million in various US banks in September 2008 and the amount runs some risk if these banks are downgraded. With no holding of any corporate bond, the country's financial sector has very little exposure to the global market.

foreign reserve holdings are insulated from the turmoil in the financial markets in the US and EU countries.

- Bangladesh's capital account remains nonconvertible with few private transactions permitted such as foreign direct investment (FDI) and portfolio investment. The net inflow of FDI has remained relatively stable in recent times whereas private debt transactions are limited and strictly monitored by Bangladesh Bank. Capital flows take place mostly in terms of concessional lending and FDI constituting around 2 percent and less than 1 percent of GDP respectively. Capital flows in the form of portfolio investment is minimal. Thus the financial sector is largely insulated from the risk of transmission of financial crisis from abroad.
- Bangladesh has a positive current account balance that reduces the risks emanating from short run fluctuations in the exchange rate and foreign reserve situation.
- The country's financial sector has reasonable resilience and is relatively immune to the current global crisis. The financial institutions are not exposed to complex financial derivatives and synthetic securitization instruments. As such contagion effects of the global financial markets are non-existent. There is no sign of any crisis of confidence or liquidity problem. Prudential regulations and strong monitoring by Bangladesh Bank has ensured a relatively good health of the banking sector including lending-deposit ratio within acceptable limits.
- Bangladesh's banking system is well placed to weather the short term effects of the global financial crisis as it has a generally sound health underpinned by prudent regulation and sound management. The banking system is mostly separated from international financial markets, and does not have sophisticated financial products.
- In view of the grave market uncertainty especially in the advanced economies, one potential threat for the banking sector is the likely incidence of payment default by foreign buyers against export orders, especially of RMGs, in the event of their going bankrupt. Similarly, some foreign buyers may enhance the volume of their orders and face difficulty in settling deferred payments in the event of their becoming bankrupt.

Major Transmission Channels

Although the financial sector is expected to remain largely immune to the global financial crisis, Bangladesh's exposure to real economy effects of the financial crisis is likely to be greater through exports, remittances, and foreign capital inflow channels. The major source of the potential adverse impact is the projected slowdown in growth in advanced economies resulting in a fall in consumer expenditures which comprise around two-thirds

of total incomes in these countries. Recent trends in exports, imports, remittances, and net inflow of foreign aid are given in Table 7.¹⁶

Exports and imports

For Bangladesh, the composition of exports makes export sector the most vital transmission channel of the effects of recent global financial developments. Two features contribute significantly toward increasing the export sector vulnerability: first, high dominance of RMGs in total export earnings; and second, almost entire reliance of Bangladesh's RMG exports on US and EU markets. With growth slowing down in the country's major export markets (especially in USA and EU) and in view of the pessimistic projection that growth in these as well as in most other advanced economies is likely to become negative in 2009, export prospects could be lower for Bangladesh.

The data on exports are available only for the first two months (July-August) of FY09 which show that total exports as well as RMG exports have maintained robust growth over the same period of the last fiscal year.

This, however, does not reflect the fuller impact of the financial crisis in these markets which are yet to be transmitted. For Bangladesh, a number of factors are important in determining the net impact on its exports. First, given the overwhelming dominance of RMGs in the export basket, the impact on RMGs would determine the impact on Bangladesh's exports. In view of the low share of other export items like leather products, frozen shrimps and fish, and tea in the world market, it is unlikely that these products would face a much adverse situation due to the current financial crisis. Second, since Bangladesh's RMG exports mainly cater to the low-price segment of the apparel market where income elasticity is lower than that in the high-price segment, the current slowdown may create less impact on the country's RMG exports. With incomes falling, even some diversion of demand from high-end garment segment to low-end segment may take place counterbalancing the otherwise negative impact.¹⁷ Third, considering the

Table 7: Changes in Global Crisis Transmission Channels

	Million USD		
	Jul-Sep 2008 ^p	Jul-Sep 2007	% change
<u>Total exports¹</u>	2,903.8	2,032.8	42.9
<u>RMG exports</u>			
Knitwear	1,210.1	791.8	52.8
Woven	1,033.2	762.2	35.6
<u>Import LC settlement</u>	5,931.4	4,491.2	32.1
Consumer goods	393.4	557.3	-29.4
Intermediate goods	489.2	346.5	41.2
Industrial raw materials	2,474.9	1,763.3	40.4
Capital machinery	423.7	366.9	15.5
<u>Remittances²</u>	2,985.3	2,187.8	36.5
<u>Net Aid Inflow¹</u>	229.0	28.3	709.1

Note: 1. Data refer to July-August only. 2. Data cover July-October period. P: provisional

Source: Bangladesh Bank and Export Promotion Bureau.

¹⁶ The change in many of the indicators, however, needs to be interpreted with caution since their values in July-September 2007 were not normal due to economic disruptions resulting from successive floods during the time.

¹⁷ Some RMG exporters are optimistic regarding riding out the current storm with such possibilities. However, if consumer spending drops significantly, it is more likely to undermine Bangladesh's RMG

current growth forecasts, the critical period is the second half of FY09 when recession in advanced economies would probably reach lowest levels. Fourth, in the export sector, new dimensions are likely to creep into price negotiations especially if the major purchasers of RMG products move to take advantage of the market situation.¹⁸ Fifth, in view of the country specific changes due to the crisis and other developments, it is likely that RMG importers in advanced economies (especially in USA and EU) may introduce adjustments in sources of procuring apparel products which may compensate Bangladesh's negative effects on RMG exports by enabling it to capture greater market shares in these countries.¹⁹ Thus, opposing forces are likely to work in RMGs export sector and the net impact would determine the final outcome.

In the case of imports, the prospects are likely to favor Bangladesh through lowering the growth of import bill. In the international market, prices of commodities for which Bangladesh is a net importer (especially food, oil, fertilizer, and other essential products) have experienced significant decline in recent months.²⁰ The settlement of LCs for consumer goods declined by more than 29 percent during July-September 2008. The opening of new LCs for consumer goods during the period declined more sharply showing improved domestic supply conditions (especially of rice) and benefits of global price declines.²¹

Remittances

The overall remittance inflow is unlikely to be much affected since the bulk (63 percent) of the remittances originates in the Gulf region where growth prospects, as noted earlier, are mostly unchanged in 2008 and projected to lower marginally in 2009. Remittances from advanced economies (especially from USA, UK, and Germany which together account for 29 percent of the total) could be adversely affected if the recession prolongs and job cuts persist. It is difficult, however, to predict the net impact since the low-skilled jobs in which Bangladeshi migrant labor is mostly concentrated are likely to be less affected from the growth slowdown. Moreover, the resilience shown by remittance inflows to Bangladesh to past changes in economic growth in major remittance sending countries gives some hope of optimism. Over the first four months (July-October) of FY09, remittances grew by 37 percent over the same period of the previous fiscal year

exports. The BGMEA and BKMEA, relevant manufacturer and exporter associations, have reported slowdown in export orders below trends in recent months mainly due to sluggish retail sales in the US.

¹⁸ There are reports that top buyers of Bangladesh's RMG exports are renegotiating prices, asking for rebates on existing orders, and delaying orders to take advantage of RMG market developments.

¹⁹ There are reports that many US and EU importers, who earlier sourced apparels mostly from China, Indonesia, and Sri Lanka, are diverting parts of their orders to Bangladeshi suppliers due to many reasons. If Bangladesh can successfully allure more orders, the potential reduction in orders from traditional buyers can be more than compensated by new orders.

²⁰ The price of rice was 36 percent lower in October 2008 than its peak in April 2008, that of crude oil 40 percent lower in October relative to its peak in July, and the price of urea was 48 percent lower in October than its peak in August.

²¹ However, one concern which has baffled the importers of essential products is the anticipated loss on their stocks imported at higher prices earlier. For the financial sector, this could lead to rise in default on borrowings against those imports and the banks should monitor the situation carefully and take appropriate actions.

showing strong growth.²² Information by country/region during July-September 2008 shows that remittances grew from all regions/countries except Germany and UK (Table 8).

Aid inflows and foreign direct investments

The aid budget in advanced economies (especially in USA and European countries) is under pressure due to their reduced ability to sustain recent levels of foreign aid resulting from debt overhang and weak fiscal positions created by the financial crisis and slow growth. As a result, the aid budgets of these countries are coming under increased pressure which would particularly affect the flow of bilateral aid to recipient countries. Over the first two months (July-August) of FY09, net aid inflow to Bangladesh has increased by more than seven-fold to USD 229 million over the same period of the previous fiscal year. Moreover, Bangladesh's aid mostly comes from multilateral sources

(nearly 80 percent of the total) while the share of bilateral aid is 20 percent. Nevertheless, Bangladesh's prospects of expected large increases in aid in FY09 may be weakened.

Tighter global credit markets have raised the cost of capital in the international market and are likely to reduce foreign direct investment (FDI) in developing countries. Bangladesh, however, has little FDIs. As commodity prices fall in the world market, FDIs in commodity-based projects for which prices have fallen may appear less profitable making foreign private investments in these projects less attractive. On the other hand, since most FDIs in Bangladesh are longer term in nature, the current financial crisis is unlikely to have an immediate impact. The full impact would only be clear when investors begin to assess longer term investment decisions depending on global growth prospects and price developments.

Potential Implications

The Bangladesh economy has so far sustained its regained momentum after the natural disasters last year and current indications are that the economy is on track in terms of major macroeconomic fundamentals. This review shows that the unfolding financial crisis ravaging the global economy has several downside risks for the Bangladesh

Table 8: Remittance by Region/Countries

Country/region	Million USD		% change
	Jul-Oct 08	Jul-Oct 07	
Total	2,985.3	2,187.8	36.5
Gulf Region	1,952.4	1,371.3	42.4
Saudi Arabia	894.3	611.2	46.3
UAE	465.2	301.1	54.5
Kuwait	329.7	253.6	30.0
Qatar	111.0	88.3	25.6
Oman	89.4	78.7	13.6
Bahrain	61.8	37.1	66.5
Europe			
U.K.	268.9	290.8	-7.5
Germany	6.7	7.8	-13.9
Asia Pacific Region			
Singapore	44.4	30.8	44.2
Malaysia	53.8	5.9	813.9
Japan	5.3	4.0	31.4
Rest of the World			
USA.	517.9	360.7	43.6

Source: Bangladesh Bank

²² Information by month, however, shows decline in growth rates. Over the same month of the previous year, the growth rate was 45 percent in July, 53 percent in August, 35 percent in September, and 17 percent in October this year.

economy. However, significant uncertainty still surrounds the nature, scope, severity, and duration of the crisis so that it is extremely difficult to derive quantitative assessment of the impact of the crisis on the Bangladesh economy. Nevertheless, the analysis brings out following major areas of concern in which timely action is required to minimize possible negative impacts.

- Bangladesh's export sector (especially RMG export) is most vulnerable to the fallout effects of the financial crisis. Despite positive growth in 2008, economic growth in two of the country's major export destinations (USA and EU) is bleak in 2009. This might affect both Bangladesh's export volume and export prices (although, as mentioned above, opposing forces are more likely to work with the net impact on export earnings depending on success in addressing the underlying factors), but the impact on export prices is likely to be dominant in view of the country's concentration of exports into low-priced products in the RMG sector. Since the RMG sector accounts for about 40 percent of the country's manufacturing output and provides support to a variety of ancillary industries and services, analysis at PAU shows that, in the event of deeper slowdown in this dominant export industry, GDP growth would reduce to the lower bound (6.2 percent) of PAU projection for FY09.
- In the event of prolonged recession in the advanced economies, remittance growth from these countries may face temporary setback. The short run impact on remittances is not likely to be significant especially due to the nature of employment of most expatriate Bangladeshis and the dominant utilization pattern of remittances in the domestic economy.
- External balances are likely to remain reasonably satisfactory even under the pessimistic scenario of strong adverse impact on export growth and slower growth in remittances. Import payments are likely to record a slower growth in FY09 relative to the strong growth observed in FY08 resulting in a narrower trade deficit. In that event, current account surplus would be lower than the base projection of 0.7 percent of GDP.
- The potential adverse effects on the real economy need careful assessment. More importantly, several direct and indirect social impacts may set in requiring action and policy support to minimize the negative implications especially on the poor. In the backdrop of high inflation, the erosion of purchasing power and devaluation of savings and asset values of the poorer groups (as they hold a larger share of their assets in liquid form compared with the non-poor) and constrained hedging capacity due to their limited access to the financial system need countervailing measures to protect their real worth and purchasing capacity. The real sector impacts may also have important implications for the labor market and employment prospects especially on the key challenge of creating remunerative and decent jobs for the educated youth through rapid expansion of productive and skill intensive formal and informal sector activities.

4. Conclusions and Policy Responses

As the above analysis shows, the low level of global integration has somewhat shielded the Bangladesh economy from the current financial turmoil. In particular, the relative insulation of the country's capital market and limited role of foreign portfolio investment, supported by reasonably strong macroeconomic fundamentals and strengthened policy and management frameworks have ensured resilience of the Bangladesh economy to the ongoing financial crisis and resulting global growth slowdown and other consequences. The country's banking sector is free from exotic or toxic derivatives and the off-balance sheet items comprise mostly basic swap contracts with no risk of sustaining unexpected losses. With low level external debt (about 30 percent of GDP and consisting mostly of concessional loans from multilateral financial institutions), strong foreign reserves, and low FDIs, the country is not likely to face any perceptible asset quality problem and credit crunch in the event of any future external shocks.

The analysis also reveals that the economy is not fully immune to the global crisis and the potential effects are likely to percolate through indirect channels mainly emerging from global growth slowdown. The transmission mechanisms are likely to work through exports, remittances, and aid and capital inflow channels. The major source of vulnerability is the export sector and its (especially of RMGs) very high dependence on markets of advanced economies. Although remittances are not likely to be affected in the short term, some pressure on remittance inflows may arise if the recession deepens and persists for a longer period in the advanced economies and Middle Eastern economies slowdown due to decline in oil revenues. Aid inflows are likely to remain unaffected in the short run although the promises of significant aid increase may not materialize up to the expected levels.

Strengthen the trade sector

Bangladesh's exports have grown at a robust rate averaging more than 15 percent in recent years; and temporary declines in export performance, if that happens, are not unusual since not much can be done about demand changes in the importing countries. Nevertheless, appropriate response in the face of a possible slowdown in export demand should include:

- For RMGs, orders are not likely to dry up in the Western markets. However, situations may arise in which the buyers may ask for longer credit periods and other facilities. In order to meet such exigencies, if required, Bangladesh Bank can issue directives to banks to provide pre- and post-shipment credits for longer periods and allow rescheduling of loans.
- Based on assessments in future, the government may come up with an assistance package for the export sector if the situation demands after identifying vulnerable activities/sectors for adopting proper mitigation strategies.
- The best way of providing assistance to the RMGs sector is to enhance the efficiency of customs, ports, and infrastructure, as producers/exporters need cost-cutting measures to stay competitive. The government may also consider holding off increases in power and gas tariffs for now. For increasing

productivity, this is the time to install and strengthen safety net programs for garment workers through public-private partnerships.

- Along with remaining vigilant regarding price competitiveness, more efforts are needed toward diversifying the export basket, adding more value added products to export items, and exploring new markets in order to expand both export products and destinations. For the RMG sector, it would be critical to ensure smooth and production friendly environment and uninterrupted access to power and other inputs to retain competitiveness.
- Implement measures to tap the opportunity created by the just-started process of diverting fresh apparel orders from US and EU importers who earlier sourced apparels to China and other countries to enhance Bangladesh's market share.
- Adopt a comprehensive export (including export of services) promotion program to expedite the implementation of short and medium/long term export promotion measures employing a product and country specific approach.
- The newly elected US President's economic agenda of tagging labor and environmental standards with trade, although unlikely to affect the volume of transactions in the near term, is an area of concern for Bangladesh. Bangladesh needs to be well prepared to adopt appropriate strategy since the issue, though dropped from the ongoing Doha negotiations within the WTO, is likely to be brought back by US when the current round concludes.
- Since much of the remittances come from low skilled workers from oil-rich countries of the Middle East, their remittances do not face much immediate risk as these economies have accumulated large reserves from the oil price boom and, in real terms, oil prices are still higher than in 2002. The fall in oil prices might partially wipe out the windfall gains, but the massive programs of modernization and infrastructure buildup in the region are likely to be tempered but not halted. As such, migrant workers from Bangladesh would continue to be in demand. However, new recruitments might be slowed down. Remittances from USA and Europe could face modest but temporary setback. As such, Bangladesh's policy priority should be to resolve the hurdles facing expatriate workers at home and abroad and explore new markets especially for skilled technical and service workers.

Pursue prudent monetary policy

The Bangladesh Bank should continue to pursue its present prudent monetary policy measures keeping in view the rising downside risk of slowing economic activity as external conditions deteriorate and inflation starts to moderate. If exports and remittances witness good growth and import payments slowdown due to declining food and oil prices in the global market, net foreign assets of the banking system can become a major source of liquidity expansion. This would also have implications for exchange rate stability. It would then be appropriate to adopt a combination of actions for managing the potential liquidity situation. In this context, the major concern is to ensure that high inflation does not enter into the medium/long term expectations of economic agents and become a permanent feature of the economy. It would therefore be important to:

- Balance the concerns about inflation on the one hand and ensuring adequate liquidity in the financial system on the other through signaling Bangladesh Bank's intention of limiting undesired credit expansion and ensuring adequate flow of credit to productive activities. The priority should be to correct the short term debt yield curve and 'plan for tomorrow' especially in terms of dampening inflation expectations and ensuring price stability.
- Continue the current policy of providing adequate credit support to agriculture, small and medium enterprises (SMEs), and other productive sectors which are primary sources of job expansion and take measures to ensure improved functioning of the credit markets and payment systems.

Gear exchange rate policy toward fighting inflation

In recent months, there have been some sharp cross-rate movements through strengthening and weakening of currencies of Bangladesh's major trading partners the impact of which on the country's export competitiveness is an issue that needs careful consideration. In adopting an appropriate foreign exchange policy, Bangladesh needs to take into account a number of considerations including (i) direction of trade covering both origin of imports and destination of exports; (ii) industry composition of trade flows; and (iii) origin of capital inflows especially remittances. The analysis in this report shows that, although Bangladesh's real effective exchange rate has somewhat appreciated in recent months, Bangladesh still enjoys competitiveness. In addition, since the exchange rate issue has inflation dimension, Bangladesh needs to confront the challenging tradeoff between keeping inflation down and achieving better competitiveness through exchange rate management. Any improper exchange rate adjustment can harm even the exporters, if this raises costs through increasing domestic prices of imported raw materials especially in the presence of limited scope for exporters to raise prices due to sharp competition in the world market for Bangladesh's major exportables. A better policy to support export growth could be to reduce the cost of doing business, and ensure smooth and production friendly environment along with uninterrupted access to inputs to improve competitiveness especially of the RMG sector. The present circumstances and the current state of macroeconomic fundamentals do not provide enough justification of pursuing any policy of letting the exchange rate to depreciate to any significant extent. Besides, any large depreciation of Taka is not likely to increase Bangladesh's exports appreciably in the present global situation. On the other hand, it might adversely affect the country's gradually improving domestic growth prospects through raising import cost of capital goods and other essentials. Therefore, it would be important to:

- Keep a close watch on exchange rate movements of currencies of Bangladesh's close competitors in the export market and assess the pressure on the country's current exchange rate policy of maintaining reasonable exchange rate stability and Bangladesh's competitiveness.
- With priority to reducing inflation expectations and the inflation rate from its current double digit level, avoid market interventions aimed at depreciating Taka to any large extent. This will help evade any dilution of the pass through of declining global commodity prices to domestic prices and strengthen the depressing effect on inflationary pressures.

Consolidate the fiscal balance

The fiscal sector had to withstand significant pressure in the last year due to rapidly rising cost of subsidies and other current expenditure. In view of the large demands for public funds that are already accommodated in the FY09 budget, it would be prudent to:

- Prepare an action plan to create some fiscal space to respond to any downturn in economic activities or external shocks due to the ongoing global crisis.
- Plan to accommodate, if necessary, additional fiscal support to expand safety nets and provide assistance to the exporters especially RMG exporters.
- As a sensible and quick response, trim low priority expenditure and improve revenue collections to help protect fiscal positions and the government's ability to respond when needed.
- Rationalize tariffs/duties on imports of nonessential/luxury goods and similar goods produced locally as a means of increasing the fiscal base as well as to support priority domestic production.

Revisit financial sector management

Although relatively well protected from the direct effects of the global financial crisis, Bangladesh's banking sector would probably face more pressure over time. The loan quality may deteriorate and liquidity may reduce if economic growth slows. The Bangladesh Bank should carefully monitor liquidity conditions and other financial developments to take appropriate actions. Obviously, in view of the current experience, the longer term concern for Bangladesh would be to move toward a macro-prudential and regulatory architecture that is effectively integrated and involves needed coordination among all concerned agents including Bangladesh Bank. In this respect, the following issues deserve attention:

Short term measures

- Closely monitor the possibility of rising default on borrowings by importers against stocks of essential products imported at higher prices earlier due to anticipated loss on their stocks by falling world prices and take appropriate actions as necessary.
- Regularly monitor the trend in non-performing assets of banks since there is an apprehension that such assets might rise due to lower profitability of firms especially producing for the export sector. These sectors might face increased vulnerability due to decline in prices in the global market causing value crash of their current stocks. The chain effect may not only affect the industry but the financing banks may also face liquidity problems because of repayment defaults.
- Strengthen existing supervisory mechanism of the financial institutions and regularly (e.g. biweekly) monitor the key financial sector indicators and take remedial measures as required.
- If necessary, define minimum regulatory liquidity narrowly with a dominant role to cash in order to retain unquestioned liquidity in times of stress. There

should not be any undue economization in shares of cash and liquid assets in total assets of banks.

- Strengthen oversight of the banking system, apply social criteria to all lending, and prioritize lending to meet social needs and expand domestic productive capacity.
- Along with improving liquidity management of banks, put in place backstops at Bangladesh Bank that can be applied quickly and flexibly in the event of system-wide pressures.
- The existing minimum risk-weighted capital ratio may be assessed and, if necessary, may be raised with accompanying increases in the Tier I ratio and other parameters.
- In view of the potentially valuable service that the credit rating agencies provide, measures should be taken to improve the quality of output of these agencies. In particular, the need is to avoid mispricing of risk particularly in credit markets and ensure institutional and legal frameworks that would ensure that outputs do not get contaminated.
- Obviously the best path to achieving sustainable growth for Bangladesh is to pursue structural reform that has the capacity to lessen the downside of crisis, carry out needed adjustment to high food and oil prices that are likely to remain at historically high levels, improve rural productivity, and strengthen the supportive environment for private sector led growth and the economy's resilience to external events.

Medium/long term measures

- Rationalize the financial regulatory structure preferably in a manner such that the responsibility of all prudential regulation rests with a single agency. A similar approach should be followed for business conduct and consumer protection, and for financial market stability. The global financial crisis identifies a number of areas for strengthening prudential supervision, such as setting adequate capital requirements for some credit products and loan requirements, ensuring that investors and rating agencies assess products more diligently, reforming the legal framework for dealing with problem institutions, and strengthening supervisory framework and crisis management arrangements.
- Ensure good risk management for institutions and for the entire financial system. For an institution, a good risk management system should enable it to take risks and reap the returns ensuring exit at the first opportunity if the situation demands. For ensuring this, right capital and liquidity are important requisites to withstand any shocks if necessary through raising capital and liquidity buffers.

The present global financial crisis, unprecedented in recent times, shows that there is no substitute of prudent government intervention and careful regulation even when market determined incentive structures operate. The pursuit of free financial sector nostrums does not guarantee against moral hazard, adverse selection, and the financial institutions to cause systemic distress. This does not, however, mean that the financial sector should

be administratively controlled and not be allowed the freedom to innovate, compete, and use market based incentives. A liberalized, market based, and effectively supervised and regulated financial sector is necessary in order to promote and sustain rapid growth in Bangladesh.

In addition, the priority for Bangladesh is to improve the quality of information that the banks and other financial sector institutions put out and those collected by the regulatory agencies. Clearly, Bangladesh needs to plug the gaps in regulatory and supervisory infrastructures and strengthen its regulatory regime in a comprehensive manner covering all institutions dealing with both household savers and institutional investors in order to avoid the creation of any systemic distress. The important agenda for Bangladesh would be to convert the current global crisis into an opportunity in order to move forward.

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