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SELECTED ISSUES

May 11, 2018

Approved By
Asia and Pacific Department

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STATE-OWNED COMMERCIAL BANK: PERFORMANCE, ISSUES AND REFORMS[1]

A. Introduction

1. **Historically, state-owned commercial banks (SOCBs) have played an important role in Bangladesh.**[2] In addition to other banking activities, they were tasked to focus on promoting financial inclusion. With a large network of branches, the SOCBs serve as a source of credit to borrowers, such as small and medium enterprises and agriculture, who are unable to otherwise access financing from private commercial banks (PCBs). The SOCBs currently face challenges from weak balance sheets and high non-performing loans (NPLs). The Government of Bangladesh (GoB) has had to repeatedly recapitalize the SOCBs, but achieving financial soundness of the SOCBs has proven to be elusive. However, the share of the SOCBs in the banking sector has declined significantly since 1990s, and along with it the systemic risk they pose to financial sector stability and to the economy more generally.

B. Bangladesh's Experience with State-Owned Banks

2. **Bangladesh's experience with the SOCBs is not unique: the SOCBs have been underperforming in comparison to private banks and foreign-owned banks.** Experiences from countries around the world show that state-owned banks are often subject to political influence and interference, and suffer from overstaffing, lower quality of services, lack of innovation, and inefficiency. This entails as both direct costs (recapitalization of these banks), and indirect costs (misallocation of resources as credit is provided to inefficient borrowers that are often unable to repay their loans) to taxpayers.

3. **In Bangladesh, the SOCBs' share in the banking sector has been generally declining.** The asset share of the SOCBs in total banking sector assets has declined from about 55 percent in 1993 to around 27 percent in 2017. A sharper decline has been observed in the SOCBs' share in banking sector deposits. However, most of the decline took place during the late 1990s and the first decade of 2000s. Since 2010, the share of SOCBs in the banking sector has remained broadly stable. While the authorities have been imposing limits on the SOCBs' lending growth, these limits (which vary by the individual banks) have not, in aggregate, been tight enough to result in a further decline in the SOCBs' share in the total banking sector. In addition, the share of the SOCBs' deposits is now almost identical to the share of the SOCBs' assets, a change from the 1990s when the share of SOCBs' deposits was almost 10 percentage points higher. Similarly, the share of development

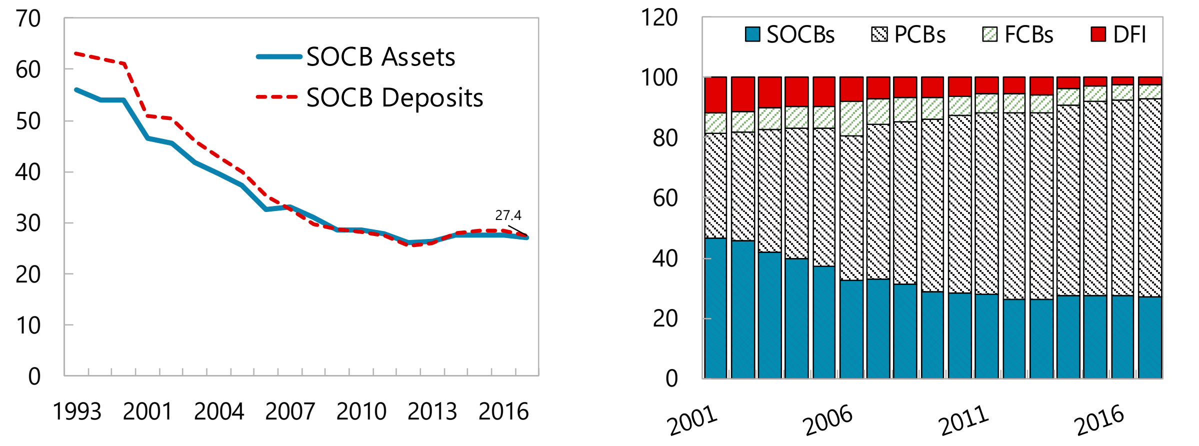
[1] Prepared by Jiri Jonas and Muhammad Imam Hussain.

[2] This paper focuses on SOCBs. In addition, there are also two DFIs operating in Bangladesh. The DFIs are government-owned and financed, and hold less than 3 percent of banking sector deposits and 2.5 percent of assets. They specialize in providing loans to targeted sectors, including agriculture. While their performance is in some respects even weaker than that of the SOCBs, their limited and declining size imply that they do not pose a systemic risk.

finance institutions (DFIs) fell notably, from 12 percent in 2001 to less than 3 percent by 2017. Instead, the PCBs' share in banking sector has expanded significantly.

Figure 1. Banking Sector Structure

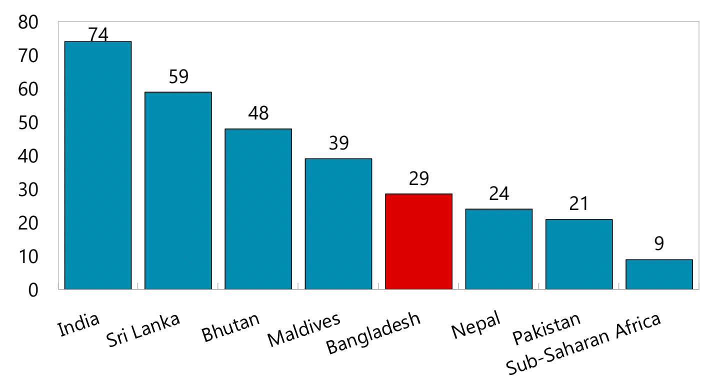
State-Owned Banks Assets & Deposits, 1993-17 | **Share in Bank Assets, 2001-17**



Source: Bangladesh Bank and Staff Estimates

4. The decline of SOCBs' share in the banking sector is not unique to Bangladesh. Government ownership of banks has been generally declining in all regions, including South Asia, though the share of assets of government-owned banks in the financial system varies widely across countries and regions. In some countries, government-owned banks account for more than 50 percent of financial sector assets (India and Sri Lanka), while in others (Bhutan, Maldives, and Indonesia) this is in the 30–50 percent range. In comparison with other South Asian countries, the SOCBs' share in Bangladesh is relatively low (Figure 2). However, it is much higher compared to East Asia & Pacific (except Indonesia) and Sub-Saharan Africa (Cull et al., 2017).

Figure 2. State-Owned Banks' Asset Share, 2010
(In percent of total banking sector assets)



Sources: R. Cull et al. (2017)
Bangladesh Bank for Bangladesh data (Cull shows higher share of 34 percent).

5. Figure 3 provides an overview of the structure of bank lending by industries. The charts on the left show a composition of each group's lending portfolio by industry (in percent), and the charts on the right show the amount of loans in each industry by bank groups (in taka). Several observations emerge from the data:

- Loans to agriculture sector represent a major share of total loans by the DFIs, and to a less extent, of the SOCBs. For the PCBs and the foreign-owned commercial banks (FCBs), loans to agriculture are a small percentage of their total loan portfolio. However, the PCBs still represent about one third of total agriculture loans.
- Industrial sector is the single most important borrower, except for the DFIs, with shares between 40-50 percent. Loans to industry represent a very small and declining part of the DFIs loan portfolio. From the perspective of the borrower, the PCBs are the dominant source of loans.
- Loans to construction provide a similar picture as industry. However, loans to construction represent a very small share in the FCBs total loan portfolio.
- Loans to trade and other sectors, such as commerce and services, represent a sizable share of total loans, similar to loans to industry. However, during the past decade, this share has gradually declined for the PCBs and the FCBs. The PCBs loans are the most significant source of borrowing for these sectors.

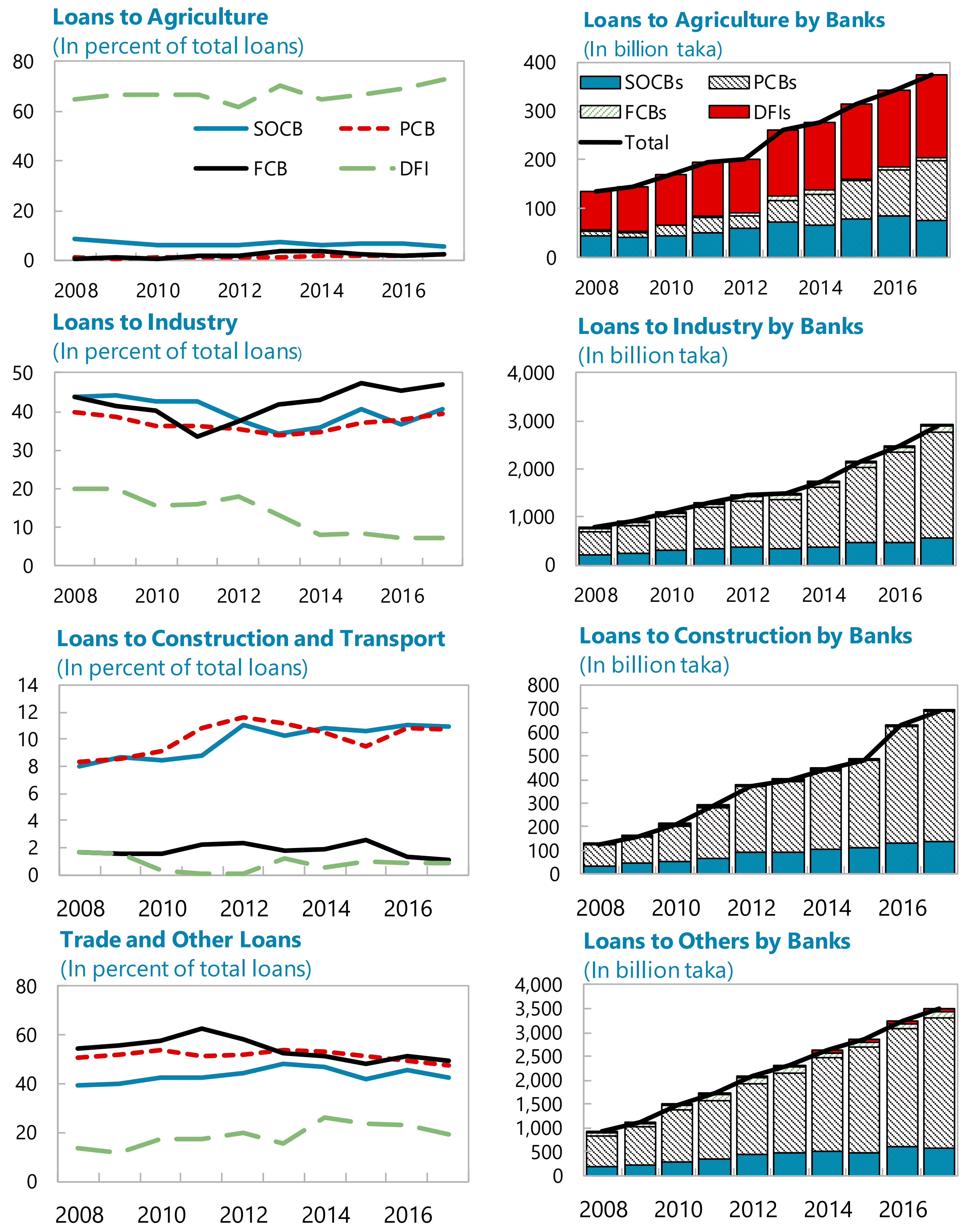
C. Comparative Performance of Banks in Bangladesh

6. This section describes the relative performance of different groups of banks. The picture that emerges is quite clear: the SOCBs are in much weaker financial position than either PCBs or FCBs.

7. Figure 4 compares NPLs as a percent of total loans (gross and net of provisions and interest suspense). After peaking at 35 percent in 2000, the NPL ratio in the banking system declined significantly, to around 6 percent in 2011. However, starting in 2012, NPLs have begun to increase, partly reflecting the change in loan classification, and have crossed 10 percent in 2016 and 2017. The SOCBs have been showing much higher NPLs than the PCBs and the FCBs, and the difference has significantly increased over time. In 2017, the SOCBs' NPL ratio was almost five times as high as those for the PCBs.

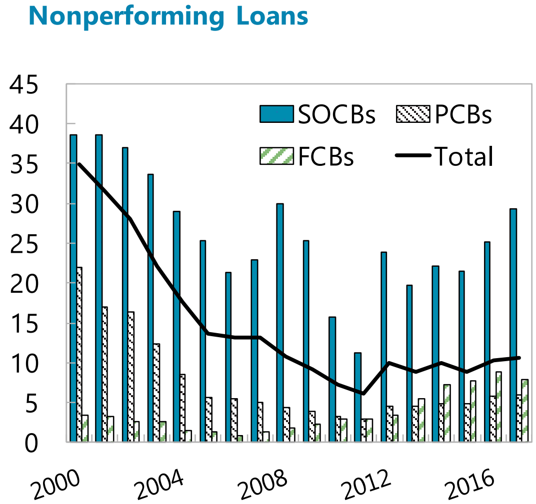
8. The increase in the NPL ratio since 2011 also reflects loan deterioration in all types of banks: in all three groups, the NPL ratio has more than doubled. It is noteworthy that this deterioration took place when the real GDP growth remained within 6-7 percent range. A similar picture emerges from net NPLs. For the banking sector as a whole, they fell from almost 30 percent in 2000 to close to zero in 2011 (and even below zero for the SOCBs), but then began to increase again, mainly due to higher net NPLs in the SOCBs, where provisioning did not keep up with loan deterioration.

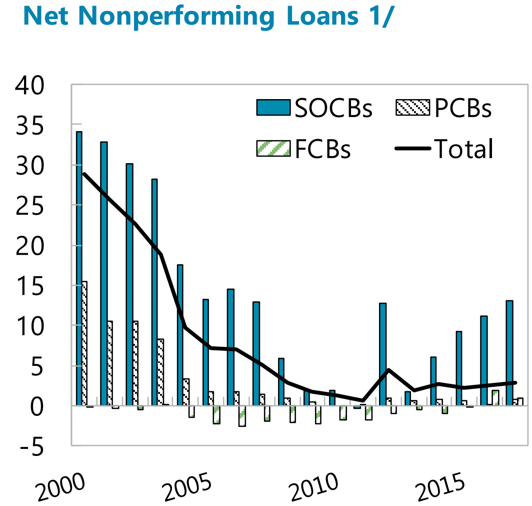
Figure 3. Bank Loans by Industry



Source: Bangladesh Bank and Staff Estimates

Figure 4. Non-Performing Loans to Total Loans

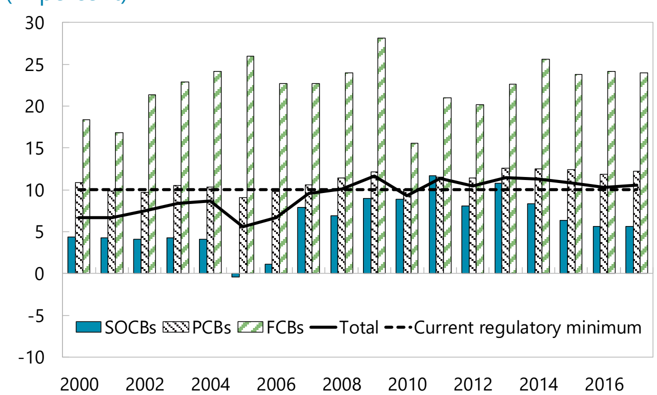




Source: Bangladesh Bank
1/ Net of provisions and interest suspense

9. Not only do the SOCBs have a significantly higher share of NPLs, but their capital adequacy ratio (CAR) is much lower compared to the PCBs and the FCBs (Figure 5). The SOCBs' CAR had reached close to 11 percent in 2013, above the minimum CAR requirement of 10 percent. Since then, it has been declining despite several rounds of recapitalization by the GoB. The ratio has now fallen below 6 percent. In contrast, the PCBs' CAR has been relatively stable and above the minimum CAR requirement.

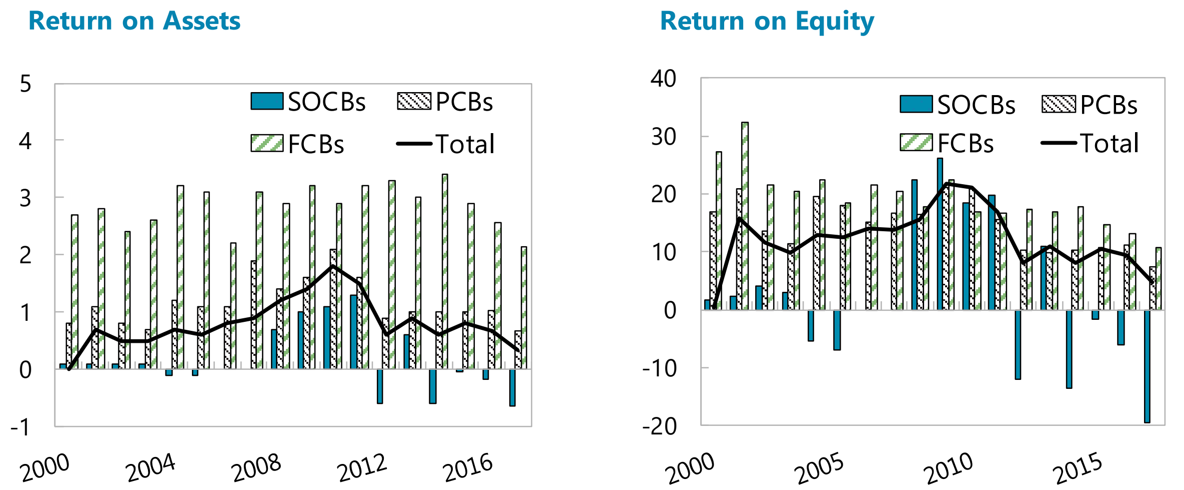
Figure 5. Capital to Risk Weighted Assets Ratio
(In percent)



Source: Bangladesh Bank

10. The poor performance of the SOCBs in terms of NPLs and CAR has also led to poor profitability indicators. Both return on assets (ROA) and return on equity (ROE), two standard indicators of profitability, show weak performance in the SOCBs (Figure 6). Since 2014, the SOCBs as a group have been reporting losses, and thus have a negative ROA and ROE. In 2017, the SOCBs losses have accelerated, with ROE reaching a negative 20 percent. In contrast, the PCBs and the FCBs have maintained a relatively stable ROA and ROE in recent years, though with some decline in 2017.

Figure 6. Bank Profitability Indicators



Source: Bangladesh Bank

11. Figure 7 provides more insights into the financial performance of the banking sector. In 2012, there was a significant jump in the required provisions, in particular for the SOCBs, where required provisions doubled. This jump reflected a major tightening of the provisioning requirement (see section E for more details).[3] However, required provisions continued to grow thereafter, and the pace accelerated in 2016 and 2017. The tighter provisioning requirement led to the decline in profitability in 2012, as banks increased their provisioning.[4] While the PCBs maintained actual provisions in line with this requirement, the SOCBs had a large shortfall in provisioning in 2012, but were able to reach full provisioning by 2013-14, before falling behind again in the last three years. Due to the under-provisioning, the actual SOCBs' profitability has been even weaker than suggested by the ROE and ROA.

12. The weak financial performance of the SOCBs can be partly linked to a relatively low interest rate margin – the difference between the costs of funds (deposits) and the lending rates. While the SOCBs' average deposit rates have been only slightly lower than the PCBs' rates, their average lending rates have been lower by about 2 percentage points, resulting in a much lower (by about one third) interest rate margin (Figure 8).

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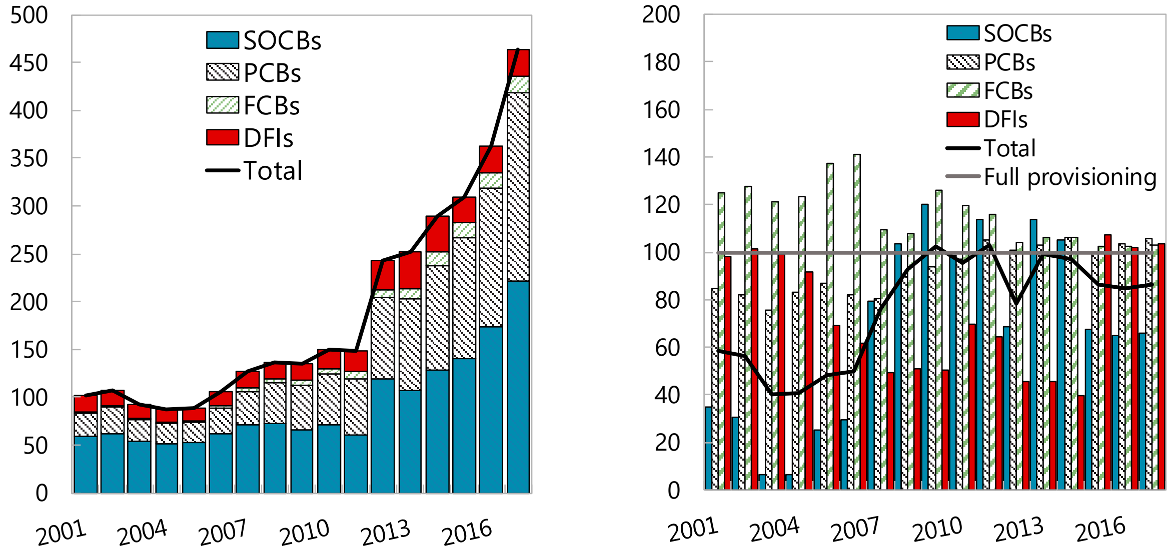
[3] For past due/overdue loans, the minimum time due has been reduced from 6 months to 3 months, while the provisioning for classified loans remained unchanged at 20, 50 and 100 percent for the sub-standard, doubtful and bad/loss loans.

[4] The SOCBs moved from profits to losses in 2012. The profitability of the PCBs also deteriorated in this year, dragging down the ROA and ROE for the entire banking sector. In addition to the change in provision requirement, the stock market correction in mid-2011 and 2012 could also have had some impact on banks' profitability.

Figure 7. Bank Provisioning

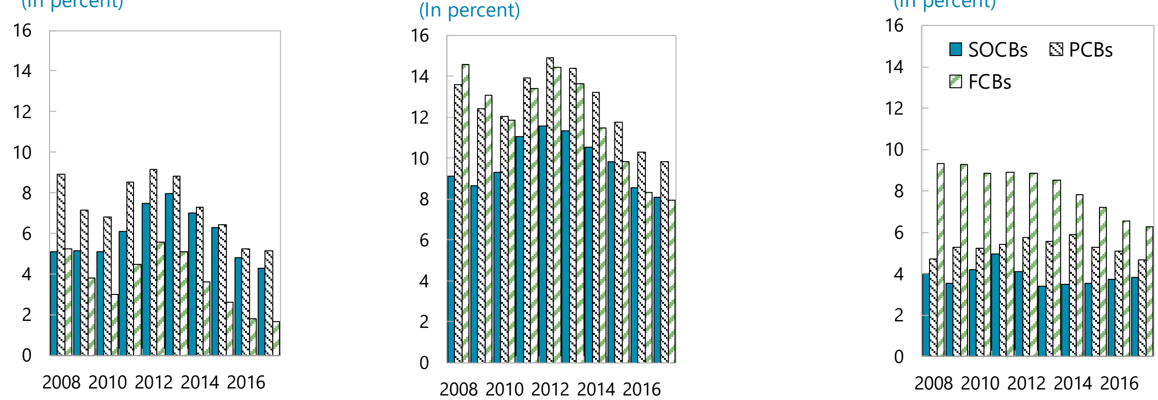
Bank Required Provisions (In billions of taka) | **Provision Maintenance Ratio,** (In percent)



Source: Bangladesh Bank

Figure 8. Bank Deposit and Lending Rates

Average Deposit Rates (In percent) | **Average Lending Rates** (In percent) | **Bank Interest Margin** (In percent)



Source: Bangladesh Bank

13. Table 1 confirms the positive relationship between banks' interest margin and their profitability. Given their ownership status and perceived government backing, the SOCBs are able to attract deposits at lower costs than PCBs (including government deposits and deposits by state-owned enterprises), but this does not translate into higher profitability as their lending rates are even lower, compared to PCBs' rates.[5]

Table 1. Bangladesh: Interest Margin and Profitability
(Average value over 2008 to 2017)

	Spread	ROA	ROE
SOCBs	3.87	0.27	4.53
PCBs	5.29	1.23	13.37
FCBs	8.15	2.95	16.42
DFI	2.36	-0.51	-20.41

Source: Bangladesh Bank

14. The implicit government guarantee allows the SOCBs to operate with high leverage. For a given profit and ROA, a higher leverage ratio (the ratio of banks' assets to bank's equity) would result in higher ROE. As already indicated by the relatively low CAR, the SOCBs support their assets by relatively low equity, and their leverage ratio has been consistently above other banks – and progressively so in recent years. In contrast, the FCBs' leverage ratio has been almost steady at around 5, a conservative ratio.

D. Causes of SOCBs' Poor Performance

15. The relative under-performance of the SOCBs continued with various challenges. The SOCBs have always had higher NPLs, lower CAR, and lower ROA and ROE. The efforts to strengthen the SOCBs' performance (see next section) have brought some improvements, but much remains to be done to restore their financial strength when compared to the PCBs and to regulatory standards. There is no one cause for the SOCBs' poor performance. Rather, it is a combination of factors that reinforce each other:

- ***Government mandates***. The SOCBs are tasked with performing some public policy roles, extending loans to potentially risky borrowers - sometimes at subsidized rates- and providing some services for government without charge. While these demands may have legitimate public policy objectives, if not fully financed (either by budgetary support or pricing policy allowing cost recovery), they will continue weakening the financial position of the SOCBs.
- ***Risk management***. There are still shortcomings in the SOCBs' risk management. Comprehensive risk management policy is lacking and early fraud detection could still be a challenge.[6]

[5] The FCB deposit rates are even lower than SOCBs rates. One reason could be better FCBs' service quality and advisory expertise. Also, the multinational companies' policy is to do transactions with only three foreign banks in Bangladesh.

[6] Bangladesh Institute of Bank Management recently conducted a survey of chief risk officers, which revealed significant shortcoming in using risk management tools, not just in SOCBs, but in the whole banking sector. See http://today.thefinancialexpress.com.bd/first-page/most-banks-not-using-risk-tools-1518197084?date=10-02-2018

- ***Weak governance.*** The SOCBs have a history of weak governance and outright fraud which has resulted in large losses.[7] Independent, qualified, and reputable professionals are not always present on their boards. The "Fit and Proper Test Criteria" guidelines for bank directors are not yet fully implemented. Decisions are often made against the interest of the bank, with insufficient evaluation of loan requests, connected lending, and insider dealing of client company's share. Importantly, there were often no consequences for these poor decisions. Not many board members or chairmen were charged.
- ***Unconditional recapitalization***. Repeatedly, the SOCBs have been recapitalized without sufficiently addressing the underlying problems of undercapitalization. Giving more funds to the SOCBs without resolving the causes of past poor performance will not produce sustained financial improvement.
- ***Supervision and regulatory forbearance***. While the supervisory and regulatory authority of Bangladesh Bank (BB) over the SOCBs has increased, the implementation has not been sufficiently robust. Without a firm enforcement of regulatory limits, and the possible resolution of banks that are continuously in breach of regulatory requirements, BB's ability to improve the SOCBs' performance will be limited.
- ***Automation and management information system.*** The SOCBs have been lagging behind other banks in adopting information technology-based banking services, including electronic banking services, electronic fund transfers, and automated teller machines. This has adversely affected their efficiency and profitability, as well as internal controls and fraud prevention and detection.
- ***Human resources.*** There are shortcomings in the SOCBs human resource (HR) management, including the limited role of HR departments in recruitment and promotions. Limited HR capacity could cause insufficient due diligence in lending decisions, and thus increase the risk of wrong or even fraudulent decisions.

16. An ineffective system of bad loan recovery is also adversely affecting the banking sector. The current system allows some borrowers not to repay, even if they are able to do so. The legal framework does not help banks to recover such loans quickly: courts are overburdened; borrowers can file writ petitions to the money loan courts and delay the whole process; seizing the collateral is very lengthy and time-consuming. There are many writ petitions filed against the Credit Information Bureau of BB not to classify these borrowers as defaulters. Borrowers are not always encouraged to service their debt on time, particularly if they can continue borrowing while their case is pending. All of these contribute to relatively high NPLs in the banking sector.

E. Previous Efforts to Improve SOCBs' Performance

17. In the past, the authorities have undertaken several steps to improve the performance of the SOCBs with mixed results. While these initiatives have brought some limited improvements,

[7] Several examples of fraud in the SOCBs are described in the article "From Cancer to Pimple" in *the Economist*, April 16, 2014.

as is evident from the analysis in section C, they failed to realize a decisive turnaround in the SOCBs weak performance.

18. The GoB, with the support of the World Bank, undertook the state bank reform program to improve the financial performance of the SOCBs. In 2007, the SOCBs were corporatized and brought under BB's regulatory authority, with notional capital increase in goodwill/capital equivalent to the SOCBs accumulated losses. Steps were taken to select the SOCBs' management competitively, and the SOCBs were expected to operate in the same way as private commercial banks. In addition, the GoB began to set up annual monitorable goals for the SOCBs based on cash recovery of NPLs, limits on new NPLs, computerization of branches, profitability, and disclosure. The SOCBs management and boards were made responsible for achieving these targets.

19. In 2007, BB increased the minimum CAR from 9 to 10 percent (and from 4.5 to 5 percent for tier 1 capital). These steps contributed to higher SOCBs' CAR (though it remained below the required minimum – see Figure 5).

20. The authorities were also implementing a program of the SOCBs divestment. Three banks were slated for privatization during 2005-07, while Sonali, the largest SOCB with a strong rural presence, was supposed to be restructured and divested over the medium term. However, the privatization of Rupali Bank fell through and the whole divestment plan was eventually suspended. The authorities instead changed their focus on improving the SOCBs' performance, with the view that stronger performance would improve the odds of successful divestment.

21. In 2012, the loan classification was tightened, to bring it more in line with international practices. This resulted in a jump in required provisions (Figure 7). The revision shown here applies to continuous and demand loans. The definition and delinquency periods were also tightened for fixed term loans.

Table 2. Bangladesh: Loan Definition and Delinquency Periods

	Original	Revised in 2012	Provisions 1/
Sub-standard	6-9 months	3-6 months	20%
Doubtful	9-12 months	6-9 months	50%
Bad debt	More than 12 months	More than 9 months	100%

Source: Bangladesh Bank

1/ For some priority sectors, including agriculture and SMEs, delinquency periods are longer before provisions are required.

22. Strengthening the SOCBs performance has also been one of the objectives of the Fund-supported program under the Extended Credit Facility. In 2013, the Bank Companies Act was amended, to give BB full regulatory and supervisory control over the SOCBs. BB was given more authority to take punitive actions against SOCB management.[8] In 2015, BB announced that it will place observers for the board of directors in the SOCBs with worsening internal governance. As part of its enhanced supervisory powers, BB has also begun to sign memoranda of understanding (MoU) with the SOCBs with specific quantitative targets, including the reduction of NPLs, limits on the growth of their lending portfolio (ranging from 8 to 20 percent in 2017), and cash recovery from the largest defaulters. BB also completed a special diagnostic examination of the SOCBs in 2013 and formulated a plan to address the identified deficiencies.

F. Policy Recommendations and Conclusions

23. Bangladesh's growth has been strong in recent years, but this should not mask the potential costs of inefficient SOCBs that account for more than a quarter of the banking system. Large NPLs imply that a large amount of the savings is being wasted by financing loss-making activities, and therefore becomes unavailable for financing productive investments. High NPLs and the need for provisions also increase the cost of credit to good borrowers, further dampening investment and growth. Perceived government guarantees of the SOCBs create an uneven playing field for private banks, while the SOCBs undercapitalization presents a potential fiscal liability.

24. Resolute steps are required to resolve the SOCBs' weak performance, reflecting empirical evidence and mixed-results from the previous efforts. The following steps could be considered:

In the short to medium term:

- BB and the GoB should strictly enforce the existing bank regulations and rules. In particular, the current practice of no punitive action for not observing the annual performance agreement with the Ministry of Finance or the failure to meet the goals set out in the MoUs with BB should be reconsidered.
- In performing its regulatory responsibilities, BB should be free of political pressure.
- To avoid potential conflict between the MoU's targets and the GoB's demand on the SOCBs to pursue non-commercial objectives, there is a need to clearly spell out the SOCBs' mandate and provide budget support, if necessary, to finance this mandate. To the extent that the SOCBs are not allowed to apply cost recovery pricing to the services and products they are asked to provide, the upfront budget transfers rather than ex-post recapitalization should be considered.
- Independent management should be put in place in the SOCBs that meet the fit and proper criteria.

[8] BB can remove the managing director of the SOCBs. However, BB's action against any member of the Board of the SOCBs requires a consent of the Finance Ministry.

- The SOCBs should be gradually recapitalized to meet the regulatory capital standards.[9]

In the long-term:

- The authorities should formulate and implement a long-term plan for the SOCBs and their role in the financial system. To the extent that the GoB needs to continue using the financial system to deliver certain policy objectives, such as providing financial services to under-served groups or areas of the economy, it needs to carefully consider the most effective way to achieve such objectives.
- The GoB should consider the reduction of the number of the SOCBs by either merging or privatizing some of the existing SOCBs. In the long run, there could be 1-2 SOCBs, financed from the budget, that would be tasked with pursuing specific mandates given by the GoB. Other SOCBs could be divested.
- Strengthening the financial position of the SOCBs with support of above-mentioned short and medium-term measures could prepare the SOCBs for divestment. The GoB could consider SOCBs restructuring before divestment. Alternatively, prospective strategic investors could undertake this task, though this would come at the cost of a lower sale price of these SOCBs.

25. The GoB has ambitious medium-term growth aspirations, and wants to achieve middle-income status. However, for these ambitions to materialize, an efficient financial system, including a healthy banking sector and well-functioning capital market, are indispensable.

[9] It is sometimes argued that because of the implicit or explicit backing by the government, deposit-taking SOCBs do not need to maintain a high capital cushion as private banks because there is little risk of depositors' run. However, applying the same capital requirements to the SOCBs provides more transparency about budgetary support than guarantees, and serves as a break on expansion of their activities. See Mitra and Zephirin, (2014).

References

Cull, R., M.S.M. Peria and J. Verrier, 2017. "Bank Ownership: Trends and Implications", IMF Working Paper 17/60, International Monetary Fund, Washington.

Mitra, S. and M. Zephirin, 2014. "State-Owned Financial Institutions – Strict Oversight is Key", MCM Policy Position Note, International Monetary Fund, Washington.

NATIONAL SAVINGS CERTIFICATES AND BUDGET FINANCING[1]

A. Introduction

1. **In recent years, the issuance of National Savings Certificates (NSCs) has increased rapidly and become the dominant instrument to finance government borrowing, repeatedly exceeding the budgeted amount by a large margin.** The proliferation of the NSC issuance has complicated fiscal policy, debt management, and financial market development. If left unaddressed, this could lead to significant costs and distortions.

2. **NSCs were introduced as a saving scheme for small savers, when the banking system was less developed.** It was intended to motivate people to save money, collect scattered small savings, and provide a safety net for certain groups of population, including senior citizens, women, and physically handicapped. NSCs pay a higher interest rate than bank deposits with similar maturity. There are presently eleven different savings instruments with maturities of 3 or 5 years, available on demand and managed by the Directorate of National Savings under the Ministry of Finance (see Annex for details). To ensure that the scheme is used mainly by small savers, the ceiling for investment in most NSCs schemes is set at Tk. 3-5 million (about $37,000 - $61,000) for an individual, and Tk. 6 million (about $72,300) for a family.

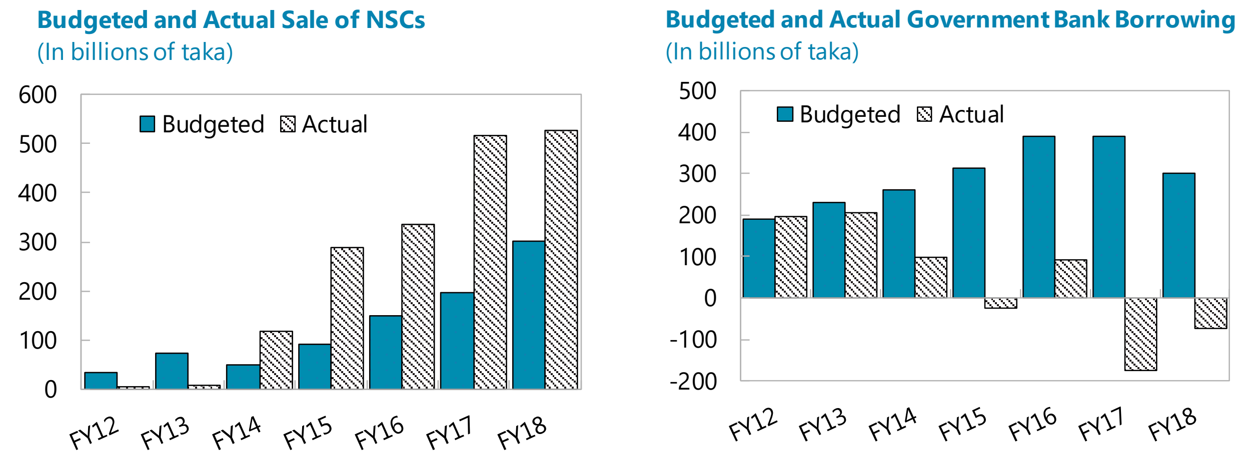
B. Recent History of NSC Issuance

3. **Following relatively modest issuances in the past, sales of the NSCs accelerated in FY15 and FY16, and then jumped further by almost 60 percent in FY17, reaching a record Tk. 524 billion (2.7 percent of GDP).** This sharp acceleration was not envisaged by policy makers, as evidenced by the progressively widening gap between the budgeted and actual amount of NSCs financing (Figure 1). With actual deficits and external financing broadly in line with budget targets, domestic bank borrowing had to be reduced, which turned significantly negative in FY17. The government borrowed by issuing expensive NSCs to repay less expensive T-bonds and T-bills.

4. **The large NSC issuance has continued in FY18 as well.** During the first half of FY18, the net sales of NSCs have reached to broadly the same level as during the first half of FY17. However, in the last three months (November 2017-January 2018), the net issuance has declined by about 10 percent compared to the same period of FY17 (Figure 2). The NSC issuance in FY18 will continue to exceed the budgeted amount by a sizable margin and this will result in a further reduction of bank borrowing, depending on the overall domestic financing requirements.

[1] Prepared by Jiri Jonas.

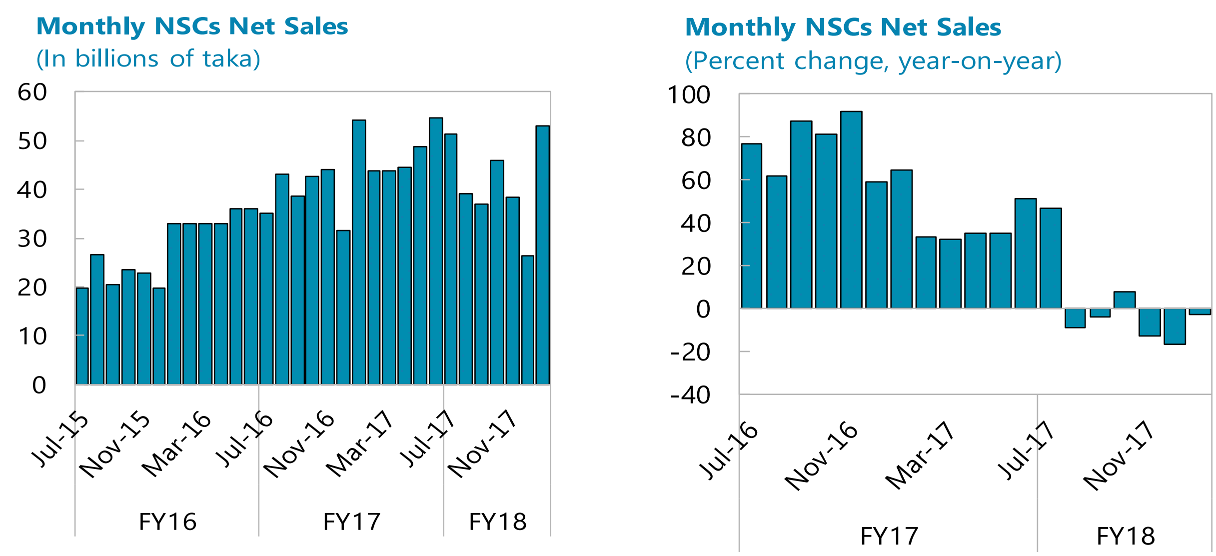
Figure 1. Budgeted and Actual Budget Domestic Financing 1/



Source: Bangladesh Bank

1/ For FY18, actual NSCs in H1 plus projected issuance in H2 equal to H2 FY17. FY18 bank financing is derived as residual, assuming that total domestic (bank and NSC) financing is equal to 75 percent of the budgeted amount (it was 60 percent in FY17).

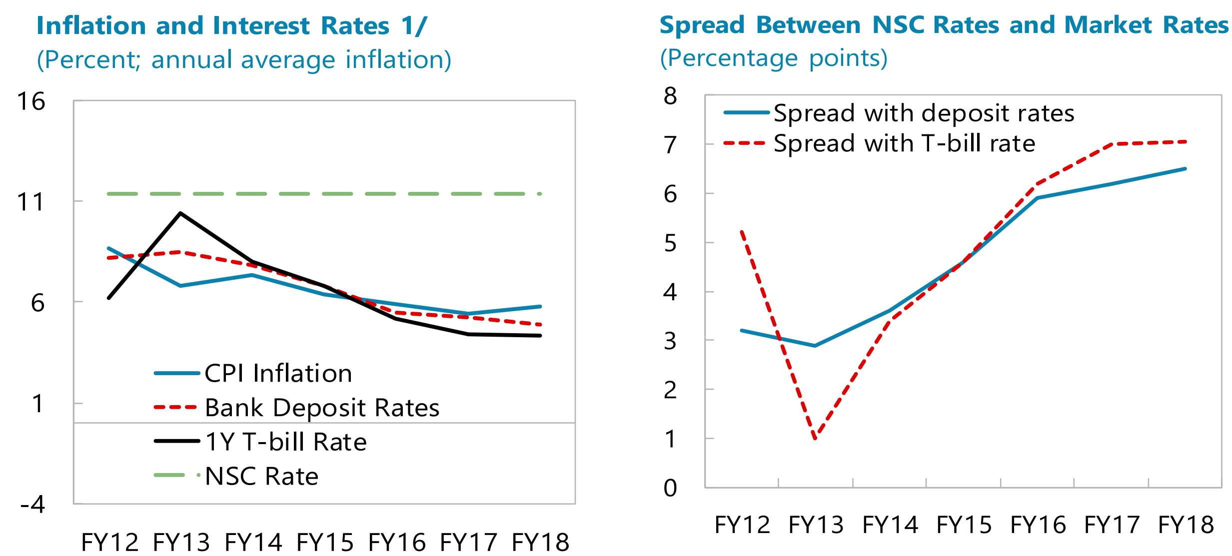
Figure 2. Monthly Sales of NSCs



Source: Bangladesh Bank, Staff Estimates

5. The main reason for the recent sharp increase in the NSC issuance appears to be the large difference between the NSC rates and the bank deposit or government securities rates (Figure 3). Starting in FY14, inflation began to decline gradually, followed by a similar decline in bank deposit rates and T-bill rates. Given the relatively stable administratively determined nominal NSC rates (over 11 percent), this resulted in a larger spread between the NSC rates and market-determined rates, making the former more attractive to investors. More recently, deposit rates have begun to increase somewhat and the difference with the NSC rates have become slightly smaller, reflecting tighter liquidity conditions in the banking sector. This may have led to slower growth in the NSC issuance from November 2017.

Figure 3. Inflation and Yields



Source: Bangladesh Bank, Staff Estimates

1/ NSC rate is assumed to be the average of 11.04-11.76 percent

6. With a rapid increase in the NSC issuance, the stock of NSCs as a percent of GDP has doubled from 5 to 10 percent between FY13 and FY17. It has also reached almost one third of the total government debt, compared to 15 percent in FY13 (Figure 4). At the same time, the share of NSCs in total budget deficit financing jumped from close to zero in FY12-FY13 to 60 percent in FY17, and is likely to remain close to that level in FY18 as well.

7. The recent high level of NSC issuance has several negative implications. These include a higher cost of government borrowing, slower development of the government securities market and other financial markets, and the inability to plan and execute government borrowing and debt management strategy. Specifically:

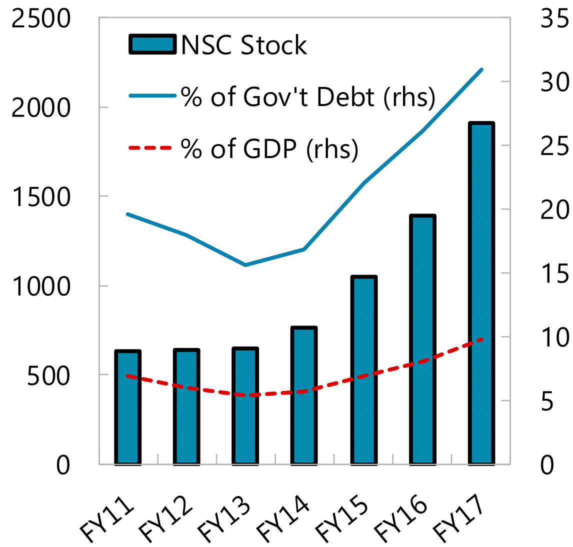
- NSCs provide an expensive source of government financing. The NSC rate is well above the rate of government securities (Figure 3). As a result, the cost of government debt is increasing with higher interest payments on NSCs both in nominal terms and as a share of domestic debt interest payments (Figure 5). While increased NSC issuance has not yet had a significant impact on public debt sustainability, this could change if the current high issuance persist for an extended period.

- NSC interest rates now significantly exceed those on bank deposits and this serves as an indirect source of subsidy to households. If the NSC holders include investors not originally targeted, this would imply unwanted and wasteful subsidies to wealthy individuals or households.
- NSC instruments are supplied on demand and the government is unable to control the amount of financing it receives from NSCs. This makes it more difficult to plan the issuance of T-bills and T-bonds, hampering the development of the government securities market. In fact, the outstanding amount of T-bills and T-bonds peaked in 2014 and has begun to decline in nominal terms in 2015. With the NSC issuance repeatedly exceeding the budgeted amount, the government had to cancel T-bill and T-bond auctions, which has adversely impacted the liquidity of secondary markets in government securities.
- The failure to develop a well-functioning liquid market in government securities is hampering the development of the broader financial market, including the market for corporate bonds and the equity market.
- With longer-term savings channeled into the NSC instruments, less savings is available to finance private investments, adversely affecting the long-term growth performance.[2]
- The absence of a well-functioning government securities market is also adversely impacting the efficiency of monetary policy transmission, and thus ability of Bangladesh Bank (BB) to use monetary policy to pursue its objectives.
- The diversion of savings into NSCs also has adverse implications for the financial health of the banking sector. While there are other reasons for the deteriorating financial performance of deposit-taking banks, in particular, state-owned commercial banks, the shrinking supply of government securities is likely to have contributed to this deterioration, as it implies reduced availability of safe assets, which in turn could push banks to extend more risky loans.

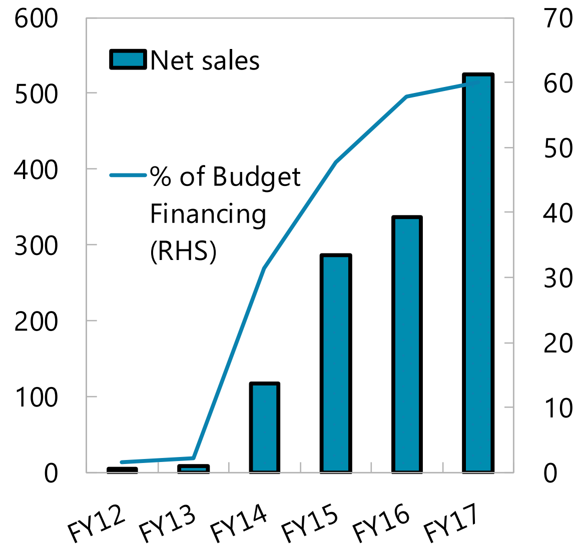
[2] Strictly speaking, this problem only arises with NSC purchases by those who are not originally targeted recipients. Channeling the same amount of funds as a means of income support to the targeted groups via NSCs or direct budgetary transfers should not have significantly different impact on government savings.

Figure 4. NSCs, Budget Financing and Government Debt

NSCs Outstanding
(In billions of taka and percent)



NSC Sales and Budget Financing
(In billions of taka and percent)

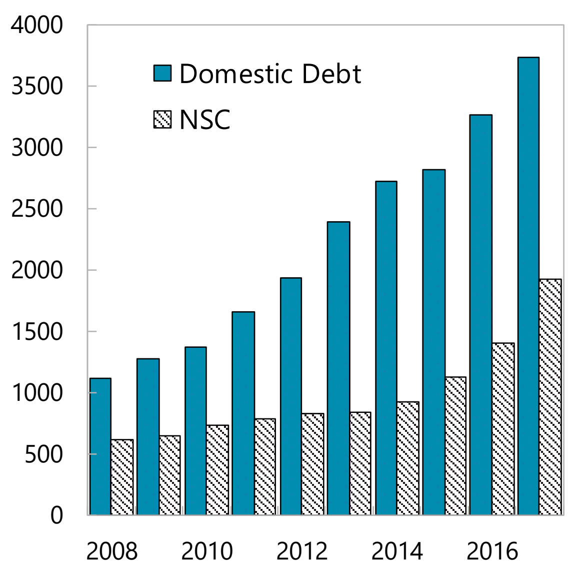


Source: Bangladesh Bank, Staff Estimates

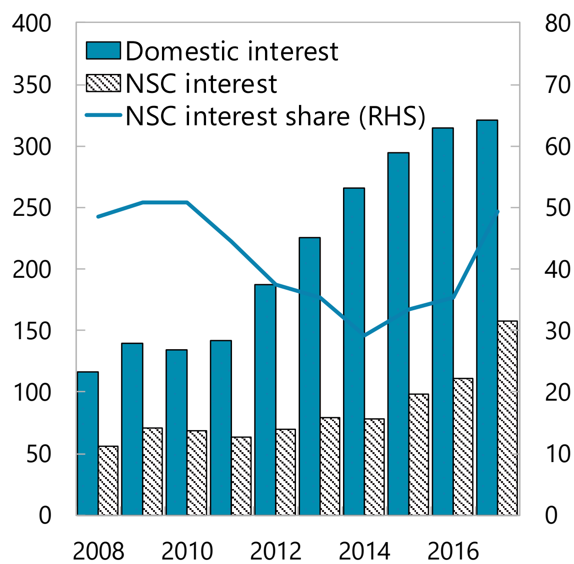
1/ NSC rate is assumed to be the average of 11.04-11.76 percent

Figure 5. Government Debt and Interest Payments

Government Domestic Debt and NSCs
(In billions of taka)



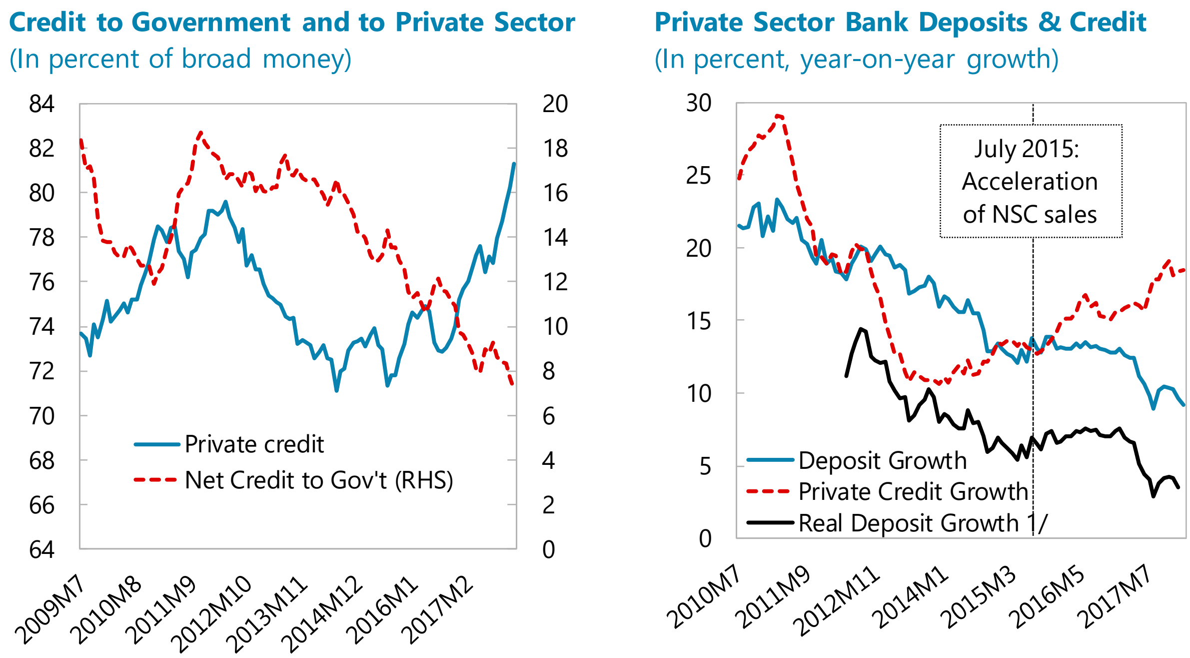
Domestic Interest Payments
(In billions of taka and percent)



Source: Ministry of Finance, Staff Estimates

8. Private credit growth has been strong despite with the recent slowdown in deposit growth due to higher NSC issuance (Figure 6). The difference between private credit and deposit growth began to widen around mid-2015, when the NSC issuance accelerated. Negative government borrowing and banks' excess liquidity from a strong balance of payment position allowed banks to maintain rapid increases in private credit until recently. However, excess liquidity fell from Tk. 1.26 billion in September 2016 to Tk. 0.867 billion in December 2017 because of a weaker external position and strong private sector demand for loans. With the reduction of the maximum advances-to-deposit ratio by BB, deposit and lending rates have started to increase recently.

Figure 6. Banking Sector Deposits and Credit



Source: Ministry of Finance, Staff Estimates

1/ Nominal growth deflated by increase in CPI over previous twelve months.

C. Alternative Interest Cost Scenario with Continued High NSC Issuance

9. Using more expensive NSC financing to repay less costly market borrowing will result in higher interest payments and higher fiscal deficit and debt. While these additional borrowing costs do not appear to be significant yet, they will accumulate over time, and limit the government's capacity to finance other spending without running a higher fiscal deficit and weakening fiscal sustainability. The FY17 data illustrates the magnitude of increased borrowing costs from higher-than-budgeted NSC issuance.[3]

[3] Another way to look at the costs of NSCs would be to compare the evolution of interest payments on NSCs over time – both in nominal terms and as a percent of GDP and of total interest payments – see Figure 5.

10. Additional borrowing costs from higher NSC issuance can be estimated by using the difference between actual FY17 NSC issuance and its hypothetical issuance with the budgeted share of NSC in domestic deficit financing. This enables to separate the effect from different level of domestic finance needs, and focus solely on the effect of changes in the NSC/bank financing share. The average cost of NSC borrowing is assumed at 11.4 percent, a mid-rate for the NSC rates (11.1-11.7 percent). Further, it is assumed that the reduction in bank financing (purchases of government securities) is split 50:50 between T-bills and T-bonds, and that the T-bill rate and T-bond rate would be 4 and 8 percent, respectively.

Table 1. Bangladesh: FY17 Additional Borrowing Costs from NSC Issuance
(In Billions of Taka)

Assumptions:	a.	Bank financing: 50/50 T-bills and T-bonds
	b.	T-bill rate 4%
	c.	T-bond rate 8%
	d.	NSC rate 11.4%
Additional NSC borrowing:		341.6
Additional NSC interest costs:		38.9
Less T-bill issuance:		-170.8
Less T-bond issuance:		-170.8
Less T-bill costs:		-6.8
Less T-bond costs:		-13.7
Total:		-20.5
Net additional interest costs		**18.4**
% of GDP		**0.1**

11. Under these assumptions, additional NSC issuances (Tk. 341.6 billion) implies additional interest costs for the financing of the FY17 deficit of Tk. 18.4 billion (around 0.1 percent of GDP). This is derived as the difference between additional NSC interest costs of Tk. 38.9 billion, and lower interest costs on T-bills (Tk. 6.8 billion) and T-bonds (Tk. 13.7 billion), reflecting lower issuance of these government securities compared to the issuance that would have been achieved with the actual deficit and the budgeted share in the total domestic financing. Using the same approach, additional net interest payments resulting from higher share of NSCs during FY14 and FY17 amount to Tk. 43 billion, or about ¼ percent of FY17 GDP.

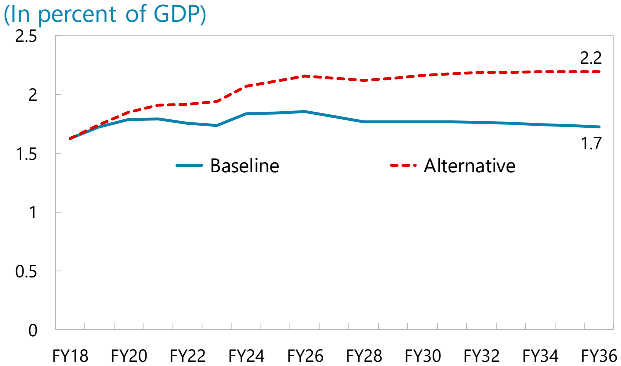
Table 2. Bangladesh: Interest Costs from Additional Issuance

	Additional Financing		Additional Interest		Net Additional
	Bank Financing	NSC	Bank Financing	NSC	Interest
FY14	-61.9	61.9	-3.7	7.1	3.3
FY15	-180.0	180.0	-10.8	20.5	9.7
FY16	-207.4	207.4	-12.4	23.6	11.2
FY17	-341.6	341.6	-20.5	38.9	18.4
Total	*-790.9*	*790.9*	*-47.5*	*90.2*	*42.7* **(0.22% of GDP)**

12. **Continued NSC issuance at the present level would imply a notable increase in interest payments over the medium term.** The medium-term implications for interest payments on government domestic debt can be estimated by using the same assumptions for the interest costs of NSCs and market securities as described in the previous paragraph. Figure 7 shows two paths of interest payments on domestic government debt as a percent of GDP. The baseline scenario assumes a gradual decline in the NSC issuance as a percent of GDP from 2.7 percent of GDP in FY17 to close to 1 percent of GDP. The alternative scenario assumes that the issuance will remain twice as high as the baseline (as a percentage of GDP) during the projection period, close to the recent peak. Over the medium-term, the difference between the interest payments in these two scenarios becomes more pronounced: while interest payments remain broadly stable as a percent of GDP in the baseline scenario, under the alternative scenario, interest payments continue to increase gradually to about 2.2 percent of GDP by 2036, 0.5 percentage points higher than in the baseline scenario.[4]

Figure 7. Interest Payments on Domestic Government Debt

(In percent of GDP)



Source: Staff estimates

D. Possible Measures to Address the NSC Problem

13. **Addressing the NSC problem in a relatively speedy and comprehensive manner should remain an important policy priority.** The above projection of interest payments illustrates that the high NSC issuance could, in the medium term, have tangible impacts on debt sustainability. The actual impact on debt dynamics could be worse if the possible adverse implications of the higher NSC issuance on investments and growth are considered. As discussed above, the current NSCs scheme could – if continued – carry significant costs to the economy that would undermine the authorities' efforts to sustain high growth and reach middle-income status.

[4] This illustration does not capture the effect of higher interest payments in the alternative scenario on the deficit and the overall borrowing needs. Accounting for this would further add to interest payments under the alternative scenario.

14. The authorities should start with establishing a database that records the existing holdings of NSCs.[5] The monitoring of the investment ceilings could aim: investors with excessive holdings would have to bring them below the ceilings before becoming eligible for new purchases; or they may become ineligible to collect the interest on the NSC holdings above the applicable ceilings. Consideration should also be given to whether the current eligibility criteria, the investment ceilings, and the number of instruments still serve the original purpose. Presently, almost all citizens of Bangladesh are eligible to buy some NSCs (see Annex for details). Thus, even rich people can invest in the scheme and receive an implicit subsidy. While excluding persons above a certain income threshold would reduce this untargeted subsidy, it could come with increased monitoring costs and administrative challenges.

15. Currently, little information is available to assess the extent of misuse in the NSC scheme. In 2013, BB released a survey report about the NSC scheme. The findings indicated that most of the NSC investors were of modest income, and that their average invested amount was fairly small.[6] This suggests that the scheme was successful in targeting the intended group. However, since 2013, NSC issuance has increased significantly, raising the question whether the conclusion about accurate targeting and the absence of widespread misuse remains valid. Unless the number of NSC investors has increased dramatically since the time of the survey, the size of the NSC issuance increases (from Tk. 7.7 billion in FY13 to Tk. 516 billion in FY17) would suggest possibly a significant breach of the investment limit of Tk. 3 million for an individual (or Tk. 6 million for a family). Thus, it can be expected that effective monitoring of the NSC scheme and enforcing corrective measures could result in the reducing the issuance from the recent elevated levels.

16. However, a more resolute solution may be necessary to reduce distortion and costs from the current NSC scheme. The demand for NSCs will be strong as long as their relative attractiveness over other investment facilities remains and their issuance will continue to be outside of the control of the government. Therefore, more far-reaching reform of the NSC scheme would entail:

- Changing the pricing policy by linking the NSC rates closer to the market rates (bank deposit rates, T-bill and T-bond rates), which will reduce the current high spread. To the extent that the original objective of the NSC scheme – to provide a means of savings to small savers – remains valid, the scheme with a reduced number of instruments could still be maintained. However, this does not require maintaining the large subsidy element in the current high NSC rates.

[5] As discussed in the Staff Report, the authorities are planning to launch such database, using the National Identification Number Database.

[6] Bangladesh Bank (2013). According to the survey, the average monthly family income of the investors in the NSC scheme was Tk. 28,700 (about US$360). About 55 percent of investors in NSCs invested less than Tk. 0.5 million (less than $6,250).

- Delinking budget financing from providing income support to the poor and vulnerable population. Instead, such support should be provided as part of the budget spending in the form of direct transfers to the targeted recipients. For example, expanded pension coverage would reduce the need to use NSCs to provide support to the elderly. That would allow the authorities to regain control over budget financing.

17. A radical solution would be to completely abolish the NSC scheme, or to stop the issuance of the NSCs once the annually budgeted amount has been reached.[7] However, completely abolishing NSCs is not necessary to contain the problems of the current scheme. And limiting the issuance to the budgeted amount could create new problems. First, the existence of the limit on issuance could significantly accelerate the issuance as everyone seeks to secure their purchases. Second, once the issuance stops, the government would have to switch to other means of borrowing. As government borrowing usually increases in the final months of the fiscal year, that could force a volatile schedule in issuance of T-bills and t-bonds, possibly resulting in a large volatility in yields which, in turn, would limit the potential benefits of this approach in terms of lower interest costs.

E. Conclusion

18. In recent years, the NSC issuance has accelerated rapidly, creating various side-effects. The increasing role of NSCs in government borrowing has led to higher interest costs, while the unpredictability of the "on tap" NSC issuance has complicated budget financing and debt management strategy, which has hampered the development of capital market. The question remains on whether the original objectives of the NSCs are still pertinent and whether there are more effective ways to achieve them.

19. Reforming the NSC scheme has become a matter of urgency. The near-term steps could include: (i) creating the database of the NSC subscribers to increase the monitoring capacity and reduce the scope for misuse by breaching the access limits to NSCs; (ii) reducing the number of savings instruments to simplify the system and further increase the capacity to monitor NSCs; and (iii) limit the access to NSCs to retail investors. In the medium to long term, the NSC scheme should be separated from budget financing, and the NSC rates should be linked to market interest rates, to reflect the new role of NSCs as a savings instrument for targeted population segments rather than a tool for subsidy provision.

20. Income support to the vulnerable population should be done directly from the budget. Such a mechanism would be more efficient, better targeted, and more transparent, with appropriate political control and approval. Under the present system, this support is not well targeted, and the size of indirect subsidies extended from the budget (in the form of higher interest payments) is outside of political control and approval.

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[7] Mansur (2017) suggested that one option to address the NSC problem would be to completely stop selling new NSC instruments. The argument is that with modern banking system in place accessible to most people, there is little justification for the NSC scheme originating at the time when banking system was underdeveloped. Instead, the savings could be directed from NSCs to the banking system and capital market.

Annex I. National Savings Certificates – Overview

Scheme	Maturity	Eligibility	Max Limit	Interest Rate	Tax
5Y Bangladesh Sanchayapatra	5-year	Citizens of Bangladesh	Tk. 3-6 million	11.28% at maturity; 9.35% to 10.75% in 1-4 year	5% on profit
		Recognized Provident Funds and agricultural farms	Unlimited		
3-monthly profit basis Sanchayapatra	3-year	Citizens of Bangladesh	Tk. 3-6 million	11.04% on maturity; 10% after 1st year and 10.5% after 2nd year	5% on profit
Pensioner Sanchayapatra	5-year	Retired gov't officials	Tk. 5 million	11.76% on maturity; 9.7 to 11.2% in 1-4 year	5% on profit
Poribar Sanchayapatra	5-year	Adult women, senior citizens, physically challenged	Tk. 4.5 million	11.526% on maturity; 9.5 to 11% in 1-4 year	5% on profit
Bangladesh Prize Bond	---	Citizens of Bangladesh	Unlimited	6.5%	20% on prize money
Wage earner development bond	5-year	Valid wage earners and his beneficiary	Unlimited	12%	Tax free
US Dollar Premium Bond	3-year	Non-resident account holder	Unlimited	7.5% on maturity; 6.5% in 1st year; 7% in 2nd year	Tax free
US Dollar Investment Bond	3-year	Non-resident account holder	Unlimited	6.5% on maturity; 5.5% in 1st year; 6% in 2nd year	Tax free
Post Office Savings Bank Ordinary A/C	---	Citizens of Bangladesh	Tk. 3-6 million	7.5%	10% on profit
Post Office Savings Bank Fixed Deposit	3-year	Citizens of Bangladesh	Tk. 3-6 million	11.28% on maturity; 10.2% in 1st year; 10.7 % in 2nd year	10% on profit
Postal Life Insurance: (I) life; (ii) fixed term	5-year or multiple	Citizens of Bangladesh	Unlimited	(i) 4.2% yearly or (ii) 3.3% yearly	Tax free

National Savings Schemes and the Outstanding Stock		
	(Billion BDT, outstanding stock as on end the period)	FY16
1	Defence Savings Certificate	0.4
2	5-Year Bangladesh Sanchayapatra	186.2
3	3-Year Sanchayapatra	0.3
4	Bonus Sanchayapatra	0.3
5	6-Monthly Profit Bearing Sanchayapatra	1.8
6	Family Savings Certificate	538.7
7	3-Monthly Profit Bearing Sanchayapatra	316.3
8	Jamanat Sanchayapatra	0.3
9	Pensioner Sanchayapatra.	94.1
10	10 Years Bangladesh Sanchayapatra	0.1
11.a	P/O Savings Bank: a) Ordinary Account:	12.7
11.b	P/O Savings Bank: b) Fixed Deposit	154.2
11.c	P/O Savings Bank: c) Bonus Account:	0.2
12	Postal Life Insurance	5.4
13	Bangladesh Prize Bond	4.4
14	Wage Earner Development Bond	67.8
15	3-Year National Investment Bond	0.6
16	US Dollar Premium Bond	2.8
17	US Dollar Investment Bond	17.1
Grand Total		**1403.8**

Annex II. Pakistan's Reform of Savings Certificates

1. In the past, Pakistan faced similar problems with the national savings scheme that currently exists in Bangladesh. There were many saving instruments, with pricing delinked from the benchmark instruments, and it was difficult to control and project the issuance. During the 2000s, Pakistan undertook a reform of the scheme, successfully addressing many of the issues. While the implementation of the reform has proceeded gradually, it has been done comprehensively, covering simultaneously different fronts.

- *Pricing mechanism and benchmarking*. Under the previous system, the pricing of the savings instruments was delinked from the benchmark government securities, creating room for arbitrage and fragmenting the financial market. To correct this, the return on the savings certificates were linked to the yield of the government security (T-bills and T-bonds) of the corresponding maturity (the adjustment of return does not have to be made in one jump, and can be done in several steps). For example, the 6-month saving certificate rate was based on the 6-month T-bill rate from the latest auction. This reform brought several benefits. It implied reduced borrowing costs to the government, and removed the source of arbitrage. All savings instruments and other securities were now linked via the new pricing mechanism, which improved the liquidity of the government securities market, broadened the investor base, and strengthened the monetary policy transmission mechanism. Initially, the rates on savings certificates were set equal to the auction yields on government securities, but later, a 50-basis points margin was added.
- *Eligibility*. Originally, there was no limit to access: all types of investors could invest in saving certificates, including individuals, groups, companies, pension funds etc. The stated objective was to provide secure savings instruments to any investor. Following the reforms, the access was limited to individuals only, with the savvier institutional investors assumed to invest in the wholesale market. At the same time, individual investors were allowed access to T-bond and T-bill auctions via noncompetitive bidding (with limits of 5-10 percent of the issuance).
- *Reduction of the number of savings instruments*. Originally, there were over 30 different instruments, often several instruments with the same maturity, resulting in fragmentation and low liquidity of individual issuance. Thus, the number of instruments was reduced to eight, which reduced the need for monitoring and simplified the scheme's implementation. In addition, to increase liquidity, some less liquid maturities were abolished. The savings certificates currently come in two forms, prize bonds and coupon-bearing instruments.
- *Limits on purchase*. The effective removal of room for arbitrage between the saving certificates and government securities obviated the need for monitoring and limiting access. Thus, savings certificates are treated as any other security. The only exception is a special certificate for retirees (person over 60 years old) and widows, which can purchase up to 5 million rupees (around US$45,000) of special certificates that provide an additional return of 150 basis points over the benchmark return. The use of national identification cards and death certificates made controlling the access to these instruments straightforward.

- *Issuance*. Commercial banks can issue the savings certificates on behalf of the government, and are paid a commission for this service. This also allows the banks to keep the investors as their customers, because the investors are using the bank accounts, and thus could advertise their services. The National Savings Office, attached to the Department of Finance in the Ministry of Finance, is in charge of managing the issuance of savings certificates. The ad hoc ("on tap") issuance of savings certificates can take place any time, regardless of the timing of the T-bill and T-bond auctions, and the minimum investment requirement could be calibrated to meet the specific needs of the retail investors.

- *Tax treatment*. The tax treatment of saving certificates and other securities has been aligned. For registered taxpayers (holders of tax identification number), a 10 percent withholding tax is applied on interest income, while non-registered taxpayers are subject to a 20 percent tax rate.

- *Debt management strategy*. One of the problems caused by financial instruments not linked via a pricing mechanism to other securities is inability to predict their demand and issuance with reasonable accuracy. This inability seriously complicates the debt management strategy and the annual budget financing planning. Linking all financing instruments via a pricing mechanism and benchmarking makes it easier for the authorities to predict demands with a reasonable accuracy. Given the absence of differences in pricing and tax treatment, government securities and savings certificates become close substitutes which improves the liquidity of both markets, and thus the attractiveness of both instruments to investors. In turn, this improves the ability of the authorities to formulate and execute budget financing and debt management strategies.

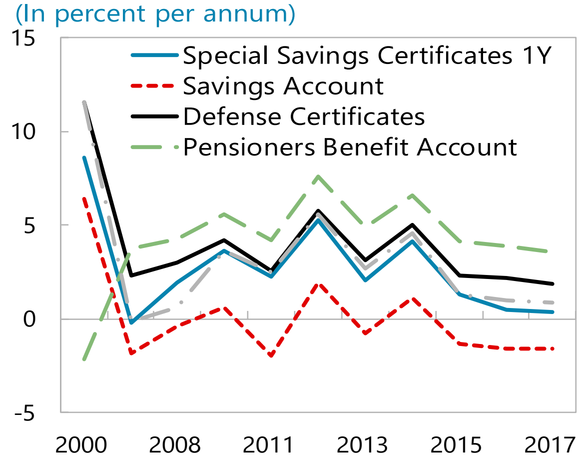
2. Figure A1 highlights several contrasting developments between the national savings scheme in Pakistan and Bangladesh.

- In Pakistan, returns on the savings certificates have been broadly declining in real terms (calculated as nominal return per annum adjusted for the CPI). CPI inflation fell from over 10 percent in 2011 to below 6 percent in 2017, and the nominal returns on savings certificates have been broadly following the decline in inflation. In Bangladesh, the rigidity in nominal returns, in combination with a similar decline in inflation, has resulted in a sharp increase in the real returns of the NSCs, which in turn has triggered the significant increases in the NSC issuance. In Pakistan, linking the returns of the savings certificates to the benchmark securities did not open the difference in returns, and the corresponding scope for arbitrage.

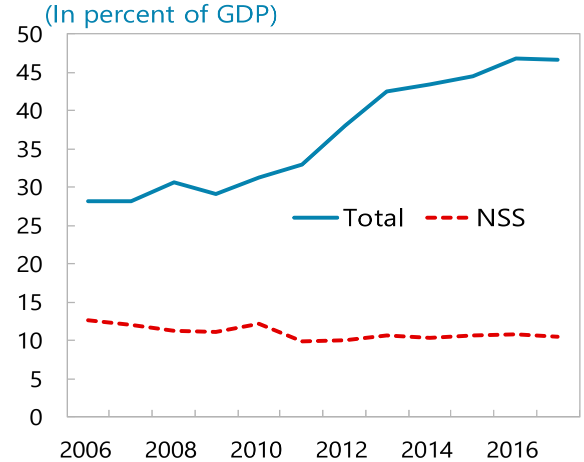
- In Bangladesh, the stock of savings instruments has been growing rapidly in the last five years, both as a percent of total government debt and as a share of GDP. In Pakistan, the outstanding stock of savings instruments has been relatively stable (as a percent of GDP) during the last decade, and it has fallen from about one half to about one fourth of the domestic public debt stock. While the share of NSCs in financing the budget has increased sharply in recent years in Bangladesh, it has fallen markedly in Pakistan, and it is now less than one third of the share in Bangladesh (Figure A2).

Figure A1. Pakistan: National Savings Scheme

Real Return on Savings Certificates 1/
(In percent per annum)



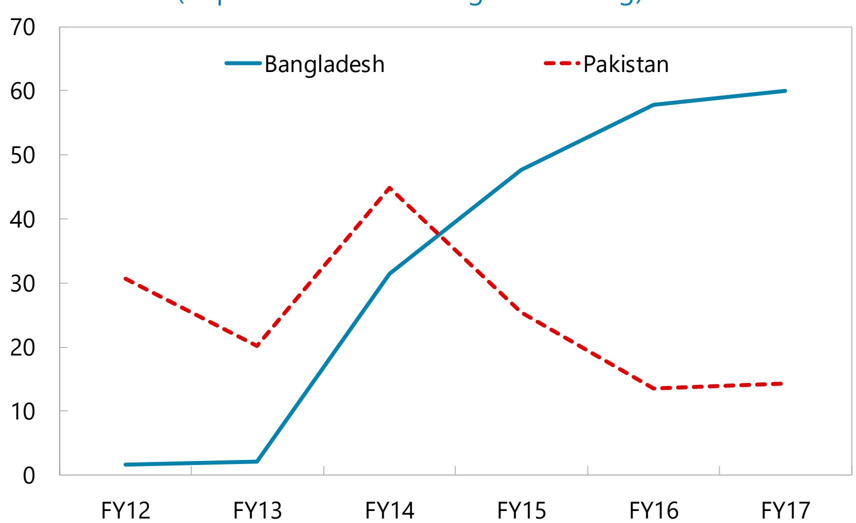
Domestic Public Debt
(In percent of GDP)



Source: State Bank of Pakistan, National Savings Pakistan, CEIC, Staff Estimates

1/ Nominal return adjusted for annual CPI

Figure A2. Budget Financing by Savings Certificates
(In percent of total budget financing)



Sources: Bangladesh Bank, National Savings Pakistan, staff estimates

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EXPORT DIVERSIFICATION[1]

Bangladesh's narrow export base, notably the low-skilled garment industry, is nearing saturation. Export growth is constrained by the lack of diversification, inadequate infrastructure, shortage of power, and insufficient investment. Bangladesh's diversification, and in turn growth potential, will hinge on whether these challenges are met in the coming years.

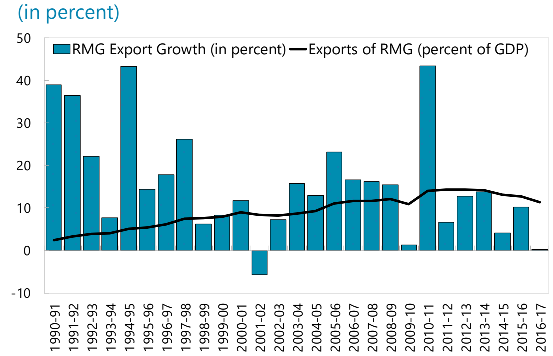
A. Why Diversification?

1. **Exports in Bangladesh are dominated by the large Ready-Made Garments (RMG) sector which is the real backbone of the economy.** The RMG sector provides about 4 million jobs directly, empowers women as well as economically disadvantaged households, and accounts for over 80 percent of the total exports. The sector took off with the introduction of the multi-fiber arrangement (MFA) in the 1970s, along with supportive policies from the government such as lower tariffs on imports and bonded warehouse facilities. It helped Bangladesh to diversify from more traditional agricultural based sectors towards manufacturing, in particular, garments. Currently, Bangladesh is the fifth largest garment exporter to the European Union and among the top ten apparel suppliers to the United States.[2]

2. **Studies show that diversification lowers output volatility, provides greater macroeconomic stability, and in turn supports growth (IMF, 2014).** Diversification and structural transformation play important roles in improving the macroeconomic performance of low-income countries. Increases in income per capita at early stages of development are typically accompanied by a transformation in a country's production and export structure. This can include diversification into new products and trading partners as well as increases in the quality of existing products.

3. **Given the current challenging external environment, diversification has become even more crucial.** In recent years, the global RMG trade has stagnated. Per the World Trade Organization, the world's garment export has decreased by 0.3 percent in 2016. While the global upswing in the economic activity is strengthening recently, raising potential output growth will continue to be a challenge for many countries. Furthermore, a retreat from globalization by major countries could also affect the outlook of the RMG sector. In this setting, the lack of diversification may increase the exposure to adverse external shocks and macroeconomic instability.

Performance: RMG Sector
(in percent)



Sources: Bangladesh Bank

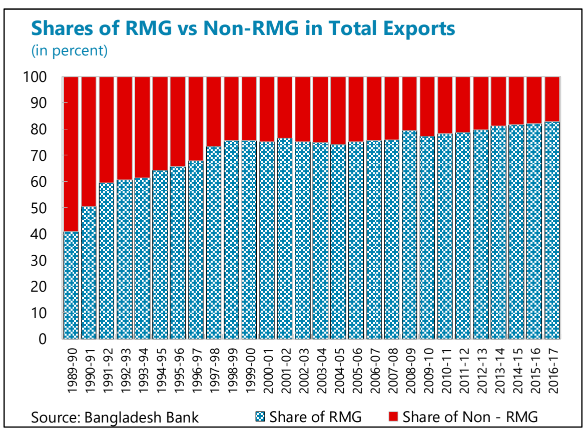
[1] Prepared by Jayendu De.

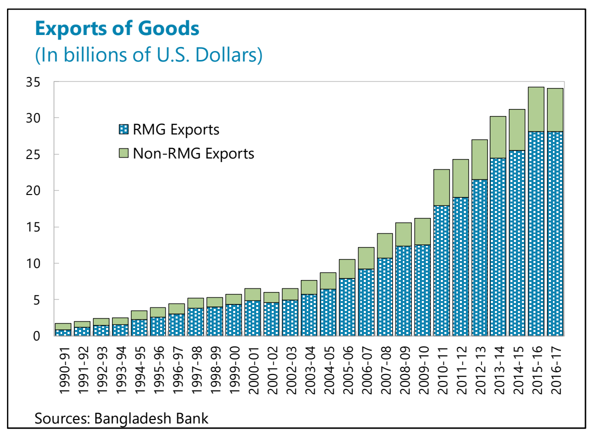
[2] The MFA governed the world trade in textiles and garments from 1974 through 2004, imposing quotas on the amount that developing countries could export to developed countries.

4. The authorities acknowledge that diversification is necessary. The Seventh Five-Year Plan (FY16-20) refers to two positive developments on export diversification; (i) the recognition of new products and growing sectors, and (ii) growing diversification within quality in the RMG sector. Sectors, such agro-based products, light engineering, footwear and leather, and pharmaceutical are growing and have shown potential for diversification.

B. Status of Export Diversification

5. Bangladesh has exported over US$34 billion worth of goods in FY17 representing a 1.7 percent growth from the previous year. Bangladesh exports 82 products with revealed comparative advantage.[3] Top export destinations include Australia, Canada, China, European Union (EU), India, Japan, and United States. Europe, particularly the United Kingdom and Germany, is the largest export market accounting for more than sixty percent of exports followed by the United States and Canada (20 percent), and then Asia (15 percent). Exports by Bangladesh are broadly classified as primary and manufactured commodities. Primary commodities include frozen food, live fish, and agriculture products, while manufactured commodities include RMG, jute and jute goods, leather, footwear, and chemical products. Top products in FY16 include RMG (US$28 billion), followed by leather (US$1.2 billion), jute and jute goods (US$1 billion), frozen foods (US$0.5 billion), and footwear (US$0.2 billion). RMGs continued to dominate the export performance in FY17.





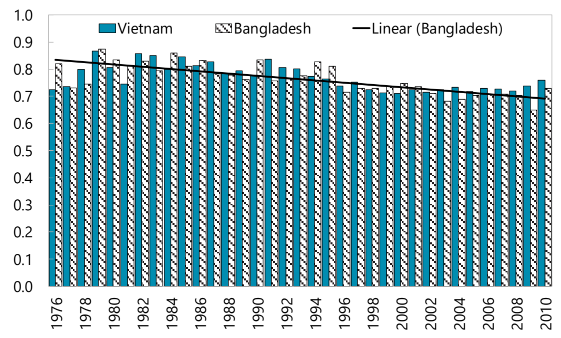
6. Compared to the past, current diversification efforts have met with limited success. While the RMG sector continues to maintain a large and steady share in total exports at around 80 percent, its growth has been tepid and its production costs continue to increase.[4] Growth in FY17

[3] Revealed comparative advantage refers to when the country's share of global exports is larger than what would be expected from the size of its export economy and from the size of a product's global market.

[4] According to Bangladesh Garment Manufacturers and Exporters Association (BGMEA) in 2017, cost increases over the two years included wage costs (by 32.4 percent), accessories, packaging and washing costs (by 4.9 percent), freight and transportation costs (by 40 percent), and costs from an increased consumption of power and gas (by 15 and 7 percent respectively). The costs of compliance are also high. A small to medium sized factory spends about BDT 50 – 200 million (approximately US$0.6-2.4 million) to maintain compliance.

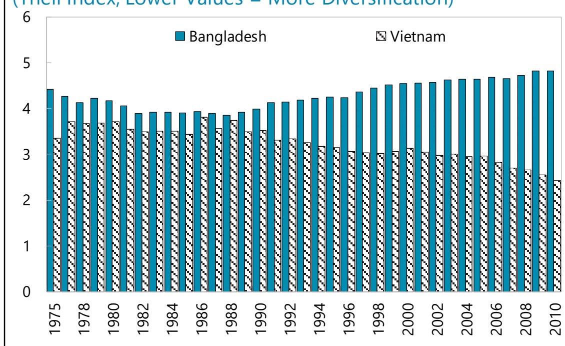
was only 0.2 percent – the lowest observed in the last fifteen years – while the average growth in the past five years has been half of what it used to be in the five years preceding. In addition, since FY13, the sector has been declining as a share of GDP. Challenges in export diversification are also observed in the Theil index – a lower value of the index corresponds to more diversification.[5] Comparing Bangladesh with a competing country such as Vietnam – a lower middle-income country and a close competitor in the garments sector – shows how diversification has evolved over the years in both countries. Starting early 1990s, Vietnam and Bangladesh diverged – Vietnam became more diverse over time while very little progress was observed in Bangladesh.

Quality Index: Manufactured Goods
(Higher index value represents higher quality)



Sources: IMF, Diversity Toolkit

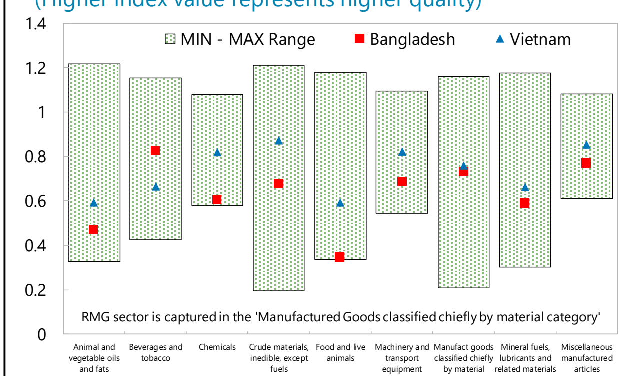
Export Diversification Index
(Theil Index; Lower Values = More Diversification)



Sources: IMF, Diversity Toolkit

7. **Producing higher-quality varieties of existing products can constitute a way of building on existing comparative advantages.** An index to measure quality for manufactured goods shows that quality in Bangladesh has not been improving since the mid-1990s.[6] Furthermore, this index reveals that both Bangladesh and Vietnam benefit from upgrading quality in several ranges of products when compared to other countries. For example, in manufacture goods sector, which includes RMG, both countries are at comparable quality, however, they have room to improve, when compared to the quality of the rest of world. Similarly, Bangladesh does relatively well on quality in the beverages and tobacco sector, but is taken over by Vietnam in crude material or chemical sector.

Quality Index 2010
(Higher index value represents higher quality)



Sources: IMF, Diversity Toolkit

[5] The IMF's diversification index is available for product and for partners, and it can be decomposed into two components. The "between" component of the Theil index captures the extensive margin of diversification (i.e. the number of products/partners), while the "within" component measures the intensive margin (i.e. product shares).

[6] To examine the impact of quality upgrading, Fund staff developed a dataset with estimates of export quality for 178 countries from 1962-2010. Concentration in sectors with limited scope for increases in productivity and quality may result in less broad-based and sustainable growth.

C. What can Help Diversification?

8. A range of general policies and reform measures have proven effective in promoting diversification (IMF, 2017). These include improving infrastructure and trade networks, investing in human capital, supporting SME development, and reducing barriers to entry for new products. In the case of Bangladesh, infrastructure and power are the two main bottlenecks for diversification. The lack of proper infrastructure and power supply leads to increased production costs. For example, much of the garment manufacturing is dependent on uninterrupted power. Frequent power interruptions hurt production and increase final costs. At the same time, as per data from BGMEA, the price of Bangladeshi garments has, on average, declined in 2016 and has continued to drop in 2017 in major markets such as the United States and in Europe. With increased international competition, this shortage of power coupled with poor infrastructure has dampened profits and competitiveness. In the "World Economic Forum's Global Competitiveness Report 2017-2018", Bangladesh's rank improved from 107 (of 140 countries) in 2016 to 99 (of 137 countries), but the quality of institutions, infrastructure, education, technological readiness, and innovation continue to be highlighted as arears where more needs to be done.

Growth in Garment Prices
(in percent, 2017)

	Europe	USA
January	4.0	-4.0
February	-0.6	-6.1
March	-1.6	-4.7
April	-3.4	-3.9
May		-5.7
June		-3.5
July		-7.8

9. The chronic under-implementation of the Annual Development Program (ADP) should be addressed. Despite its higher priority and continuing growth in each year's budget, the actual spending under ADP has been falling short of the original budget over the recent years, reflecting implementation bottlenecks. The 2015 Article IV consultation reported that delayed execution, significant intra-year revisions to the ADP, and cost over-runs of development projects have been common, suggesting problems with planning and budget practices. Some of the underspending has been attributed to problems with the project tender process, delays in financing, land requisition, and legal issues amongst others.

10. Infrastructure needs, especially the quality and service provided at the ports, must be also addressed urgently. A large share of import and export related activities are carried out via the Chittagong seaport, Benapole land port, and Dhaka airport. At both Chittagong and Benapole, congestion, shortage of needed equipment, and long wait times for consignments have been long standing problems. Given this, exporters resort to costlier options, such as air freight, to meet deadlines thereby increasing operating costs. However, problems at Dhaka airport such as the lack of storage facilities for goods, including the loss of goods from theft or from damage due to natural causes like rain, have been quoted as major problems. The expansion and modernization of the ports and upgrading the facilities at the Dhaka Airport need immediate attention.

11. While the power generation capacity has increased, its transmission and distribution are still lacking, affecting businesses including new factories. In addition to electricity, the shortage of gas has also been a problem for businesses. No new gas connections, line transfers, or increases in capacity had been approved given the shortages. Recently, this restriction was eased, but factories still find it increasingly difficult to have new connections due to the labor-intensive efforts and complicated approval process to install new gas lines. Investments in power, including in new technologies harnessing renewable sources, should be proactively pursued.

12. **There is a need to reform the tax regimes, including supplementary duties, to increase competitiveness in non-RMG industries.** Some of the tax benefits for the RMG industry, such as duty exemption for imported inputs, should also be extended to non-RMG sectors. In addition, many import-substitute products are shielded from competition with supplementary duties imposed on imported goods. This leads to higher profitability from domestic sales than from exports through the price differentials between the domestic and international markets. These barriers must be scaled down to expand export production.

13. **Efforts in investing in human capital, enhancing the business environment, and expanding into new markets should continue.** Policies to boost higher education, training, and improving health would increase the quality of human capital. A favorable business environment, particularly reducing barriers to entry, would reduce costs and encourage entrepreneurs to expand business. Further efforts are necessary for improving banking services for business; easing the processes for issuing letters of credit; and increasing research and development. Some of these challenges have been picked up in the latest SME Competitiveness Outlook for 2017. This report praises Bangladeshi SMEs in capacity utilization, dealing with regulations, access to an educated workforce, and business licensing and permits. But it also points to several detriments such as the lack of international quality certification, bank accounts, e-mails, websites, audited financial statements, foreign technology licenses, and formal training program to employees (World Economic Forum, 2017). Marketing programs to promote Bangladesh through trade fairs, road shows, sending of business representatives, and other campaigns could aid new market expansions. The government could help these efforts, including through involvement by the Bangladesh embassies abroad.

14. **The importance of macroeconomic stability along with security cannot be underestimated in encouraging new investments.** The threat of political instability and the rise in religious extremism with security risks have held back business activities. Sporadic organized protests by the opposition have recently resumed and religious fundamentalism has been on the rise as observed in the targeted killings of secular bloggers, minorities, and foreigners during 2016. In addition, some countries imposed restrictions against direct imports from Bangladesh, quoting security concerns. It is therefore essential for the authorities to take appropriate steps reassuring the business community that measures are being put in place to minimize these concerns.

D. Towards More Diversification

15. **The authorities continue to make efforts to improve the power situation.** In the Power System Master Plan 2016, the authorities have formulated an extensive energy and power development plan up to the year 2041, covering energy balance, power balance, and tariff strategies (Government of the People's Republic of Bangladesh, 2016). The Power System Reliability and Efficiency Improvement Project supported by the World Bank and other upcoming projects, such as the nuclear power plant in Ruppur and a coal-fired electricity plant to be built by the Chinese joint

venture - Bangladesh-China Power Company Limited - are expected to help reduce power outages. Bangladesh is also planning to import LNG in 2018.

16. More infrastructure investments are expected from the Belt Road Initiative with China. Per Hong Kong Trade Development Council, under the Belt and Road Initiative, Chinese authorities have planned to finance several infrastructure projects, including investments from entrepreneurs in several sectors, such as telecom, agriculture, power, and energy.[7] The initiative is also expected to provide a boost in trade with China. In 2016, Bangladesh imported US$14.7 billion of products from China and exported US$860.0 million to China (CEIC data). China is now Bangladesh's largest trade partner, accounting for 26.3 percent of its total imports.

17. Development partners, including the World Bank and Asian Development Bank, continue to support the authorities' efforts. The 'Jobs and Economic Transformation' program under IDA 18 is promoting better jobs and female empowerment, improving working conditions, closing gender wage gaps, and improving human capital. The World Bank's Private Sector Development Support Project is expected to help develop new Economic Zones through identifying, licensing, and negotiating Public-Private Partnership for economic zone development. The Asian Development Bank's development efforts in Bangladesh have focused on energy security, transport services and connectivity, education and skills development, water resources management, urban infrastructure, and finance.

18. The authorities have listed various measures in the Seventh Five-Year Plan detailing their plans for diversification. The main aim of the plan is that Bangladesh reaches middle income status by 2021 - the 50th year of its independence. To meet this objective, the authorities have envisioned several policies, including export diversification, and institutional changes to boost productivity and growth. Exports under the plan are projected to reach close to 24 percent of GDP by FY20. A multi-faceted approach has been suggested to combat (i) constraints at the borders, (ii) constraints behind the borders, and (iii) constraints beyond the borders. Bonded import facilities are being provided to the emerging sectors. And these facilities will be extended not only to export oriented sectors, but also which target the domestic market. Other efforts include redesigning the current Duty Drawback Scheme to improve its cost and time efficiency.[8] Furthermore, the removal of bureaucratic red tape should trigger large investments in export processing zones.

[7] https://beltandroad.hktdc.com/en/country-profiles/bangladesh

[8] Under the Duty-Drawback Scheme, exporters receive reimbursements for the tariffs paid on imported intermediate inputs. The scheme is expected to be revamped to reduce long lags and high transaction costs for reimbursements.

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