What it *takes to* make independent economic policy?

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THE diminishing size of aid raises the questions as to whether we can dispense with aid altogether and avoid the influence that the development partners exercise on our choice of economic policies. The counterparts to these questions are whether trade and remittance can replace aid. A critical look at the recent data shows that, as far as we can see into the future, current account transfer will be needed to offset the adverse trade balance, external savings to sustain investment above domestic savings, and external funds to finance budget deficit. The question to be asked is at what cost we can raise adequate external financing to meet the external account and savings-investment gaps, not whether we need aid or not. Aid is cheaper than raising money on the market, though it comes draped in conditionalities.

Since 1997, domestic savings have grown at a slower rate (4 percentage point for the period) than national savings (5 percentage points for the same period), and the share of external contribution to saving has grown larger (external savings/GDP ratio 4.8% to 6.3%). Investment has systematically fallen below national savings (investment/GDP ratio 2% lower). The savings-investment gap is explained by the fall in government investment (public investment / GDP ratio from 7% to 6%). Private investment maintained steady growth (5 percentage point per annum). It is possible that government used aid partly to finance consumption / non-investment expenditure. (Bangladesh Economic Survey 2006 [Bengali], p. 191).

Some people suspect that investment is over-estimated and point to the high capital: output ratio (4:1). If capital were more efficiently used, investment ratio of 23-25% should be able to attain growth of 7% or more. The national income accounts compiled by BBS have been published without validation by the Technical Committee composed of independent economists and statisticians. The accounts series should be checked by the Technical Committee as required by the procedures.

Aid is absorbed entirely by government to finance deficit expenditure; the other part of the deficit is financed by domestic pubic debt. Budget deficit without grant shows the actual excess expenditure over revenues. The deficit increased during FY 97-00 and peaked in FY00 (Deficit/GDP ration 6.1%), and stabilized to a relatively low level (deficit/GDP ratio 4-5%). Net foreign financing (excludes debt repayment) peaked in FY 00 (5.4%), corresponding with the peak of deficit.

Aid as an item of financing deficit shows greater volatility than that of budget deficit. The volatility of aid financing is due to low and uneven disbursement, given that the pipeline has been persistently strong. Excessive conditionalities attached by the development partners and limited administrative efficiency of government are responsible for low disbursement.

Domestic debt is the mirror image of aid financing of deficit. After increase up to FY 01 (2.9-2.8% of GDP), domestic public debt stabilized down to a modest ratio (around 2%). The overall low deficit has been achieved by reducing government investment, despite inadequate infrastructures and their inadequate maintenance. However, government debt to banks rose in FY 06, FY 07 (1.36% & 1.06% of GDP) and in the first two quarters in FY 08 exceeded that in FY 07 (1.84% over -0.21% of GDP). There are indications of weak budgetary management and unplanned domestic debt. (BES 2006, p. 190; Bangladesh Bank Quarterly V.1, p. 53.)

Trade has grown steadily and accounts for one-third of GDP now. Barring exceptional years, the growth of import has been stable (17% to 19% of GDP); the growth of export, also stable and modest, (12% to 14% of GDP), has been smaller than import. The adverse trade balance remained fairly stable (5% to less than 7% of GDP). FY 05 witnessed the highest level of import, export, and adverse trade imbalance (21.8%, 14.4% & 7.5%).

Export has much too narrow a base, depending mainly on garments (80% in FY 07); frozen fish / shrimp and leather (7%), the traditional items such as tea, raw jute and jute goods (5%), and several other small items make up the rest. Export cannot increase without investment in diversification and efficiency; the real constraints on investment are inadequate infrastructures, governance shortcomings and unpredictable administrative-legal regimes. It will be long before Bangladesh becomes a net exporter.

The criticism that the net value of garment export is much lower than the gross value is misdirected. The imported input is mixed with labour which is in abundant supply and gives the economy its comparative advantage. The linkage industries and the net value have grown over time, which would not be possible unless garments export had started with a low net value.

The current account was modestly negative (less than 1% of GDP mostly) but only for half of the period (5 years). The largest current account deficit in FY 01 (-2.2%) coincided with budget deficit above the trend (5.1% of GDP) but without increase of overall or government investment. The current account was surplus (non-negative in FY 00) for half of the period, which shows constrained absorption.

Current account deficit allows the economy to absorb more resources (consumption + investment) than it generates. Prudent policy dictates that current account and fiscal deficits are limited to levels which are sustainable in the medium term. The economy will continue to depend on current account deficit to meet the adverse trade balance and savings-investment gap, budget deficits in particular.

There has been dramatic growth of remittances since FY97 from US $ 1.5 billion to about US $ 5.00 billion in FY 06. Remittances in FY 08 may reach or even exceed US $ 7.00 billion, given the strong growth in the first quarter (22.48%). Remittances are most likely to be sustained; however, there are risks from the downturn of the world economy caused by the current price and output shocks. (BES 2006 reports complete data up to FY 05; data for FY 06, 07 & FY 08 computed at growth rates reported by BBQ V.1)

The growing remittance certainly adds to the strength of the economy. However, it is wrong to treat it as an item which has remained outside the national accounts. The banks pay an equivalent amount in taka to the addressees and thus remittances enter the income accounts. Remittances are invested in Wage Earners Bond issued by government and Non-resident Foreign Currency Accounts with commercial banks. No accounts of the use of WEB are published by government. NFCA makes supplies to the foreign currency market. In the rural areas, the beneficiaries use the money also for purchase of land which is not investment in the economic sense.

The growth of official foreign exchange reserve has been significant, rising from US $ 1.31 billion in FY01 to US$5.16 billion in FY 07 (BBQ V.1 data & estimates, pp. 46, 54). The latest reserve covers import outlay for more than 3 months which have become an obsolete underestimation by the larger import requirement and higher prices, particularly of food grains, fuel and fertilizer.

The reserve had been built up by remittances and disbursements by IMF and WB (budget support & local currency assistance). A tight monetary policy and fiscal discipline also helped by containing demand. More recently, the demand for import has been depressed by motivational disincentive induced by restriction on access to bank loan. This may help build up further reserve or protect depletion, but at the cost of investment and current supplies. Import of capital machinery has already declined that may lead to contraction of (gross) capital stock.

There is some pressure for easing up a bit on monetary policy which has little justification until the idle liquidity is used up by demand for credit. The idle liquidity in the banks has built up because the appetite for borrowing is not there. Similarly, there is absolutely no justification for monetized deficit since development expenditure is much too low (about a quarter of ADP allocation for the first six months). Injection of high-powered money by the central bank will create a monetary hangover which is most likely to last quite long.

Tax revenue / GDP ratio has stagnated since FY 03 (8.2% 8.5%); non-tax revenue ratio (below 2%) is offset by losses of SOEs, subsidy and other transfer payments. The effects of the losses of SOEs are transmitted to the economy via the banking sector. Government consumption expenditure has increased faster than increase of revenue, while development expenditure (ADP) and government investment have suffered decline. It is the least likely that government can contain consumption and cut unproductive expenditure.

About 2/5th of government investment is aid financed. If no aid were available and government cut investment correspondingly, public investment would be about 4% of GDP or even lower. The infrastructures, already inadequate and low in quality, would deteriorate further and act as a dampener on overall investment and growth. In a realistic sense, however, government would protect public investment partially not fully by mobilizing domestic savings.

Another way to look at the problem is to estimate how much more investment and time are needed to raise growth by 1-2% of GDP. Assuming that the capital-output ratio remains constant (4:1), investment/GDP ratio has to be raised to 29-33% (investment / GDP ratio was 24.5-25% in FY 06 & 07) which accelerates growth to 7-9% annually. It would take 8-16 years if we were to depend on domestic savings only, given that savings grew by less than 0.5% annually. By then population would increase, which would thin out the impact on per capita income.

Alternatively, disbursement of aid may be speeded up to raise net foreign financing ratio to about 3.5-5.5% from some 2.5% in recent years, which would raise overall deficit but leave domestic public debt ratio unchanged. The higher foreign debt will put pressure on domestic price if all or most of it is spent on domestic supplies. Low debt/GDP ratio (31%), TDS/GDP ratio (2.3%), and TDS/XGS ratio (7.9%) indicates a safe margin to increase external debt to accelerate growth. However, growth of GDP and export must not fall below growth of debt and export surplus. (TDS stands for Total Debt Service; XGS stands for Export of Goods & Services).

The strong growth of remittances and the reserves often leads to the argument that we can dispense with aid. There are risks to trade from the extremely narrow base and to remittances from the downturn in the global economy. Further, the economy is not yet strong or adaptive enough to respond to shocks. In the event aid is given up, government financial management has to go through some drastic changes or certain consequences are to be accepted including increase of tax revenue, reduction or containment of public consumption with the deepest cut on unproductive expenditure, increased public saving and investment or further deteriorations of infrastructures. The call for dispensing with aid is premature optimism disconnected from the structural and political economic constraints.

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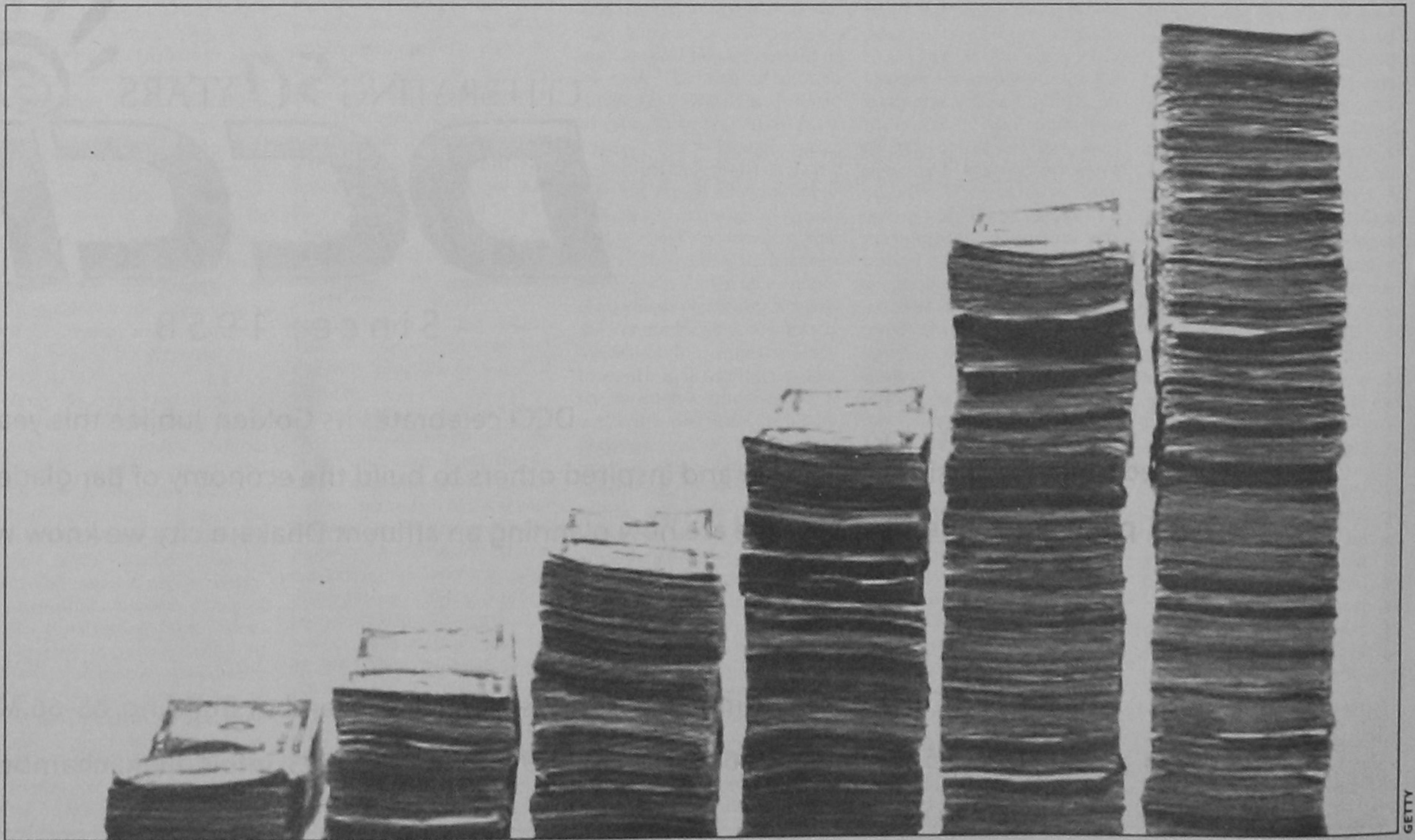

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