Chapter 5

Macroeconomic Impacts of LDC Graduation and Strategies for Post-Graduation Adjustment

5.1. Bangladesh Long-term Development Goals

The long-term development goals are articulated in the Perspective Plan 2021 (PP2041). The PP2041 draws on the experience of implementation of Perspective Plan 2021 through the Sixth and Seventh Five Year Plans. It also draws on the analysis of the Bangladesh Delta Plan 2100 and the UN-initiated Sustainable Development Goals (SDGs) 2030. The Bangladesh Delta Plan 2100, the SDG objectives and the Perspective Plan (PP) 2041 have a number of common/shared development goals/objectives:

Goal 1: Eliminate extreme poverty by FY 2031

Significant progress has been recorded in the last one and half decade with the incidence of extreme poverty falling from 34.3% in 2000 to 12.6% in 2015. Building on this success in reducing poverty and extreme poverty and consistent with the objectives of SDG, the PP2041 aims to eliminate extreme poverty by FY 2031.

Goal 2: Achieve Upper-Middle- Income Country (UMIC) status by FY 2031

Delta Plan 2100 and PP2041 aims to attain the UMIC status by FY2031. Bangladesh has recorded significant gains in per capita GNI in the last one and half decade, with per capita GNI increasing by threefold during the period FY05 to FY15. Currently, Bangladesh's GNI per capita is more than $1900 and for the UMIC status the threshold would likely be approximately $4795 by FY30. Bangladesh would need to grow at an average rate of 8.4% during FY19-30 at minimum, along with continued macroeconomic stability characterized by domestic price stability and a significant degree of exchange rate stability.

Goal 3: Achieve High-Income Country (HIC) status by FY 2041

Building on its ambitious target of UMIC status and in the process transforming the economic structure fundamentally, Bangladesh also aspires to become a high-income country (HIC) by FY41. By 2041, the income threshold for a HIC will reach $16000, which is more than an eight-fold increase in per capita income in dollar terms over the next 22 years. The average real GDP growth would need to be sustained at 9% during the 20-year period through FY41 to achieve this target.

Goal 4: Inclusive growth with moderate poverty reduced to less than 5% by FY 2041 on the basis of current definition of poverty line

On the basis of Household Income and Expenditure Survey (HIES) of 2015 done by the Bangladesh Bureau of Statistics (BBS), 24.3% of the Bangladesh population was below the moderate poverty line. By adopting an inclusive growth strategy, the government aims to cut down the moderate poverty rate to less than 5% by FY41, when Bangladesh also becomes a HIC.

Goal 5: Building a Bangladesh resilient to climate change and other environmental and geographical challenges identified in Bangladesh Delta Plan 2100

Bangladesh is most vulnerable to global climate change (GCC) and the continued degradation of environment through man-made and natural factors. The BDP2100 has clearly identified the 6 most vulnerable Hot Spots: Haor areas characterized by large inland water bodies; coastal regions; river estuary region; drought prone Barind areas; Chittagong Hill Tracts; and urban areas. BDP2100 also identified the adaptation strategies to mitigate the adverse impacts of GCC and other environmental factors on Bangladesh economy through investment of about 2% to 2.5% of GDP per annum in support of the growth strategy of the government.

Goal 6: Establishing Bangladesh as a knowledge hub country in support of the growth strategy and promoting development of a skill-based society

The PP2041 aims to achieve this goal through emphasis on education, research, and technological development. The PP2041 underscores that a knowledge-based society would help improve efficiency in every aspect of the country's economic/resource management, thereby propelling economic development to attain the status of a HIC by FY41.

A quantitative macroeconomic framework has been prepared taking into account the above-mentioned six major goals envisaged under the Government's PP2041, BDP2100, and the SDG implementation strategy. As noted in Chapter 3, Bangladesh's graduation from the LDC status while a welcome and positive development will also pose some problems in terms of loss of duty free and quota free (DFQF) access to many major export markets including in the European Union common market. This loss of DFQF status is likely to have a significant negative impact on Bangladeshi exports to these markets with potential adverse impacts on total exports, employment and economic growth.

Another important concern is the potential loss of concessional and grant financing in the aftermath of LDC graduation. Though this is not likely to be a major issue for Bangladesh because aid dependency has fallen substantially over the years and also the concessionality element has been falling in recent years. The World Bank and the Asian Development Bank, the major multilateral financial institutions, have already moved to blend financing by combining IDA based concessional financing with IBRD based non-concessional financing. Other multilaterals like the Islamic Development Bank and the Asian Infrastructure Investment Bank are also moving in that direction. Some official bilateral creditors like Japan, China and India are similarly moving in that same path. The loss of concessional financing will increase the average interest rate that Bangladesh will be paying to service its foreign debt over the coming years.

There will be other minor areas where Bangladesh may lose some benefits such as scholarships, travel grants from multilateral organizations for government delegates/officials, technical assistance grants from different development partners, and other grant supported projects by development partners such as poverty alleviation, climate change, etc. The overall impact of all these relatively minor areas of losses may add up to a significant amount in absolute terms, particularly if the various donor-supported grant financed projects, especially from DFID and EU, are taken into consideration, but these will be very small as a share of GDP or export earnings.

The remainder of this chapter briefly discusses the baseline macroeconomic scenario up to FY41; the scenario which captures the effects of the LDC graduation related three types of losses discussed above—named as the shock scenario; and briefly discuss some of the mitigating strategies. The baseline scenario is consistent with the achievement of the six goals specified above. This scenario is essentially and updated version of the PP2041 which implicitly and explicitly embodies the key challenges and objectives envisaged under the BDP2100 and the attainment of SDG objectives. The shock scenario outlines the extent of deviations in key macroeconomic performance indicators in quantitative terms from the baseline due the adverse impacts of the three types of shocks separately and combined. This provides an estimate of the likely macroeconomic impact of LDC graduation in terms of balance of payments, external debt and debt servicing and the magnitude of the policy adjustment challenge. The socioeconomic impact in terms of growth, employment and poverty are discussed comprehensively in Chapter 8 using a sectorally disaggregated general equilibrium model. The two chapters, 5 and 8, therefore complement each other in providing economywide impact assessment of LDC graduation.

It is important to note upfront that the analysis of chapters 5 and 8 provide a lower bound quantitative assessment of impact of LDC graduation because they do not include the possible impact of withdrawal of the benefits from the preferential and differential application of several WTO rules relating to TRIPS, TRIMS, AoA and SCM. Since the impact of this withdrawal cannot be assessed quantitatively in the absence of relevant data and uncertainty of private sector responses, their likely impact was discussed qualitatively in Chapter 3.

5.2. The Baseline Scenario, FY18-FY41

Key National Accounts Indicators

Building on the remarkable success in steadily accelerating its GDP growth in real terms over the last several decades, the baseline scenario aims to achieve 9% real GDP growth by FY30 with a view to becoming an UMIC with per capita income in dollar terms increasing to $ 5745, crossing the threshold for UMIC status in current dollar terms. Bangladesh will become a trillion-dollar economy by the time it becomes a UMIC and per capita real consumption will almost triple, despite a projected significant increase in gross national savings (GNS)

Table 5.1: Per Capita Income and Indices of Per Capita Real Consumption and Population 2016-2030

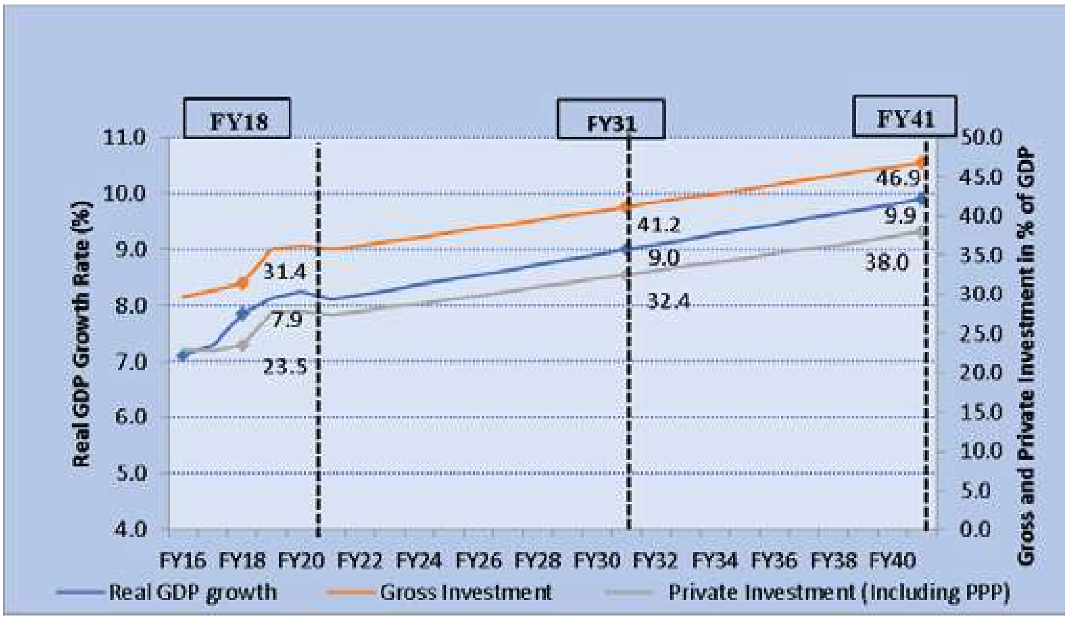
	2016	2020	2025	2030	2041
Per Capita Income (In Current Dollars)	1382	1976	3153	5181	16908
Index of Per Capita Real Consumption	100.0	102.9	142.5	198.8	457.9
Index of Population of Bangladesh	100	104.6	109.9	114.5	121.5

Source: Bangladesh Bureau of Statistics and GED Projections

The projected time paths of GDP growth, the total gross investment rate and the private investment rate are shown in Figure 5.1. As envisaged in the PP2041, investment will be the most important driver of this growth strategy. The average GDP growth for the period up to FY30 would need to be at least 8.4% and gross domestic investment at 41.2% of GDP. Bangladesh has already achieved real GDP growth of 8.1% in FY19, and thus realizing the growth target of 9% by FY30 may not appear too ambitious. However, sustaining the current growth momentum over the next decade will require a massive increase in the level of private investment, which is still languishing at around 23% of GDP. Total/gross private investment would need to increase by about 9 percentage points to 32.4% of GDP over the next 13 years. A significant part of the increase in private investment—about 25% of the additional amount or 1.5% of GDP—would also need to come from foreign direct investment (FDI).

Moving from an UMIC to a HIC in the next decade will require the growth rate to peak at 9.9% by FY41 and the average real growth rate to be at least additional one percentage point higher at 9.45% throughout the decade of FY31 through FY41. Gross investment would need to increase by further 5.7 percentage points to 46.9% of GDP, to sustain the GDP growth rate at this level, after taking into account the modest increase in incremental capital output ratio (ICOR) to 4.7 in FY41 from 4 in FY18.

Figure 5.1: GDP Growth rate and Investment Projections FY16-FY41



Source: GED Projections

This high growth scenario, underpinned by very high level of investment to GDP ratio can only be sustained if the gross national savings (GNS) rate is commensurately high. Otherwise, the external current account imbalance and external foreign borrowing will become unsustainable leading to a rapid buildup of foreign debt.

Fiscal Management under the Baseline Scenario

Bangladesh has a long tradition of prudent fiscal management which has served as the anchor to its continued macroeconomic stability. Fiscal deficit has been consistently limited to below 5% of GDP primarily through containment of expenditures. Performance in terms of revenue mobilization has been disappointing with the tax/GDP ratio at about 9% of GDP in FY18. As a result, the fiscal operations of the government may be characterized as low-level steady state operation with very low overall size of the government expenditure (14.3% in FY18). Bangladesh has the lowest tax/GDP and public expenditure/GDP ratios among the comparator countries.

For Bangladesh to become first an UMIC and then a HIC, this poor state of public finance, constrained by very low tax/GDP ratio, must change. Bangladesh's very low public spending on health (0.7% of GDP), education (about 2% of GDP), and social protection through about 125 safety net schemes (1.6% of GDP) are not at all compatible with the objectives of the SDG or the development of human capital needed to reach UMIC and HIC, and the Government's poverty alleviation goals stated earlier.

Accordingly, the fiscal plan of the Government in support of the PP2041 envisages a strong drive to mobilize revenue—by breaking away from the stagnation of the tax/GDP ratio in recent years. The tax/GDP ratio would need to be increased to more than 15.4% of GDP by FY31 and further to 19.4% by FY41. The projected increase will be a major challenge, given the recent performance of the National Board of Revenue (NBR) in terms of mobilization of domestic resources. In the last ten years no fundamental reforms were done in the areas of tax policy and tax administration and the result is a stagnation in the tax/GDP ratio. This has to be changed—business as usual on the tax front is not an option.

The trust of tax policy and administration reforms would need to be primarily in the areas of direct tax and VAT systems. Currently, the efficiency of the VAT and direct tax systems in Bangladesh is only around 33%-35%, which should be around 70%-80% over time in order to achieve the intended targets. The ratio of direct taxes to GDP would need to increase from the current level of 2.7% of GDP to 6.4% by FY31 and thereafter to 8.6% by FY41. Revenue from the VAT system would also need to increase from the current level of 3.4% of GDP to 6% of GDP by FY31 and thereafter to 7.9% by FY41.

External Sector Outlook

External sector stability is fundamental determinant of macroeconomic stability in any country, and Bangladesh is no exception. Bangladesh will continue to have a sizable deficit in the merchandise trade balance, given the needs for meeting its import payments associated with infrastructural investments with high import contents, increasing incremental capital output ratio (ICOR) associated with private investment, and growing consumption demand in the economy. This deficit will continue to be covered by inflow of workers' remittances and a faster growth of exports compared with the growth in import payments.

Given the huge import demand associated with the ongoing and future investments in the mega infrastructure projects, Bangladesh will probably not see a surplus position in the external current account in the foreseeable future. However, the magnitude of the external current account deficit would need to be manageable in terms of foreign exchange reserve coverage, external debt sustainability, and inflow of FDI and other capital account inflows to cover the current account deficit and also help build up of foreign exchange reserve in nominal terms to ensure reserve coverage in months of imports at 6-9 months of import payments.

In terms of economic policies realization of these objectives—particularly accelerating export growth and export diversification--would require:

- Maintaining an open trade regime with lower degree of import protection (which is currently one of the highest in the world) so that more resources/investment goes to the export sector;

- Ensuring exchange rate flexibility through market mechanism;

- Creating better investment climate by removing the constraints on domestic and foreign private investments including through effective operations of the Special Economic Zones (SEZs) and One Stop Service Facility.

- Improving the transport network and port facilities to reduce the lead time for Bangladeshi exporters and ensure uninterrupted access to power and gas.

In short, Bangladesh would need to move back to an export-led development strategy, away from the recent experience of domestic demand driven growth which is likely to hit a balance of payments (BOP) constraint.

Debt Management and Debt Sustainability

Bangladesh has an enviable track record in terms of public debt management and servicing of debt always on time. This was the result of prudent fiscal management and relying on concessional long-term financing with high proportion of grant elements from multilateral and official bilateral sources. As Bangladesh has crossed the LDC graduation threshold, all multilateral and bilateral creditors have started to offer blended financing in putting together the overall financial packages for Bangladesh. As the country progresses to become a UMIC, the proportional of concessional financing will go down and reliance on non-concessional financing will continue to increase.

Since Bangladesh's credit worthiness is improving and it enjoys a respectable credit rating with stable outlook from major credit rating companies like Moodys and S&P, many private sector companies are also accessing the international capital market to meet their financing needs. The Government agencies and private sector borrowers are also accumulating short to-medium term debt at a much faster pace than any time in the past. Private sector foreign borrowing will certainly increase and should also be supported by phased liberalization of the capital accounts of the BOP. Furthermore, much of the infrastructure financing for mega projects will be foreign financed leading to buildup of external debt at a rapid pace in the coming years.

Against this backdrop, the sustainability indicators for the macroeconomic framework has been prepared to ensure debt sustainability over the medium and long term. Managing the debt sustainability indicators along the lines outlined in Figure 5.2 will require continued prudent and efficient public debt management over the long term along the following lines:

- Private sector external debt has been increasing at a rapid pace in recent years to meet the growing financing needs of the private sector. The pace of accumulation of private external debt is likely to accelerate in the coming years to meet the growing financing needs of the private sector related to the envisaged pickup in private investment.

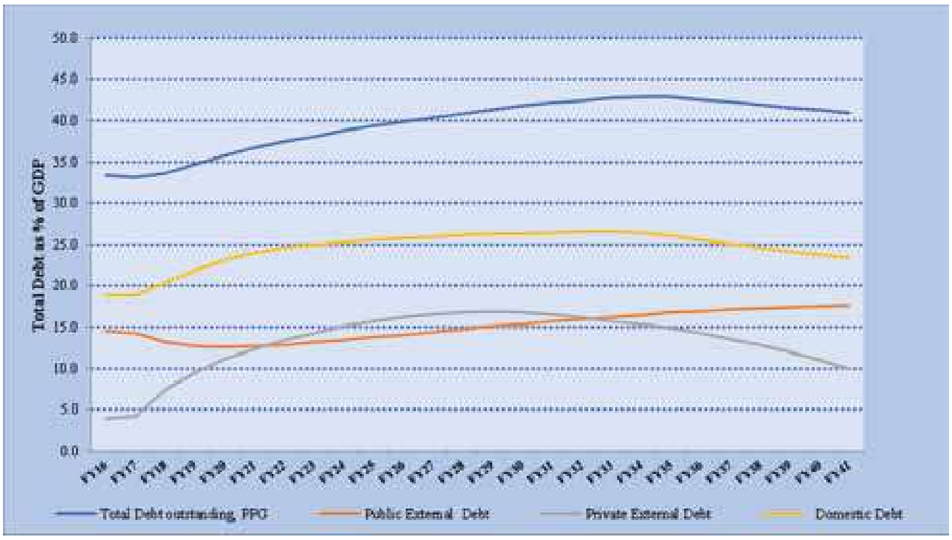
- Efforts must be strengthened to attract more FDI so that foreign financing—by both private and public sector--is non-debt creating. FDI not only brings external financing but also has many other positive contributions in the form of increased access to foreign markets, and introduction of new/modern technology and management practices.

- Reliance on National Savings Certificates must go down over time by making the interest rates market based. Domestic debt has been the fastest growing component of public debt in the last decade. While this is good, the very high interest rates paid on non-tradable non-bank instruments like national Savings Certificates have contributed to huge debt servicing costs—limiting fiscal space significantly, destroyed the whatever small bond market Bangladesh had, made infrastructure financing through bond market development impossible.

- Bangladesh should continue to rely on official multilateral and bilateral financing as much as possible since the tenor of these loans and interest rates would generally be much below what Bangladesh can obtain by issuing sovereign debt.

- Bangladesh should still make its presence in the international capital market by issuing sovereign bonds regularly, albeit to a limited extent. This will allow the development of the yield curve for Bangladesh which may be used by foreign investors for pricing private bonds to be issued by the private sector entities.

Figure 5.2: Debt Sustainability Projection FY16-FY41



Source: BBS and GED Projections

5.3. The Shock Scenario—Reflecting the Impacts of LDC Graduation

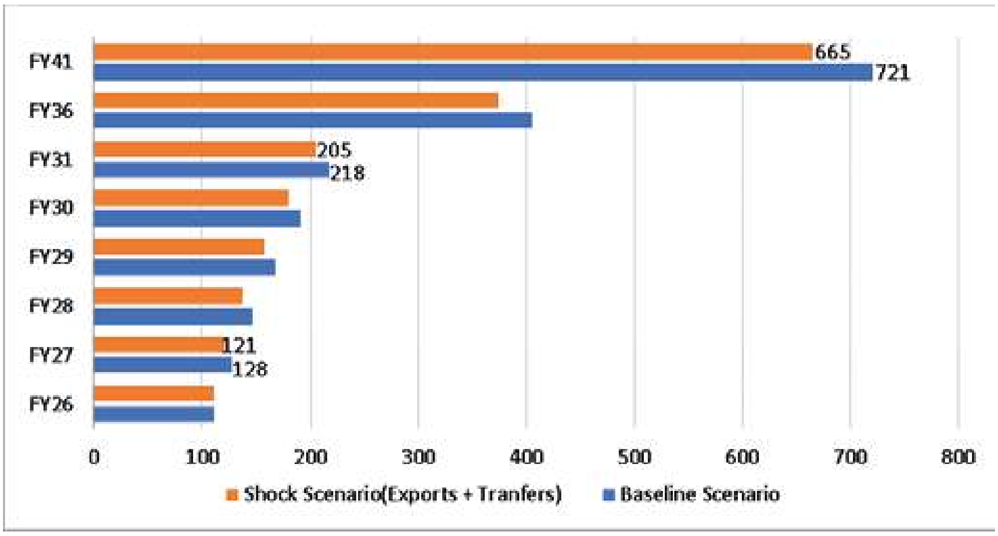
LDC graduation will impact Bangladesh in three major ways—the loss of export earnings owing to withdrawal of LDC trade preferences, the loss of access to foreign financing on concessional terms, and some loss of grants provided to Bangladesh from official (bilateral and multilateral) and private channels. This section makes an attempt to assess the macroeconomic impact of these losses on Bangladesh's exports over time, shifts in the composition of external financing and consequent increase in debt service payments, the overall impact of these losses on the external current account balance and the overall balance of the BOP. The projected loss of exports and grants and higher debt service costs would lead to higher current account deficit. Since the level of reserves are assumed to be kept unchanged at the levels envisaged in the baseline scenario, the gap will be filled by accumulation of external debt at a faster pace to prevent depletion of foreign exchange reserves below what is projected in the baseline scenario. This policy assumption is rational since reduction in foreign exchange reserves would not be sustainable and may create various forms of market instability.

Projected Export Loss

The most important source of loss from LDC graduation emerges from the loss of DFQF market access. The projected export loss from RMG products in the EU and non-EU markets using unitary elasticity and standard GSP preference assumptions market is estimated to be about 5% of total exports in FY2018. Using the Baseline BAU Scenario, this amounts to a loss of $7 billion in FY27, which would steadily increase to $13 billion by FY31 (Figure 5.3)[26]. The cumulative export loss over the 5-year period (FY2027-FY2031) could amount to $38 billion, which is a substantial loss even in the context of the much higher export base in FY2031. Policy actions will be necessary to counter these projected losses.

[26] *Since loss of the EBA facility from the EU is the biggest source of export loss and this facility will be available for another 3 years after LDC graduation in 2024, the macroeconomic impact assessment starts from FY2027.*

Figure 5.3: Exports Projections Under Alternative Scenarios (billion $)



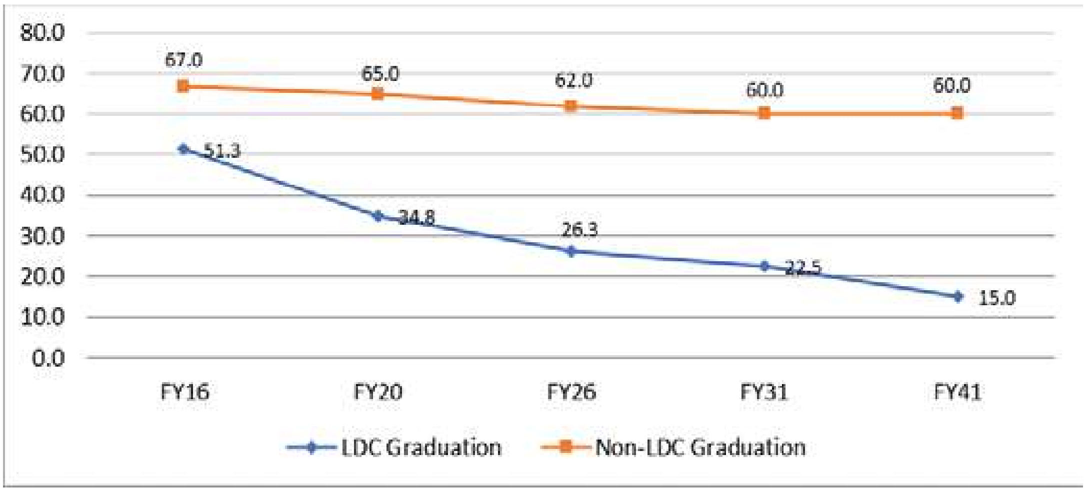
Source: GED Projections

Impact on External Debt and Debt Servicing

As discussed above, the loss of concessional elements in the financial supports received from official bilateral and multilateral creditors will lead to increased debt servicing costs. Bangladesh used to borrow from these official creditors only on IDA and equivalent concessional terms. But in recent years these official creditors have already moved to blend financing with mix of IDA (World Bank group concessional facility) / OCR (Asian Development Bank concessional facility) with non-concessional facilities. So, moving forward, the proportion of concessional assistance will continue to fall while the proportions of non-concessional loans will only increase in the coming years. This is not the direct result of graduation LDC, but a continuation of the ongoing trend owing to increase in per capita income. To capture this change in the debt financing environment for Bangladesh, the model distinguishes between a LDC graduation and a hypothetical scenario of non-LDC graduation.

Based on the considerations noted above, Bangladesh's LDC graduation coupled with PP2041 growth strategy would entail a steady decline in the proportion of concessional external public debt in relation to total external public debt will decline steadily in the coming years (Figure 5.4). The declining of concessional external debt has already started with the ratio of concessional debt coming down to 51.3% of total external debt in FY16. The decline in the ratio of concessional debt has already started with Bangladesh Government already accessing the non-concessional sources of financing in significant amounts in recent years. Under the hypothetical scenario, where Bangladesh had remained an LDC in the foreseeable future, the proportion of concessional external debt would have remained high at more than 65%. Under the LDC graduation scenario, the proportional of external concessional financing will essentially begin to disappear by FY31 .

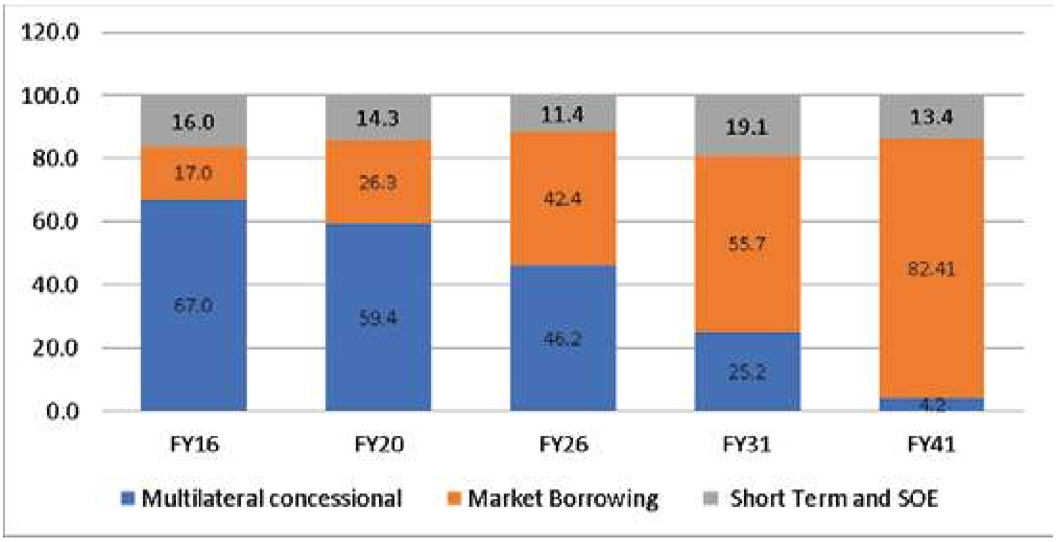
Figure 5.4: Concessional Debt Dynamics During Baseline and Non-LDC Graduation Scenario



Source: ERD and GED Projections

LDC graduation, will also open up the door for market borrowing by both the public and private sectors. The composition of Bangladesh's public debt profile will change significantly accordingly. In terms of public and publicly guaranteed (PPG) debt, the proportion of debt in terms of market borrowing will accordingly change in the following manner (Figure 5.5).

Figure 5. 5: Sources of PPG Borrowing (As % of Total PPG Borrowing)

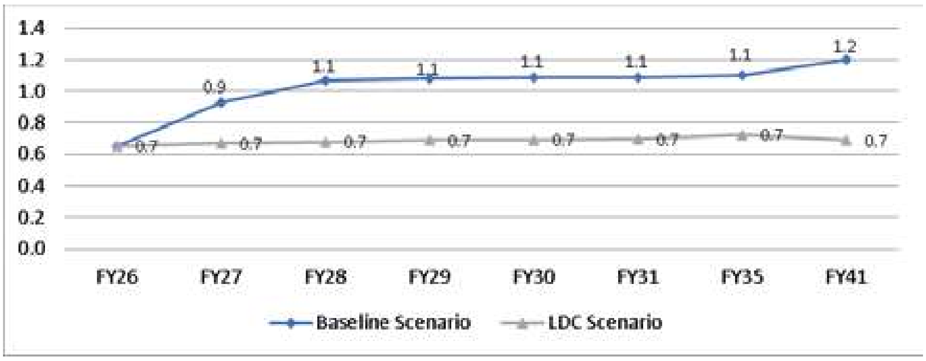


Source: ERD and GED Projections

As Bangladesh will lose access to concessional external borrowing, it will become more dependent on market base borrowing from relatively higher cost sources. In addition, private sector external debt will also increase in future.

The shift in the composition of PPG debt will have some significant impact on the external interest payments on account of PPG debt. Compared with the LDC scenario (which is a hypothetical counterfactual construction), the baseline graduation scenario envisages a significant increase in interest payments on PPG external debt from 0.7 of exports of goods and services to 1.2% of the same by FY41. The payments in US dollar terms will commensurately grow but will continue to remain well within the sustainability limit under the PP2041 macroeconomic framework.

Figure 5.6: Interest Payment of External Debt during Pre and Post LDC Graduation



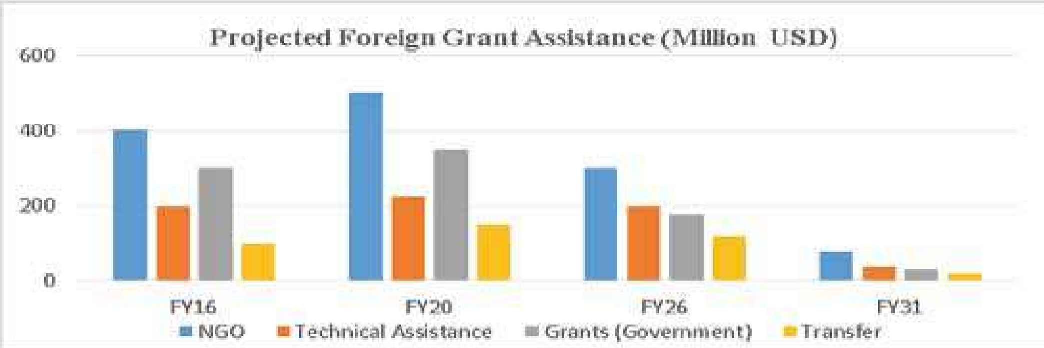
Source: GED Projections.

Loss on Account of Foreign Grants

The third important factor in order of importance will be the loss of foreign grants currently received by the public and private sectors. Bangladesh's dependence on foreign grants have come down significantly over the last several decades. In recent years, grants received by the public sector in Bangladesh (as reflected in the budget documents) are estimated to be about 0.1% of GDP or less than $300 million per annum. There are no definitive estimates for grants from the foreign private sector to the domestic private sector in Bangladesh. However, based on the data on private transfers as reported in the BOP, the amount could be up to $400 million. These total grants together accounting for about $700 million may disappear over time as Bangladesh graduates from LDC status and firmly moves towards an UMIC status.

Box 5.1: Potential loss in Grants after Graduation from LDCs

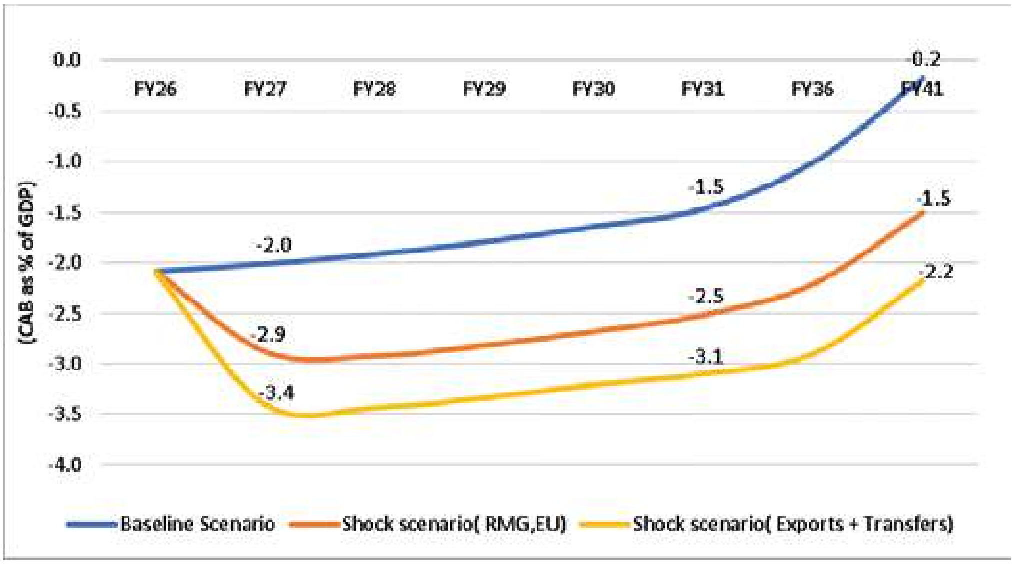
Efforts of both private and public sectors of Bangladesh are supplemented by foreign grants mainly in the form of technical assistance and funding through Non-Governmental Organizations (NGOs). There is a possibility that all these grants might diminish as Bangladesh graduates from Least Developed Countries. This potential loss can adversely affect the development process of the country; particularly people living on the margin. Currently approximately one billion USD worth of grant is received by Bangladesh (combining public and private enterprises) from foreign sources. Seventy percent of which are received by mainly non-governmental organizations and private enterprises. Effective policies should be formulated and implemented to make necessary adjustments to accommodate this loss in grants after graduating from LDCs



The Combined Impact on the BOP

The combined impact of these three types of losses will have direct impacts on the BOP leading to a deterioration in the current account deficit by 0.9-1.4% of GDP in FY27 (Figure 5.7). Most of the losses are on account of export loss in both EU and other non-EU markets. The increase in the current account deficit from RMG market loss in EU alone contributes to 0.9% increase in the current deficit. When export losses from non-EU RMG, other exports and loss of grants are considered in total, these add up to another 0.5% increase in CAD in FY2027.

Figure 5.7: Current Account Projections under Alternative Scenario



Source: GED Projections.

Impact on GDP

Exports have direct impact on domestic GDP through net value addition. The higher debt servicing costs due to reduced concessionality, higher levels of borrowing to finance the increased current account deficits would reduce the economy's capacity to invest, build up reserves or consumption by the same amount under unchanged policies. The loss of grants to the government and private/public transfers will have modest impact of about $700 million at present and the loss of that will be primarily reflected through adjustments in budgetary outlays and private NGO activities. This will also impact public and private consumption negatively almost by equivalent amounts. The impacts of these three factors on the GDP will work through both the income side of the national accounts and the expenditure side of national accounts (through consumption, investment/savings) of both private and public sectors. These first-round effects will then have multiplier effects based on the relationship between income and other variables including investment.

The full GDP effects of the LDC phase-out are captured through a dynamic CGE model that is explained in detail in Chapter 8. All the inter-relationships and the multiplier effects are captured in the model and explained in that chapter. The GDP impact depends on the assumed export loss over BAU. For the case with unit demand elasticity, average GDP growth falls by about 1.4% in 2027. GDP loses are higher in the case of higher demand elasticities for Bangladesh exports. This is a substantial shock that will have adverse effects on employment and poverty reduction unless offset by policy measures.

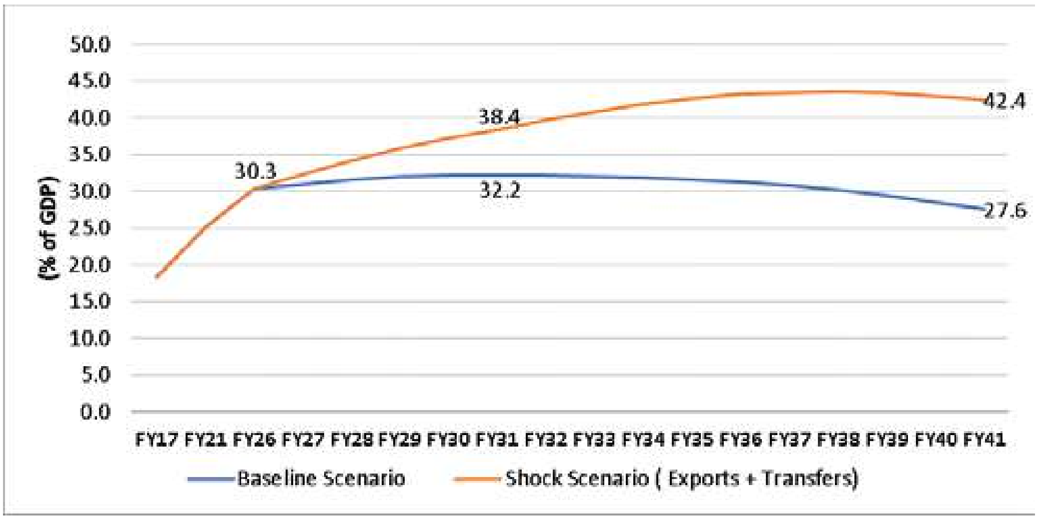
5.4. Possible Adjustment Scenarios

No Policy Change Scenario

The loss in export receipts and receipts from grants will increase BOP financing and there could be two very different approaches to close this financing gap/requirement. The first approach could be to cover the full amount of BOP financing requirement by external borrowing. In this case, external debt will increase by the full amount of the shortfall and there will be no need for compression of imports (except autonomous reduction in industrial inputs used in exports including through back-to-back LCs). There will be no need to adjust the exchange rate and other policies including monetary and exchange rate policies, and the path of export receipts will move down permanently. This may be a short-term and politically quite attractive solution but not a very desirable outcome from a medium and long-term perspective.

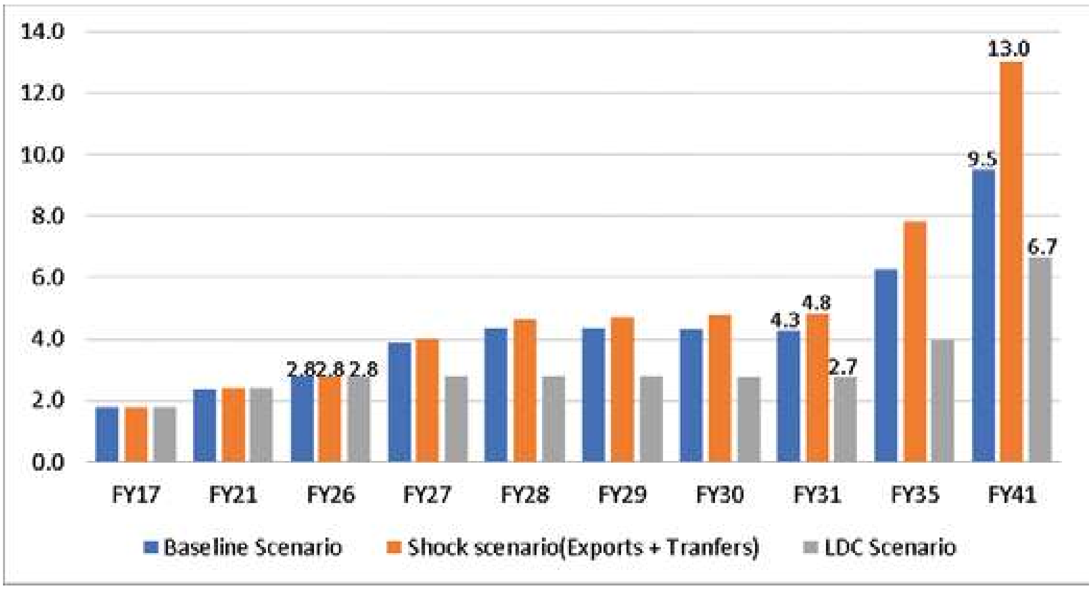
The adverse effects on GDP, which could be substantial as noted, and associated negative implications for employment and poverty will create social problems. Importantly, Bangladesh will deviate from its long-term development objectives associated with the Perspective Plan 2041. Furthermore, over time the debt sustainability situation may be compromised. As noted in Figures 5.8-5.11, debt accumulation will increase rapidly that could jeopardize debt sustainability and debt servicing owing to reliance on high-cost commercial debt in market prices.

Figure 5.8: External Debt Projection under Alternative Scenario



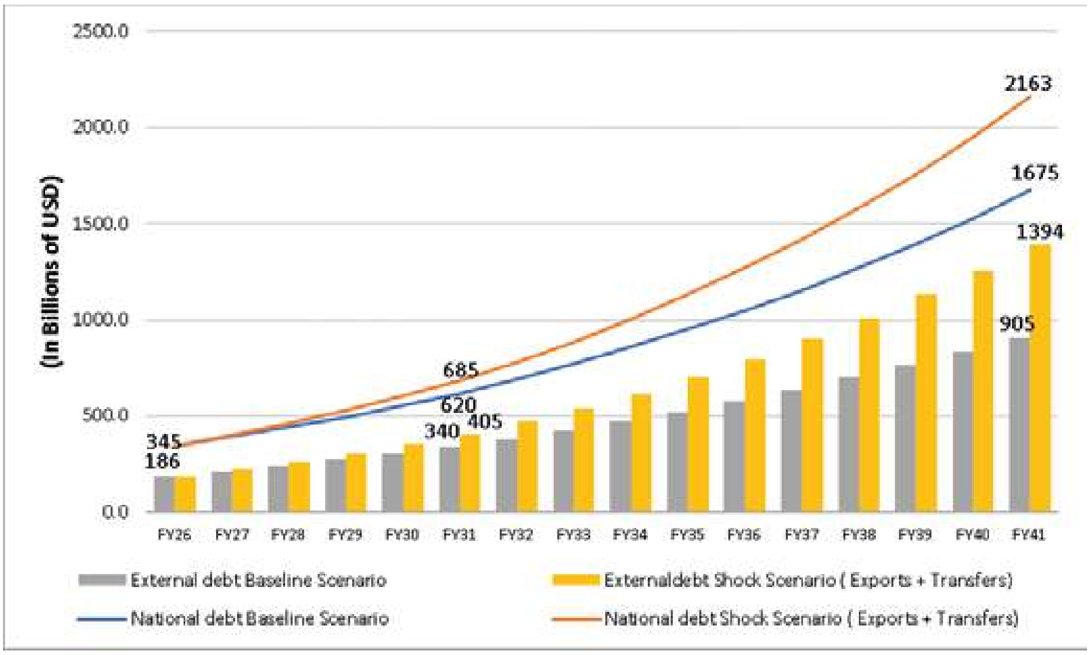
Source: GED Projections.

Figure 5.9: Interest Payments on External Debt as% of Exports & Remittance under Alternative Scenario



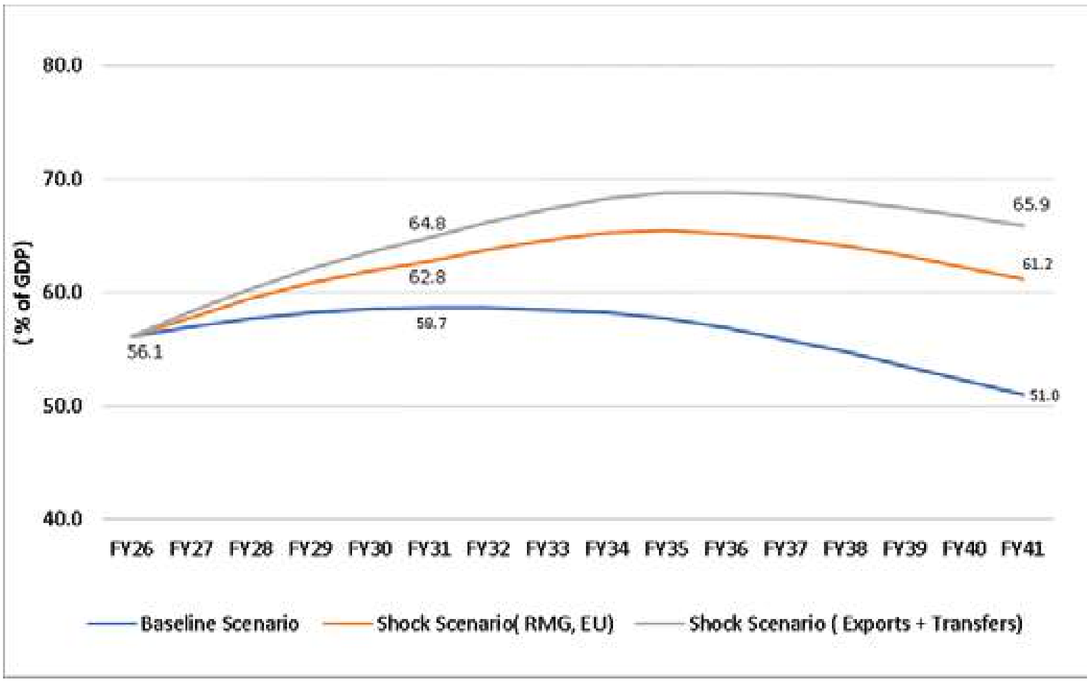
Source: GED Projections.

Figure 5.10: National Debt Dynamics under Alternative Scenario



Source: GED Projections.

Figure 5.11: National Debt Dynamics under Alternative Scenario

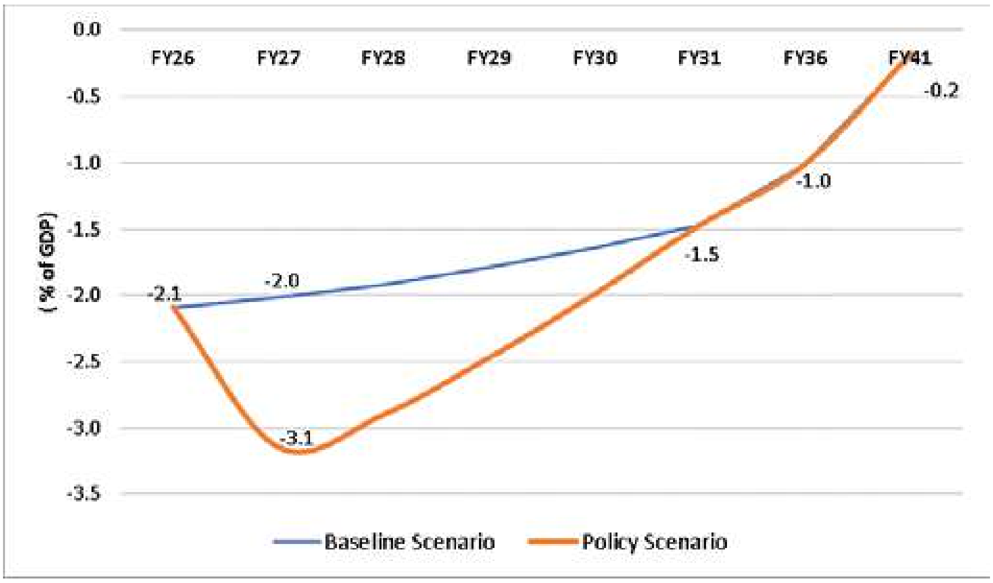


Source: GED Projections.

Appropriate Policy Response to Offset Export Shock

The second approach could be to allow the market mechanism to initiate the necessary adjustment process including trade reforms and other policies to diversify exports and adjustments (depreciation) in the exchange rate to contain imports and provide incentives for exports. Under this scenario, exports will be more competitive and the consequent boost in exports along with the containment of imports due to exchange rate adjustment will offset the impact of the export loss. Under the second scenario, the external current account deficit would steadily move towards the baseline scenario, coinciding with it once the process of adjustment is complete (Figure 5.12). Accumulation of external debt under this scenario will be for a brief transitional period of several years and there will be no major impact on the overall level of external debt and debt sustainability.

Figure 5.12: Current Account Balance under Policy Adjusted Scenario



Source: GED Projections

In order to minimize the export loss, the authorities should also engage in economic diplomacy including initiatives for continued market access in the post-LDC period. Most developing countries are either members of economic or trade blocks, and also enjoys market access as part of bilateral or multilateral (as members of different economic/trade blocks) agreements between countries or blocks. SAARC is the only regional block in which Bangladesh is a member. But as an organization SAARC is effectively non-functional because of regional political and security issues, which are beyond the control of Bangladesh Government. Thus, Bangladesh would need to actively seek access to regional economic/trade blocks or secure preferential market access to important regional blocks like the EU and ASIAN. Other new initiatives such as joining the Belt and Road Initiative (BRI) of China may also be considered in this regard.

5.5. Post LDC-Graduation Macroeconomic Strategy

Continued macroeconomic stability has been the hallmark of Bangladesh's successful LDC graduation, and will remain a major pillar in its march towards achieving SDGs and the upper middle-income status by FY31. Much of the socio-economic gains already made and envisaged to be realized in the post-graduation period must be underpinned by strengthened macroeconomic management. The baseline scenario presented above is highly ambitious and consistent with the socio-economic goals established by the Government under its PP2041. Realization of the objectives/targets stipulated under the baseline scenario will require strong efforts on the part of the government in terms of maintaining macroeconomic stability, increase public sector investment and enhance quality of services in key areas health, education and social safety net through strong efforts on resource mobilization. Public resource mobilization will be key to sustain the much-needed massive investments in infrastructure projects. The shock from LDC graduation simply strengthens the need to move ahead full stream with the reform agenda of the PP2041.

In addition to public resource mobilization, the other areas of macroeconomic management that will require particular attention include: strong balance of payments position with exchange rate stability; infrastructure development in the context of overall investment planning, financing mix/strategies and outlook; debt management strategy with focus on ODA commitments and cost of bilateral and multilateral financing; and financial sector development with focus on strengthening of the banking sector and bond market development.

Strengthening domestic public resource mobilization: This has remained one of the most challenging and frustrating part of Bangladesh's fiscal and overall macroeconomic management for decades. At less than 12% of GDP, Bangladesh has one of the lowest revenue-to-GDP ratios even among the LDCs. Despite recent progress, the weak state of the country's overall physical infrastructure relative to needs and the very low social spending in education (less than 2% of GDP), health (0.7% of GDP) and social protection (about 2% of GDP) are primarily attributable to its very limited ability to mobilize domestic resources. The recent increase in investment in major infrastructure projects is largely external debt financed, and may not be sustainable and cannot be scaled up further in the coming years without successful efforts in increasing the revenue-to-GDP ratio to 15%-20 % of GDP range.

Realizing the objectives of SDG and attaining the UMIC status by FY31 will require massive investment in the social sector programs, ensuring environmental sustainability, implementation of the Bangladesh Delta Plan 2100, and massive investment in already identified numerous mega projects. The additional costs of implementing these broad-based transformational social, economic and infrastructure programs will require trillions of takas (or tens of billions of dollars) in additional resources most of which must be mobilized from domestic sources.

In the last 10 years—largely overlapping with the 6th and 7th Five Year Plans—Bangladesh's tax/GDP ratio has moved up by less than one percentage point, which points to the lack of systematic reform efforts on this front. This must change if the Government wants to realize its ambitious growth, employment and SDG objectives in the post-graduation period. If the revenue outlook does not change remarkably in the coming years, much of the objectives envisaged under the baseline scenario described above will remain unattainable.

In the context of the Sixth and Seventh Five Year Plans a number of ambitious reform efforts were identified covering areas such as: (i) introduction of the new VAT Act 2012 and the accompanying VAT Rules, along with the modernization of VAT administration; (ii) Enactment of the draft Customs Act; (iii) enactment of the draft direct Tax Law after its proper review by international experts to make it compatible with international best practices; and (iv) effective implementation of the NBR Modernization Plan submitted to Parliament for its information and consideration. Implementation of all these laws and the associated reform of NBR tax administration along functional lines have been long delayed and the results of that are already visible in the dismal performance in terms of revenue collection and taxpayers' satisfaction. In the area of revenue mobilization, status quo is not acceptable because such inertia will jeopardize realization of all the worthy goals that the government has established for itself through various initiatives stated earlier.

Ensuring the stability of the balance of payments: In the last two decades, Bangladesh has generally enjoyed stable balance of payments along with comfortable reserve position, backed by sustained growth in exports and remittances, which helped finance the growth in import payments needed to support its impressive economic growth and private consumption. Looking ahead there will be a number of challenges:

(i) Bangladesh's export performance is excessively dependent on only RMG products (83% of total exports), and there is no definite sign of other exports providing a broader base for domestic exports. There is no other middle-income country with such dependence on one product and Bangladesh must broaden its export base both in terms of products and destinations/markets. The baseline scenario accordingly envisages a steady increase in the share of non-RMG exports in the export basket to at least 40% from the current level of only 17%. Attaining this objective alone would require major initiatives like: making the import tariff regime less protective to remove the anti-export bias; providing other sectors the same benefits (including back-to-back LC and bonded system) that is being provided to the RMG sector and thereby essentially making the free trade regime available to all other export sectors; and making the economy more attractive for FDI.

(ii) Bangladesh must also focus on export of services, an area which has not got much attention. Bangladesh has a large and growing external services account deficit on account of transports (shipping and airlines), medical services, and education. Outflow of remittances due to technical and management supports provided by foreigners to Bangladeshi enterprises is unofficially estimated to be $4-5 billion. Billions of dollars are also spent on unofficially on account of health care received abroad by Bangladeshi residents in te form of medical truism to India, Thailand, Malaysia and Singapore. The government needs to develop strategies for reversing these trends so that Bangladeshis can receive high quality healthcare, highly skilled and experienced managers, and international standard higher education institutions in Bangladesh. The amount of savings through services accounts can be more than $10 billion if the government can develop the high quality service providing institutions at home.

(iii) Rapid export growth will require much higher levels of investment that should be helped by much higher FDI, which will also bring in new technologies for new products, greater integration with regional value chains, and broader access to markets for new products. (iv) Flexible management of exchange rates in line with developments in the exchange market and prudent liberalization of capital account transactions. Bangladesh's capital account transactions are very restrictive, and a phased liberalization will be essential to promote inflow of FDI and build investors' confidence on Bangladesh. Experience of India and many other countries have demonstrated that managed opening of the capital account brings in more capital inflows through building of market confidence.

Strengthening infrastructure: Bangladesh needs massive amounts of investment in infrastructure to support its growth momentum and improve quality of life of its citizens as envisaged in the baseline scenario. The Annual Development Programme (ADP) of the government has increased modestly in recent years (from 3.6% in FY10 to 4.9% of GDP in FY18) to accommodate the new infrastructure initiatives. A list of mega projects has been well identified and some of the projects are at different stages of implementation. Bangladesh needs these projects and certainly many more will be added in the coming years. Given the tight resource position of the government, currently most of these projects are being debt financed, and in many instances with official bilateral debt from Japan, China and India on concessional and non-concessional terms. In order to avoid explosive external debt burden, in addition to higher domestic revenue to fund such projects, Bangladesh needs to develop alternate financing arrangements like Public Private Partnership, issuance of asset backed securities for financing new projects or expanding existing ones, issue infrastructure bonds, and mobilize financing from international capital market by issuing sovereign bonds on better terms to finance its infrastructure projects. Bangladesh can certainly avail the opportunities offered by programmes like the Belt and Road Initiative (BRI) of the Government of China. South Asia Regional Connectivity initiative supported by ADB and World Bank is another important initiative to improve regional connectivity to support trade and investment in the region, including Bangladesh. International experience suggests that there are risks associated with the current unsolicited debt/suppliers' credit financed project development and alternative financing strategies to mitigate the risks must be actively considered as part of overall financing and debt management strategy of the government.

Prudent management of external debt: Bangladesh has an enviable track record of external debt management, which is reflected in its very low debt service ratio and external debt to GDP ratio. Prudent fiscal management (fiscal deficits ranging between 3.5% of GDP to 4.5% of GDP) coupled with sole reliance on concessional long-term external financing over the last several decades have contributed to this very favorable outcome. As the official external financing requirements of Bangladesh will be increasing rapidly in the coming year and access to concessional financing will be declining steadily as the country graduates from LDC status and moves towards upper middle-income country status, Bangladesh would need to fundamentally reorient its debt management strategy. Financing of megaprojects will be important and the projects should have a large domestic financing component so that external public debt remains manageable in terms of long-term debt sustainability as discussed in the policy adjustment scenario above. Development of domestic long-term bond market (including infrastructure bond and asset backed securities), and possible options for restructuring of public debt management institutions for efficient debt management (which is currently managed in a fragmented manner) will be important in this regard.

Restoring the health of the financial sector and boosting its growth: Bangladesh's financial sector development—with particular focus on the banking sector, stock market and bond market--will remain a key priority area for the medium term. Banking sector will continue to be the dominant component of the financial system in Bangladesh but has been plagued by a huge and growing burden of impaired assets with adverse impacts on intermediation costs, the interest rate spread, and returns on assets and equities. Restoring the health of the banking sector with strong efforts to weed out the sources of non-performing loans at the source along with strengthening the autonomy and supervision capabilities of the Bangladesh Bank is a top reform priority. Bond and asset backed securities market development will be critical for securing long-term financing for the private sector investment and public and private sector infrastructure financing. Strategies for addressing the pressing structural problems impeding financial deepening needs to be formulated for speedy implementation.

Other macroeconomic policies: A number of other macroeconomic issues will also be critical in support of the ambitious baseline scenario developed under the PP2041. These include maintaining price stability through appropriate monetary policy, containing macroeconomic vulnerability through strengthened public financial management, sustaining export-led growth strategy to ensure reserve buildup and BOP stability, and strategy for improving Bangladesh's sovereign credit rating to investment grade over the next decade for greater access to international capital market on better terms.