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**THE GLOBAL FINANCIAL CRISIS  
IMPLICATIONS  
FOR  
BANGLADESH**

*Working Paper No-1*

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*THE GLOBAL FINANCIAL CRISIS: IMPLICATIONS FOR BANGLADESH*

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## *List of Abbreviations and Acronyms*

BEA	Bureau of Economic Analysis
BGMEA	Bangladesh Garment Manufacturers and Exporters Association
BKMEA	Bangladesh Knitwear Manufacturers and Exporters Association
BMET	Bureau of Manpower, Employment, and Training
CLI	Composite Leading Indicators
CPI	Consumer Price Inflation
EPB	Export Promotion Bureau
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GEP	Global Economic Prospects
GFC	Global Financial Crisis
IMF	International Monetary Fund
L/C	Letter of Credit
LDC	Least Developed Countries
MFN	Most Favoured Nation
NABE	National Association for Business Economics
NDPA	National Partnership for Development Act,
OECD	Organization for Economic Co-operation and Development
OTEXA	Office of Textiles and Apparels, International Trade Administration
POL	Petroleum, Oil, Lubricants
RMG	Readymade Garments
SUR	Seemingly Unrelated Regression
TUF	Technological Upgradation Fund Scheme
WB	World Bank

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Khan Ahmed Sayeed Murshid  
Director, BIDS-PRP

23.4.09

## *Executive Summary*

The world economy is currently experiencing the worst global financial crisis since the Great Depression. With the spread of toxic assets arising from the US sub-prime mortgage crisis to the rest of the financial system, including the international financial system, major world economies have taken a massive hit resulting in negative growth rates in key countries or regions, including the US, EU and Japan. Many developed countries have also been infected by the contagion from China, Brazil, India and South Africa to the countries of South East Asia and Latin America. The magnitude of impact seems to depend on the extent of integration with the rest of the world (or to use World Bank jargon, the extent of liberalization that has taken place).

This paper addresses itself to the task of assessing the likely impact that the GFC may have on Bangladesh. There is a consensus that the transmission mechanisms relevant for Bangladesh are limited to exports, remittances and imports. Since the capital account has not been liberalized, dramatic capital flows are unlikely to be an important source of vulnerability.

### **Bangladesh: Export Performances**

Bangladesh's export earnings have risen rapidly since the early 1990s. Exports have grown from around 7 percent of GDP in 1991 to around 18 percent in 2006. The GDP growth rate has been consistently over 6 percent over the last few years despite a number of weather related shocks emanating from cyclones and floods.

Two main sources of economic growth have been manufacturing and services, both crucially dependent on the RMG sector. The main driver of our exports sector is the ready-made garments industry (RMG) which accounts for almost four fifth of our total export earnings. Almost two and a half million people, ninety percent of them women, are employed in the RMG sector; while a large but undetermined number of people are involved in various ancillary and support services e.g. banking, insurance, transport etc. to this sector. The export sector is potentially vulnerable to the on-going financial crisis as it heavily depends on the EU and US markets which have been badly hit.

### **Forecast based on Export Demand Function**

Economic theory stipulates that export demand is mainly determined by real price of the items under consideration, income level of the importing countries, and other factors. Consumers in major destination regions have sharply reduced their spending leading to low demand and the closure of many firms and large unemployment levels. This reduction in consumption might also reduce the export demand of countries like Bangladesh.

Estimation of export demand functions is best suited to assess this relationship. To estimate income elasticities for our exports to major destinations, an attempt was made to estimate country specific and product specific export demand functions for Bangladesh. It was found that income elasticities for all items exported to USA and EU (except leather products exports to USA) are low although positive. These however, are found to be significant statistically, except for fish and jute products to USA. These low elasticities imply that there is a positive association between the income of importing countries and export demand from Bangladesh. The implications are obvious: the positive, significant association implies that reduced income (GDP growth) in importing countries like US and EU will dampen exports; however, the magnitude of this impact will be low given the low elasticity levels.

Bangladesh's positive export performance in the US market contrasts sharply with that of many other countries in the region: Export growth has become negative for India, Philippines and Sri Lanka although China and Vietnam have managed to post positive growth rates. Nevertheless, Bangladesh's performance would appear to be the best in this particular grouping.

However, Bangladesh has been facing problems in the EU market. Its exports to the EU grew by 3.6 percent in July-December 2008 while all other countries, with the exception of Sri Lanka, out-performed Bangladesh. In particular, Bangladesh has experienced problems in exports of shrimp, headgear, jute goods and rawhide registering a drop in exports of these products in the range of 16-25 percent. Most unusually, even woven exports registered a negative growth.

The main advantage of Bangladesh over its competitors is its price. Exporters from Bangladesh have been cutting back on prices further in trying to cope with the crisis. Indeed, unit prices reveal that except category numbers 340, 659 and 239, there is a downward price trend for all other categories. This has helped Bangladesh to remain competitive in the US market.

In the EU, Bangladesh is experiencing negative export growth for rawhides, jute and frozen fish. For rawhide, China as well as India is also experiencing negative growth. Exchange rate has important implications for export performance as it directly influences the price competitiveness of exporting countries, although it must be noted that the exchange rate is not the sole determinant of a country's export competitiveness. Sharp depreciation of Euro and Pound Sterling; and stability of the Bangladeshi taka eroded Bangladesh's competitiveness in Europe to an extent, reflected in the slowdown of Bangladesh exports to EU.

### **Can this growth be sustained in 2009?**

The 7.5 percent cap on growth on Chinese apparel exports to the US has been lifted from January 1, 2009. About 34 categories of RMG products faced such a cap since 2006. Of these, 29 categories overlap with those that Bangladesh produces. These account for 80 percent of Bangladeshi exports to the US. Thus, there is a serious potential for this to affect Bangladesh which may face stiff competition from China. China and India are high-end producers, and as restrictions are withdrawn on exports from China, Bangladesh will come under pressure. In this context, duty free access to Bangladesh as an LDC would enormously help Bangladesh to retain its market share.

The EU became the largest single market for clothing imports in 2007, surpassing the US. The end of quotas on China from January 1, 2008 brought downward pressure on prices in the EU clothing market and required the suppliers to become more efficient. Among the Asian countries, the main suppliers are China, Bangladesh and India. For all Asian suppliers except China and Vietnam, there was a decline in woven imports from August 2008. Woven exports from Bangladesh declined by 16 percent while knitwear exports declined by 9 percent in August.

### ***Survival of some firms at stake***

- Those firms who have good reputation will survive and expand.
- There will be cash flow problem for some small firms
- Manufacturing firms will face problems related to storage, disrupted project planning due to delayed orders, declining production, and cash flow
- Banks will have problems as (a) goods already exported, but payment not received; (b) goods produced but not shipped (c) goods produced but payment renegotiated
- Impact on wage payment: Firms will find it difficult to pay salary to workers

### **Impact on Remittances**

Remittance flows to Bangladesh have grown rapidly over the last ten years from around 3 percent of GDP in 1995 to around 9.5 percent today. A total of some five million Bangladeshis are estimated to be resident overseas. While initially most of the migrant labour went to the Middle East, mainly to Saudi Arabia, there has been considerable diversification of destination countries in more recent years.

Given the GFC and the worsening situation widely forecast for 2009-10, there is every reason to be worried about the demand for migrant labour in host countries and the possible impact on remittance

flows back to Bangladesh. There have been well-publicized incidents of migrants being sent back home or visas being cancelled even before visa-recipients were able to leave for their destinations. In many cases, these incidents were not directly related to the GFC but were rooted in domestic problems in the host countries. Nevertheless, there is a sense that the situation could worsen quickly as the recession deepens.

### **Likely future trend of remittance inflows**

Uncertainty in remittance flows to Bangladesh stems from several sources:

- The economic slowdown (as mainly indicated by poor GDP growth rates and high unemployment levels), in two of the major remittance source countries, namely the U.S.A and U.K (which account for almost 28 percent of remittance flows to Bangladesh);
- The fall in oil prices and the magnitude of impact on the economy of GCC countries (which accounts for 63 percent of our total remittance earnings)
- Uncertainty about exchange rates.

The rising unemployment rate in the major economies signals a discouraging picture: In the U.K, the unemployment rate was 6.1 percent for the three months to November 2008, up 0.4 percent over the previous quarter and up 0.9 percent over the year. The last time the rate was higher was in the three months to April 1999 (when it was 6.2 percent). The number of unemployed people increased by 131,000 over the quarter and by 290,000 over the year, to reach 1.92 million (the highest figure since the three months to September 1997). Total unemployment has shot up close to 2 million. Manufacturing output proved to be the biggest drag on the economy, plummeting by 4.6 percent in the fourth quarter. The service sector slumped by 1 percent, driven by a 2.4 percent drop in hotels and restaurants.

US firms are experiencing the worst business conditions in 27 years as the year-long recession worsens. The U.S. economy tipped into recession in December 2007 and there are worries that the downturn could be the worst since World War Two. The global credit crisis has eroded household wealth, causing sharp cut backs on spending and severely depressing demand. Sluggish demand was more pronounced in the goods-producing sector, where 79 percent of the firms reported falling demand - its lowest level in the history of the survey. The job loss in U.S market was 2.9 million in 2008, with 1 million in the construction sector alone. Job losses are expected to continue during the first half of 2009, with most of the layoffs seen in sectors such as goods-producing, finance, real estate, transport, utilities and communications.

The economy of the Middle East is heavily dependent on oil export earnings. Oil exporting countries in the Gulf region are expected to grow at an average rate of 6.1 percent in 2009, lower than in 2008, On the other hand, consumer price inflation (CPI) in oil exporting countries is projected to rise to 15.7 percent in 2008 from 10.0 percent in 2007 and ease to 13.6 percent in 2009. Though the recent global financial crisis will lower the growth of oil exporting countries, growth rates will remain moderately good at over 5 percent for the region as a whole. The two countries that are of particular importance to Bangladesh are Saudi Arabia and U.A.E where GDP growth rates are expected to be 4.3 and 6.0 percent respectively, in 2009.

### **Implications for Imports**

The total import payments in 2008 (January-November) amounted to US\$ 22260.7 million, which is 31 percent higher than import payments in the previous year. Total merchandise imports showed a robust 35 percent growth (on adjusted fob basis) during July-October 2008 despite a sharp decline in imports of food grains over the corresponding period of the previous fiscal year. In case of L/C settlements, except for food grains all other categories of import show positive growth in the face of falling prices in international markets.

In order to understand the nature of impact of increased imports in the economy, it is important to take a more disaggregated view. From the composition of imports it is clear that capital machinery, crude petroleum products, cotton, yarn and fertilizer, textiles and articles, were the key commodities whose imports increased significantly. In other words, the nature of imports suggests that these were meant either to increase production or raise productivity in manufacturing industry and agriculture.

The benefits of lower world prices are already being felt in Bangladesh, especially through lower inflation, including lower food and energy prices.<sup>1</sup> Another channel that can help lower the inflation rate of Bangladesh is the declining trend of inflation in major trading partners. The headline inflation rate of Bangladesh already started to decline from 10.82 percent in July'08 to 6.03 percent in December'08. The inflation rate of the major trading partners like India, China, and Hong Kong has declined significantly in recent months as well (See CEIC database & ADB website).

## Policy

- Need a permanent stabilization or counter-cyclical fund
- Need to encourage competitiveness through policy incentives and tax cuts so that new opportunities can be seized
- Encourage capacity expansion, technology up gradation and build up of key inventories
- Selective bail-out for smaller firms – mostly in terms of easy credit and repayment terms
- Should aggressively pursue an expansionary monetary and fiscal policy, encourage consumption of domestically produced goods, inject purchasing power in the farm sector
- Impact on RMG and textile sectors need close monitoring – only those units that have adopted good management practices and cut all extra costs should get benefits
- Should aggressively pursue an expansionary monetary and fiscal policy, encourage consumption of domestically produced goods, inject purchasing power in the farm sector
- Need to pay particular attention to selected sectors like leather, jute and sea food;
- It is now apparent that low farm prices for rice is also an impact of the GFC – this will have a negative impact on the next crop (*Aman*) unless adequate incentives are provided to farmers.
- Overall: the focus should be on the medium term, post-recession policy rather than being immersed in immediate problems and concerns.

---

<sup>1</sup> In the case of Bangladesh, one study finds that the change in international prices of rice and wheat affect domestic prices with minimal effect; while, a relatively significant relationship is observed between international edible oil prices and its domestic prices (M. Golam Mortaza and Habibour Rahman, 2008, Bangladesh Bank). However, other studies report a close cointegration between rice prices in Bangladesh and in India (Dorosh and Murshid).

# I IMPACT ON EXPORTS

## I.1 Introduction

The world economy is currently experiencing the worst global financial crisis since the Great Depression. With the spread of toxic assets arising from the US sub-prime mortgage crisis to the rest of the financial system, including the international financial system, major world economies have taken a massive hit resulting in negative growth rates in key countries or regions, including the US, EU and Japan. Many developed countries have also been infected by the contagion from China, Brazil, India and South Africa to the countries of South East Asia and Latin America. The magnitude of impact seems to depend on the extent of integration with the rest of the world (or to use World Bank jargon, the extent of liberalization that has taken place).

This paper addresses itself to the task of assessing the likely impact that the GFC may have on Bangladesh. There is a consensus that the transmission mechanisms relevant for Bangladesh are limited to exports, remittances and imports. Since the capital account has not been liberalized, dramatic capital flows are unlikely to be an important source of vulnerability. Another possible source of weakness relates to aid dependency and the likelihood of diminished aid flows in the wake of the meltdown.

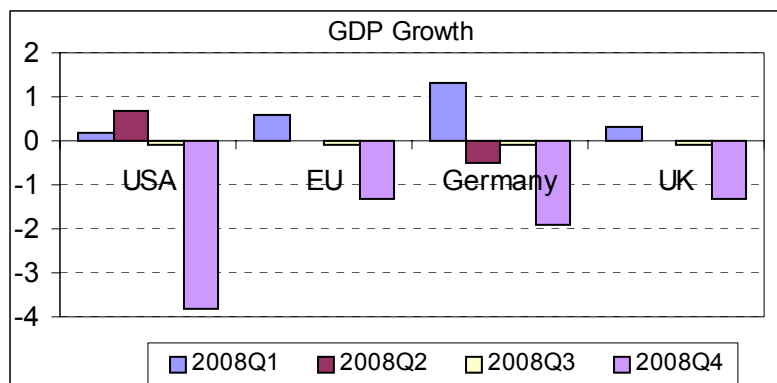
The possibility of an adverse impact on agriculture has not been raised in the current debate. However, low world and Indian prices may cause agricultural prices to be depressed, especially since Bangladesh imports significant quantities of agricultural produce, including cereals, from time to time. The current rice price situation suggests that this may be happening, causing farm incentives to be eroded.

However, the main focus of this paper is to review the recent performance of Bangladesh in terms of three key variables: exports, remittances and imports, to assess to what extent the GFC poses a threat to these key dimensions of economic activity.

## I.2 Economic Performance of Key Partner Countries

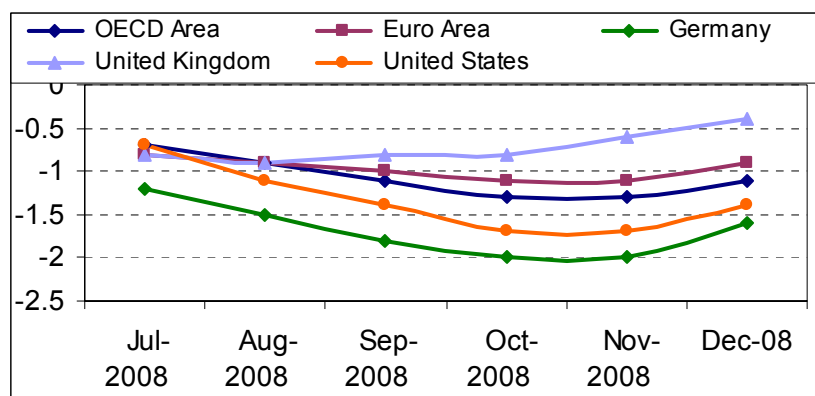
The financial meltdown in the USA was transmitted very swiftly to other developed countries, especially to the EU and Japan. These frontline countries/areas have already experienced a sharp decline in their GDP growth in 2008. Thus, the quarterly GDP growth rates in the major economies began to decline from early 2008 but by the third quarter, negative growth rates began to be posted. The USA experienced a decline of 3.8 percent in the third quarter 2008, compared to the same quarter in 2007 (Figure 1.1). Germany experienced a sharp fall in GDP as well (by about 1.8 percent) during the same period, while EU also posted negative growth of over 1 percent. Incidentally, these declines were much sharper than was predicted earlier by the European Commission.

Figure 1.1: GDP Growth for the four quarter of 2008 of USA and EU



Source: BEA and European commission, 2009.

Figure 1.2: Composite Leading Indicators for Selected Countries



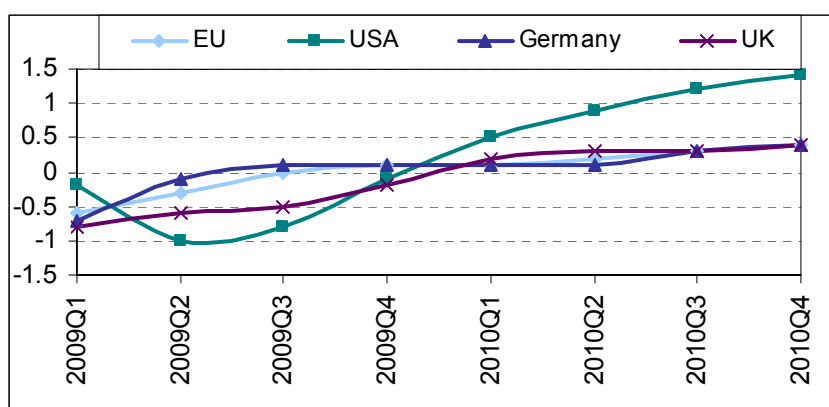
Source: OECD, 2009

The advanced economies' vulnerability to the financial crisis is clearly reflected in the OECD's composite leading indicators (CLI) which provide some indication about the likely movement of key macro variables in the short-run. Recent data shows that the downturn in CLI has become flatter and started to turn upward but still remains negative for all the OECD countries. The CLI for Germany and the USA show a sharp decline from July 2008. Negative CLI indicates that all the advanced economies are in recession and this tendency will remain unchanged throughout 2009.

Several forecasts are available that attempt to delineate the movement of the GDP in the major economies. Thus, the EC forecasts that the USA, EU, Germany and UK are going to experience negative economic growth throughout 2009 (figure 1.3). The Economic Outlook sees US output falling during the first half of 2010, then gradually picking up as the effects of the credit squeeze abate and the housing downturn bottoms out and the impact of lower interest rates takes hold. Weak household spending, due to large losses in household wealth, will limit the strength of the recovery. US GDP is projected to fall 1.6 percent in 2009, before rising 1.6 percent in 2010.

Figure 1.3 depicts that the EU, USA, Germany and UK, are going to experience negative economic growth in 2009. One important indication provided is that the US economy will play a leading role in bringing about recovery. As consumption expenditures in the USA pick up from the second quarter of 2009, import growth will also quicken from the present situation of negative growth.

Figure 1.3: GDP Forecasts for USA and EU



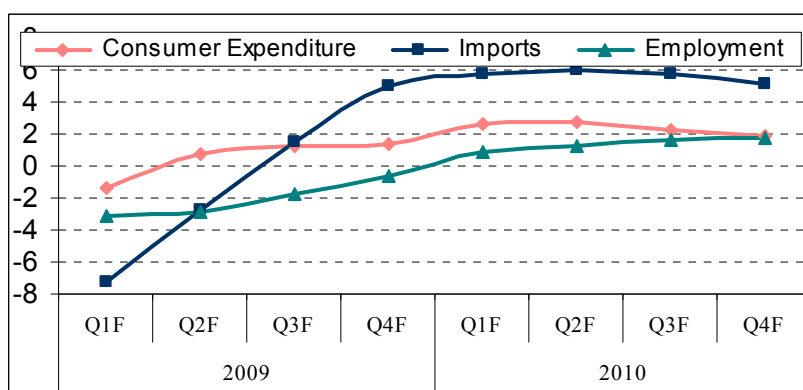
Source: European Commission, 2008

Euro area activity is also expected to fall over the first half of 2009 as consumption and investment declines. A gradual recovery should then take hold in the wake of interest rate cuts and the easing of financial market turbulence. Euro area GDP is forecast to fall 2.0 percent in 2009 and climb 0.2 percent in 2010 (IMF, 2009).

It is now a reality that a huge number of people have already been added to the ranks of the unemployed in all major world economies. The number of unemployed in OECD countries is expected to rise by about 8 million over 2009-10 (OECD Economic Outlook). Growth of employment in USA will remain negative throughout 2009 and it will take some time before these unemployed are re-absorbed into the labour market.

World GDP growth is projected to slow from 5.2 percent in 2007 to 3.5 percent in 2008 and to just over 0.5 percent in 2009, with the downturn led by advanced economies. Recovery is projected to begin late in 2009. The global slowdown will also affect the major emerging-market economies such as China, Brazil, Russia and India. Here, however, the downturn will be from high growth levels. Projections of the Chinese and Indian economies suggest a decline in GDP growth rates to 9 and 7.3 percent in 2009 from 13 and 9.3 percent in 2008 respectively. However, the magnitude of slowdown in these economies is considerable as the size of these two emerging economies is vast.

**Figure 1.4: Forecasts about consumption expenditure, imports and Employment in USA**



Source: Bureau of Economic Analysis, 2008

**Table 1.1: IMF Projections of Growth of Global Output Due to Recent Financial Crisis**

Regions	2007	2008	Projected	
			2009	2010
World Output	5.2	3.5	0.5	3.0
Advanced Economies	2.7	1.0	-2.0	1.1
USA	2.0	1.1	-1.6	1.6
Euro area	2.6	1.0	-2.0	0.2
United Kingdom	3.0	0.7	-2.8	0.2
Developing Asia	10.6	7.8	5.5	6.9
China	13.0	9.0	6.7	8.0
India	9.3	7.3	5.1	6.5

Source: IMF, World Economic Outlook, January 2009.

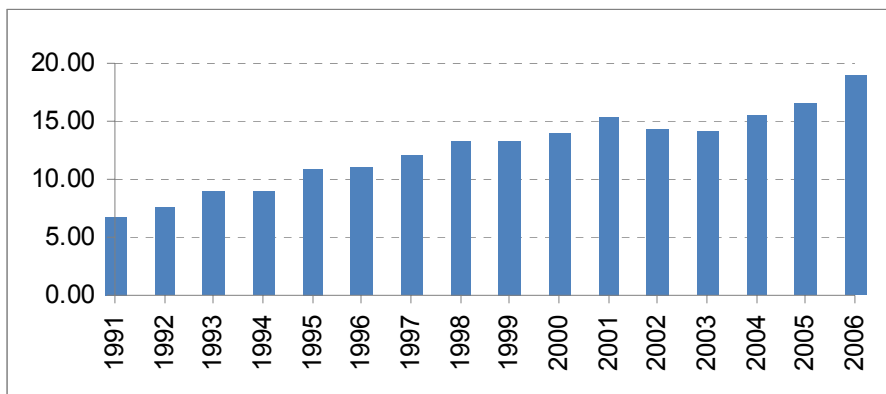
### I.3 Bangladesh: Export Performance

Bangladesh's export earnings have risen rapidly since the early 1990s. Exports have grown from around 7 percent of GDP in 1991 to around 18 percent in 2006. The GDP growth rate has been consistently over 6 percent over the last few years despite a number of weather related shocks emanating from cyclones and floods. There is considerable speculation about what impact the GFC will have on GDP growth with widely different figures emanating from different institutions. The World Bank suggests that growth could decline to 4.5 percent while most other observers consider a figure of 5.5 to 5.8 percent more realistic.

Two main sources of economic growth have been manufacturing and services, both crucially dependent on the RMG sector. Thus, any impact on the country's export processing sector, and in particular on the large RMG sector, will adversely affect economic performance.

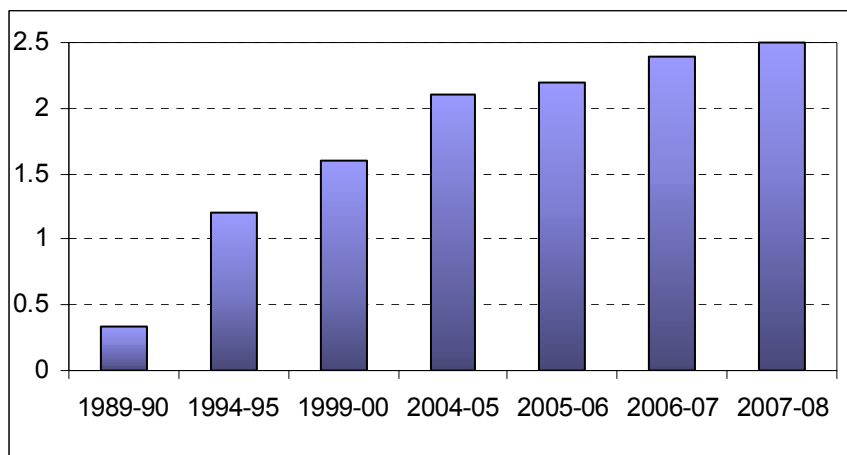
The main driver of our exports sector is the ready-made garments industry (RMG) which accounts for almost four fifth of our total export earnings. Almost two and half million people, ninety percent of them women, are employed in the RMG sector; while a large but undetermined number of people are involved in various ancillary and support services e.g. banking, insurance, transport etc. to this sector. The workers are largely drawn from the poorer sections of society. Any adverse effects on the RMG sector will thus have far-reaching implications for the entire economy and society.

**Figure 1.5: Trend in Export-GDP ratio of Bangladesh**



Source: World Development Indicators, 2008.

**Figure 1.6: Number of Workers Employed in RMG Sectors (In Million)**

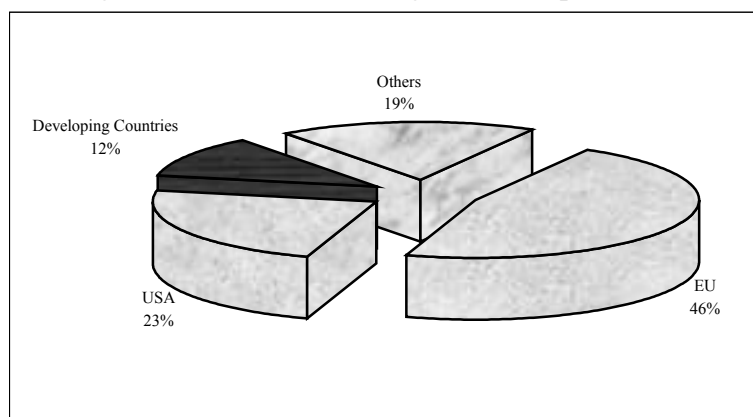


Source: BGMEA Website, 2009

The export sector is potentially vulnerable to the on-going financial crisis as it heavily depends on the EU and US markets which have been badly hit. Almost half of Bangladesh's exports go to the EU, while another quarter goes to the US. High export concentration is a source of vulnerability for Bangladesh's exports, especially in the context of the current recession.

There are at least two channels through which the crisis can hurt Bangladesh. Declining wealth and earnings in the USA and EU has reduced import demand and may reduce demand for Bangladeshi exports. Another impact could be through the banking system, reducing trade credit to buyers involved in imports from Bangladesh. This may in turn affect our exports.

**Figure 1. 7: Direction of Bangladesh's Exports (2007)**



Source: Direction of Trade 2008, IMF.

### I.3.1 Forecast based on Export Demand Function: A SUR Approach

An economic downturn usually corresponds to reduced import demand for a given country. Reduced imports in major world economies translate into very bad news for many smaller economies that depend critically on exports to those countries. Economic theory stipulates that export demand is mainly determined by real price of the items under consideration, income level of the importing countries, and other factors. Consumers in major destination regions have sharply reduced their spending leading to low demand and the closure of many firms and large unemployment levels. This reduction in consumption might also reduce the export demand of countries like Bangladesh.

However, it is important to examine the degree to which reduced incomes/expenditures in the major economies affect Bangladesh's exports. Estimation of export demand functions (and relevant income elasticities) is best suited to assess this relationship. Bangladesh exports a number of items to the USA and EU including woven and knit wear products. To estimate income elasticities for our exports to these major destinations, an attempt was made to estimate country specific and product specific export demand functions for Bangladesh.

Nur et al (2007) estimated an export demand function for Bangladesh using bilateral trade data and applying co-integration techniques. Real exchange rate and real GDP were used as explanatory variables, and the data period for the analysis was limited to 32 years (1973-2004). Estimates were generated for five major export destinations, including Belgium, France, Germany, United Kingdom, and United States. The estimates produced positive income elasticity for exports, for all five export destinations. However, the magnitude of the elasticities varied widely among countries. In case of France, Germany and USA, the relationship was elastic, while in the case of UK and Belgium, it was found to be inelastic.

Choudhury (2001) conducted a study entitled "Export Demand Function of Bangladesh: An Econometric Exercise" with a view to estimate the price and income elasticities for Bangladeshi exports. She has estimated export demand functions of total exports and exports to fifteen major trading partners of Bangladesh over the period 1972/73 to 1997/98. A simple log-linear form of the export demand function was estimated and unit value of exports and the weighted index of GDP were used as explanatory

variables. The price and income elasticity of export demand for fifteen major destinations were estimated, and were found to be -0.90 and 4.21 respectively, in aggregate. For total exports (all destinations) the figures were -0.18 and 0.65. In this case price elasticity was statistically insignificant. The study concluded that, as price was found inelastic, devaluation will not have a significant impact on export demand. However, income changes in the top fifteen trading partners has significant impact on exports.

Ahmed et al (1993) made an attempt to estimate an export demand function for Bangladesh using advanced techniques, using time series econometrics such as cointegration and error correction models. The study took into account foreign income, relative price and variability of exchange rates. It was found that all variables except exchange rate variability were statistically significant in explaining export demand. The study found the value of income elasticity to vary from 0.44 to 0.50 in the unrestricted model, while in the long-run, it varied from 0.19 to 0.23. Export demand function was found to be highly price inelastic with price elasticity ranging from 0.06 to 0.08 and significant only in the short-run.

Razzaque (2004) made an attempt to estimate the export demand function for Bangladesh RMG export to the European Union following a more realistic demand theory that overcomes problems of traditional theoretical framework. He estimated the export demand function considering the small country assumptions of Panagariya which lead to valid parameter estimations. According to small country assumption, price elasticity of Bangladesh export should be high; while the income elasticity of Bangladesh export should be insignificant or very low. The study found large price elasticity and very low income elasticity reflecting the small country assumption.

Although, the empirical studies in the context of Bangladesh provide conclusive evidence (except Razzaque, 2004) that weighted real income and relative prices are the determinants of export demand, they also provide some inconclusive evidence regarding the magnitude of these elasticities. These studies have followed the format of domestic demand studies by treating the export market as a single market rather than as a group of markets. This approach simplifies the analysis, but ignores cultural, demographic, and economic differences among countries that make each country a unique market (Lee and Fairchild 1988).

However, no attempt has been made to estimate market-specific disaggregated export demand functions for Bangladeshi exports. The present study attempts to do precisely this, in the backdrop of the global financial crisis, using quarterly data and applying the 'seemingly unrelated regression' (SUR) technique. This should provide us with a firmer basis to judge the impact of GFC on our exports.

Two major importing regions were considered, namely the USA and Europe (EU-15). The European region includes the fifteen countries in the European Union prior to the 2004 expansion.

To accommodate the nonlinear relationship between the volume of exports and the price of exports, a double logarithmic model was used. The seemingly unrelated regression (SUR) technique was employed as model disturbance terms from the different demand equations are expected to be correlated since the demand relationships are measured at common points of time. The SUR model consists of a number of regression equations, each of which satisfies the assumptions of the standard linear regression model. If each equation is estimated separately and independently, disregarding the information about the mutual correlation of the disturbances, the estimators of the regression coefficient are unbiased but consistent; however, the efficiency of the estimators becomes questionable. The SUR model estimates the system of equations simultaneously by applying Aitken's generalized least squares procedure (Zellner 1962). This increases the efficiency because there are more degrees of freedom available with which to estimate the parameters.

Demand theory identifies price as the main explanatory variable, and incomes, tastes and preferences, prices of related products (substitutes and complements) as demand shifters. In particular, the aggregate demand for Bangladeshi exports by a particular country depends on the price charged by Bangladeshi exporters, a composite price for all other goods to the consumer, consumer's income and country's population. Besides the above-mentioned factors, this study attempts to utilize exchange rates as an

explanatory variable in affecting exports. Since data on prices, and tastes and preferences for different countries was not available, a simplified model was specified for estimation:

$$\text{Log } X_t^d = \alpha + \beta \text{log } Y_t + \theta \text{log } E_t + u_t$$

The demand equation then, takes the form: where  $X^d$  = quantity of export demand,  $Y$  = Real GDP;  $E$ =Exchange Rate; and  $e$ = error term.

We estimated the function using double log method and the focal advantage of this method is that estimated coefficients represent the corresponding elasticities of the explanatory variables.

Table 1.2 presents the results from the estimated SUR model for seven major export items as well as for total exports from Bangladesh to USA and EU. It may be noted that income elasticities for all items exported to USA and EU (except leather products exports to USA) are low although positive. These however, are found to be significant statistically, except for fish and jute products to USA. These low elasticities imply that there is a positive association between the income of importing countries and export demand from Bangladesh. The implications are obvious: the positive, significant association implies that reduced income (GDP growth) in importing countries like US and EU will dampen exports; however, the magnitude of this impact will be low given the low elasticity levels.

With a view to estimate the exchange rate elasticity, we have used exchange rate of USD in terms of taka and Euro in terms of taka in our model. This implies that an increase in the exchange rate represents a depreciation of the taka against USD or Euro, as the case may be. It may be observed that the exchange rate elasticities were positive and statistically significant with few exceptions (such as fish and jute export to USA and fish export to EU). Elasticities for leather products, rawhides and knitwear export to USA were found to be higher (more responsive). Exchange rate elasticities for all products exported to EU were found to be low; however all are statistically significant (except fish items). These positive exchange rate elasticities imply that depreciation of taka will augment export demand while appreciation will affect export demand adversely. A stronger statement based on the elasticity estimates is not being made because important variables are missing from the model specification, implying that caution should be exercised.

There is a frequent argument that Bangladesh is facing hard competition in the main export markets, particularly from India and China. It is also argued that the withdrawal of quota restriction on China at the end of 2008 will be problematic for Bangladeshi RMG exports to USA. An attempt was made to examine the degree of substitutability of Bangladesh's exports with Indian and Chinese exports. The estimated parameters of Chinese and Indian exports of knit and woven products were found positive and statistically significant. This indicates that Chinese and Indian exports are not creating obstacles for Bangladeshi exports to USA and EU, and that Bangladesh is not gaining market share at the cost of China and India (table 1.2).

Table 1.3 combines the elasticity estimates with the GDP forecasts of the US and EU available from the European Commission, to arrive at the likely impact on Bangladesh's exports due to the global recession (table 1.3). In the case of USA, export of major items as well as total exports will slow down throughout 2009; however, the magnitude of slow down is less than one percent except for leather products. For leather products, the rate of decline is by over 2 percent in the second quarter of 2009. It will be observed that the second and third quarter of 2009 are crucial for Bangladesh exports. The estimate suggests that Bangladesh exports will dip by .37 and .29 percent, in the second and third quarter of 2009. In the case of EU, first quarter of 2009 is crucial for all export items and exports are generally expected to slowdown. These projections have been made under the assumption that export demand behaviour will mimic the longer-term historical trend, which of course, may not be true, at least in the short-run. We also made similar estimates using the IMF GDP forecasts instead of the EC forecasts. The conclusions are very similar.

**Table 1.2: Regression Results: Income and Exchange rate Elasticities**

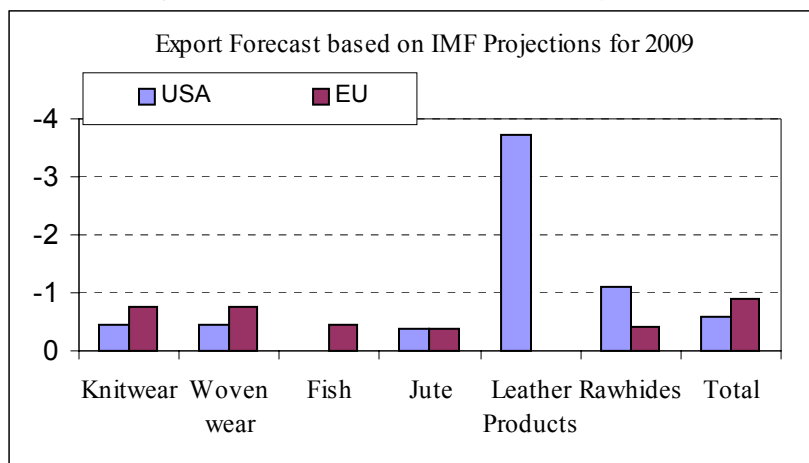
Destinations	Commodity	Income Elasticity	Exchange Rate Elasticity	Substitution Parameter of China	Substitution Parameter of India
USA	Knitwear	0.2903911*	1.85298**	0.1801**	0.4854*
	Woven wear	0.2855428*	0.8005111*	0.427**	0.337*
	Fish	0.0086	0.7962688		
	Jute	0.241779	0.2557664		
	Leather Products	2.329824*	5.307921*		
	Rawhides	0.6911198**	2.042887**		
	Total	0.3680913*	0.7344868*		
European Union	Knitwear	0.3850197*	0.0074014*	0.9198 *	0.2727**
	Woven wear	0.386823*	0.0001788*	0.571*	0.099*
	Fish	0.2326834*	0.0021747		
	Jute	0.1866102*	0.0071777*		
	Leather Products	0.0041508*	0.0017311*		
	Rawhides	0.1995184*	0.0040831*		
	Total	0.4474187*	0.0035401*		

\* indicates 1 percent level of significance, \*\* indicates 5 percent level of significance; and \*\*\* indicates 1 percent level of significance

**Table 1. 3: Percentage Change in Exports Earnings of Different Products due to Income Fall in USA and EU**

Quarters	Forecast for USA Markets							
	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4
Knitwear	-0.06	-0.29	-0.23	-0.03	0.15	0.26	0.35	0.41
Woven wear	-0.06	-0.29	-0.23	-0.03	0.14	0.26	0.34	0.40
Fish	0.00	-0.01	-0.01	0.00	0.00	0.01	0.01	0.01
Jute	-0.05	-0.24	-0.19	-0.02	0.12	0.22	0.29	0.34
Leather Products	-0.47	-2.33	-1.86	-0.23	1.16	2.10	2.80	3.26
Rawhides	-0.14	-0.69	-0.55	-0.07	0.35	0.62	0.83	0.97
Total	-0.07	-0.37	-0.29	-0.04	0.18	0.33	0.44	0.52
	Forecast for EU Markets							
Knitwear	-0.04	0.00	0.08	0.23	0.31	0.39	0.42	0.50
Woven wear	-0.04	0.00	0.08	0.23	0.31	0.39	0.43	0.50
Fish	-0.02	0.00	0.05	0.14	0.19	0.23	0.26	0.30
Jute	-0.02	0.00	0.04	0.11	0.15	0.19	0.21	0.24
Leather Products	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01
Rawhides	-0.02	0.00	0.04	0.12	0.16	0.20	0.22	0.26
Total	-0.04	0.00	0.09	0.27	0.36	0.45	0.49	0.58

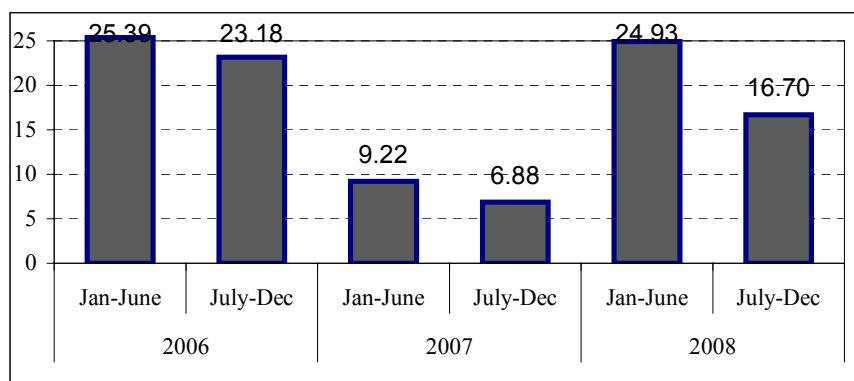
**Figure 1. 8: Forecasts based on IMF Projections**



#### I.4 Export Performance: Review of Evidence

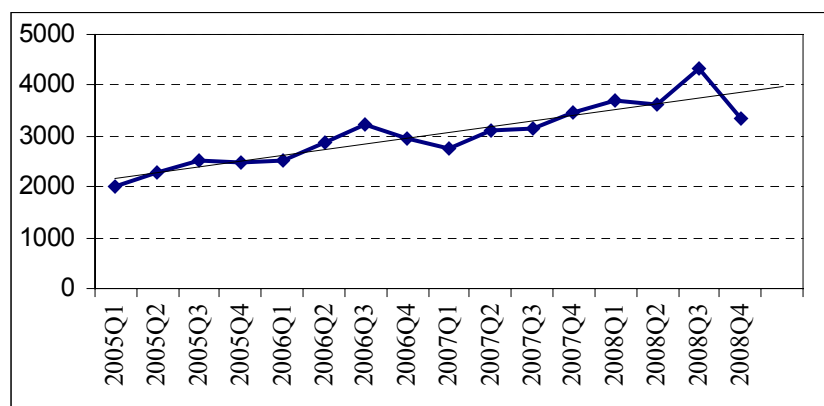
Bangladesh’s export performance in 2008 was positive compared to the previous year. Its performance was also good if compared to other countries in the region. The country’s exports grew by 16.7 percent in 2008 compared to less than 7 percent in 2007 and around 23 percent in 2006. However, a closer look at export trends suggests that by the end of the year, quarterly export growth was beginning to decline (figure 1.10). This may be an early indication of the impact of the recession.

**Figure 1.9: Half Yearly Growth of Bangladesh’s Export (Year-over-Year)**



Source: Calculated based on data accessed from IFS, 2008 and Bangladesh Bank

**Figure 1.10: Quarterly Exports of Bangladesh in Million USD**



Source: Calculated based on data accessed from IFS, 2008 and Bangladesh Bank

Bangladesh's positive export performance in the US market, for example, contrasts sharply with that of many other countries in the region (table 1.4). It will be seen that export growth has become negative for India, Philippines and Sri Lanka although China and Vietnam have managed to post positive growth rates. Nevertheless, Bangladesh's performance would appear to be the best in this particular grouping.

Bangladesh registered a 12.5 percent export growth in woven products and 25.9 percent export growth in knit products to the US market at a time when US imports of these items actually shrank by 3.6 and 1.6 percent. Overall exports to the US grew by 13.6 percent in the face of a mere 2 percent growth in total US imports over the July-December, 2008 period. This basically indicates that Bangladesh has been increasing its market share in the US apparel market at the expense of competing countries, despite the recession (or perhaps because of it). Some Bangladeshi exports have been adversely affected in the US market, including frozen fish, headgear and jute products.

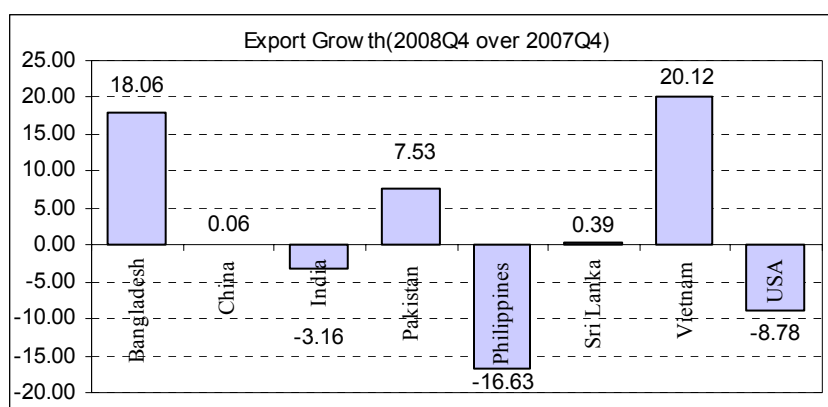
**Table 1.4: Quarterly Growth of Exports of Major Items to USA**

	Growth of Exports(Jul-Dec 2008 on July-Dec2007) (Year-on-Year)							
	BD	USA*	China	India	Pakistan	Philippines	Sri Lanka	Vietnam
Woven	12.49	-3.62	5.06	-8.88	4.08	-23.44	-3.87	7.82
Knit	25.88	-1.57	4.71	0.24	-0.89	-3.18	-25.23	0.57
Fish	-16.46	3.48	19.42	-17.99	-6.51	-20.58	-41.30	7.44
Home Textile	16.93	-3.99	-2.46	2.92	-9.39	1.34	-21.42	-25.36
Headgears	-11.53	3.12	5.44	-23.22	44.28	8.46	-11.47	7.89
Jutes	-19.76	2.55		-2.95	3.24	7.95	-7.71	
Plastics	6.69	2.02	10.48	33.61		-13.26	-0.04	15.31
Total	13.57	2.59	5.48	4.93	2.49	-12.21	-3.10	20.19

Source: Calculated based on data accessed from USITC, 2009.

By the end of 2008 (4<sup>th</sup> quarter) we note that the quarterly growth of exports from China dropped to 0.06 percent; India posted negative growth; and US imports nose-dived to a negative 8.8 percent (figure 1.11). Against all this adversity, total Bangladesh exports climbed to 18.1 percent and Vietnam did slightly better, achieving a growth rate of 20 percent - further evidence of rising market share for Bangladesh.

**Figure 1.11: Quarterly Growth of Exports to USA**



Source: Calculated based on data accessed from USITC, 2009.

However, Bangladesh has been facing problems in the EU market. Its exports to the EU grew by 3.6 percent in July-December 2008 while all other countries, with the exception of Sri Lanka, out-performed Bangladesh. In particular, Bangladesh has experienced problems in exports of shrimp, headgear, jute goods and rawhide registering a drop in exports of these products in the range of 16-25 percent. Most unusually, even woven exports registered a negative growth. China, on the other hand, experienced positive export growth for all the sectors except rawhides and leather products. The poor performance of Bangladesh in the EU market is largely attributable to the exchange rate situation that led to a sharp depreciation of the Euro against the USD and BDT.

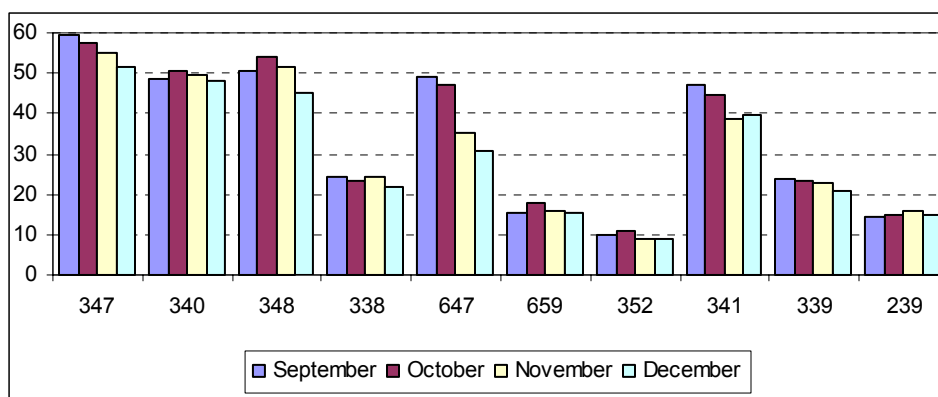
**Table 1.5: Growth of Exports to EU (July-Oct 2008 over July-Oct 2007)**

	Bangladesh	China	India	Pakistan	Sri Lanka
Woven	-2.04	6.46	4.56	1.88	3.92
Knit	6.66	32.11	-4.48	-1.57	2.07
Fish	-15.88	4.51	-11.96		0.93
Home Textile	4.28	1.50	-4.33	0.15	-14.23
Headgears	-20.02	5.08	12.91	10.09	-0.16
Plastics	33.13	7.45	-3.72	127.99	-2.69
Jutes	-13.30	2.64	-2.48		-4.87
Rawhide	-25.44	-26.96	-12.20	-23.94	-35.00
Leather Products	15.23	-1.12	11.32		14.57
Total	3.58	7.23	10.91	7.45	1.57

Source: Calculated based on data accessed from Eurostat, 2009

The main advantage of Bangladesh over its competitors is its price. Exporters from Bangladesh have been cutting back on prices further in trying to cope with the crisis. Indeed, unit prices, calculated by dividing value by quantity for the top ten RMG products exported by Bangladesh, reveal that except category numbers 340, 659 and 239, there is a downward price trend for all other categories. This has helped Bangladesh to remain competitive in the US market.

**Figure 1.12: Prices of Top Ten Categories of RMG Product Export to USA for last four months of 2008**

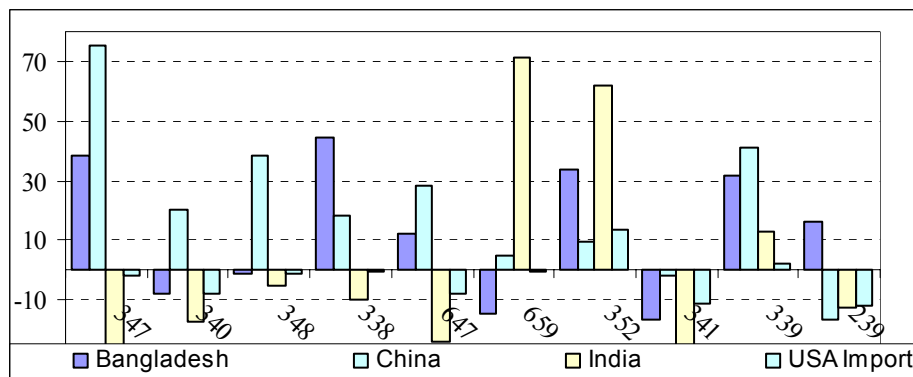


Source: Calculated based on data accessed from OTEXA

Figure 1.13 shows the quantity change of RMG exports for the top ten MFN categories to USA from Bangladesh, China and India. Out of the ten products, Bangladesh experienced negative export growth for three categories; while china and India experienced negative growth for two and seven categories respectively. China is experiencing positive growth in all categories in which Bangladesh is experiencing positive growth, except for category 239. Generally it is argued that Bangladesh is exporting low end products to the US markets. Because of income fall due to the financial crisis, it is expected that consumers are substituting their consumption of high-end products with these low end products – figures 1.13 and 1.14 lends credibility to this view. While, Bangladesh and China are experiencing

positive growth for these categories of products despite the recession, high-end products from China have actually been in decline. Thus, out of the top five Chinese RMG products exported (which are high-end), four items have been severely hit by falling demand. China has responded (somewhat surprisingly) by increasing exports of lower end products (figure 1.13).

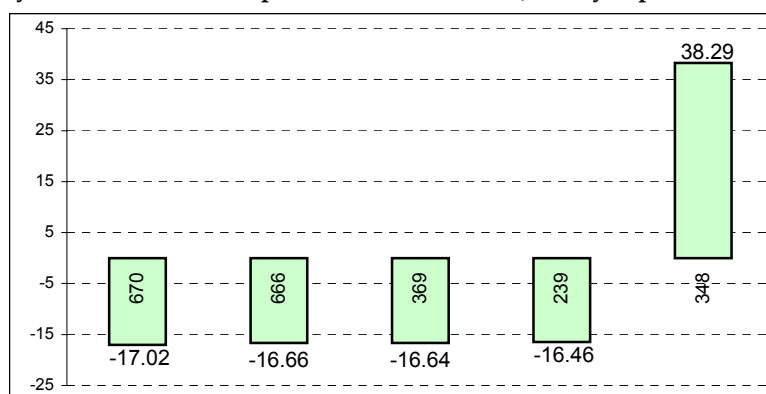
**Figure 1. 13: Changes in Quantity of Bangladesh’s Top ten MFN Category Export to USA (July-Dec2008 over July-Dec2007)**



Source: Calculated based on data accessed from OTEXA

Figure 1.14 shows that China is facing a severe fall in export quantity of its major RMG export items to USA. This scenario has confirmed that consumers in USA are using low end RMG products from Bangladesh and China, instead of high-end RMG products.

**Figure 1.14: Dynamics of China’s Top Five MFN Product’s Quantity Exports to USA**



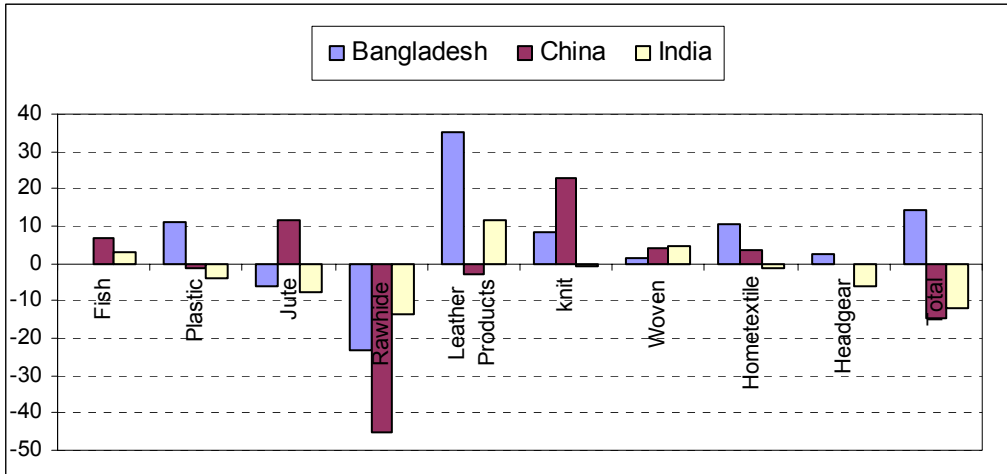
Source: Calculated based on data accessed from OTEXA

In the EU, Bangladesh is experiencing negative export growth for rawhides, jute and frozen fish. For rawhide, China as well as India is also experiencing negative growth. Figure 1.15 rules out the possibility of substitution in the case of EU.

Exchange rate has important implications for export performance as it directly influences the price competitiveness of exporting countries, although it must be noted that the exchange rate is not the sole determinant of a country’s export competitiveness. Figure 1.16 illustrates the appreciation and depreciation of major foreign currencies against the dollar in 2008. Indian Rupee, Euro and pound have experienced sharp depreciation while Bangladeshi taka and Chinese Yuan have been stable. Sharp depreciation of Euro and Pound Sterling; and stability of the Bangladeshi taka eroded Bangladesh’s competitiveness in Europe to an extent, reflected in the slowdown of Bangladesh exports to EU (table 1.5).

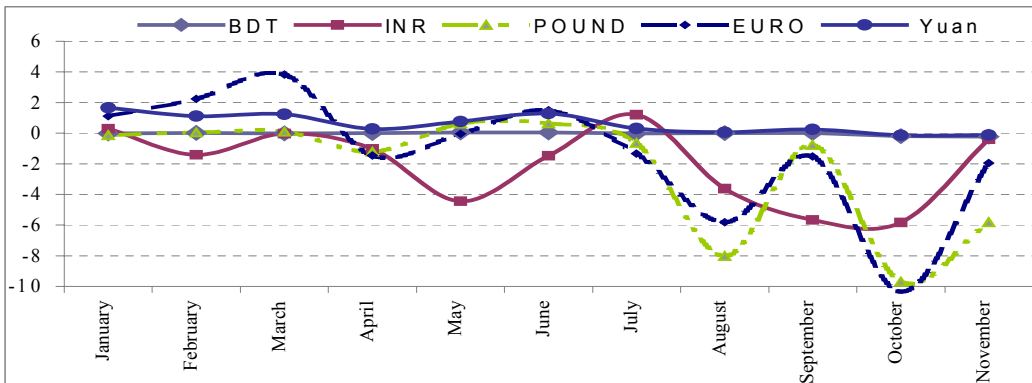
However, depreciation of the Indian Rupee has improved the competitiveness of Bangladeshi RMG export to USA to some extent, as a significant portion of yarn that is used as input are being imported from India.

Figure 1.15: Changes in Quantity of Bangladesh's Major Product's Export to EU



Source: Calculated based on data accessed from Eurostat, 2009.

Figure 1.16: Appreciation/Depreciation of Major Foreign Currencies against USD



Source: Economic Trend, Bangladesh Bank

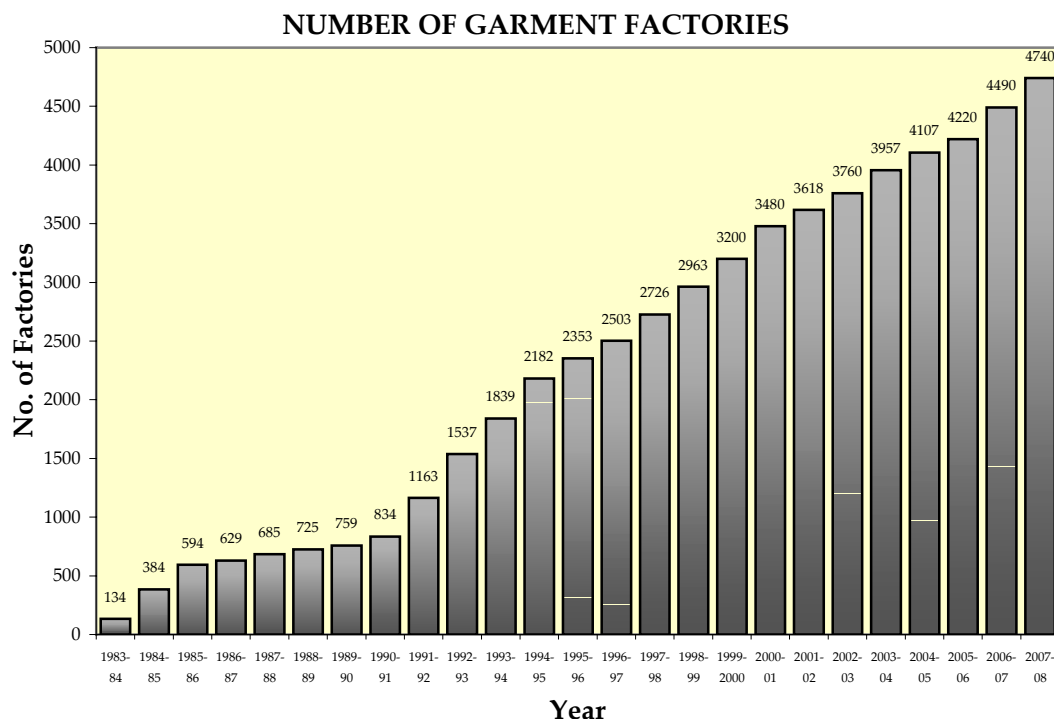
## II A Closer Look at the RMG Sector

Bangladesh has become integrated with the global economy through exports of RMG. The contribution of woven garments and knitwear were 38.3 and 37.4 percent respectively in 2006-07. The industry has grown exponentially in terms of capacity, exports and employment (figures 2.1 and 2.2). At present Bangladesh exports account for about 2 percent of the \$600 billion global textile and clothing market. Ready-made garments export rose to \$10.7 billion in 2007-08. Over the years, Bangladesh diversified its exports both in woven and knitwear. The share of knitwear increased, while that of woven fell. Within the RMG sector there has been diversification into different products: Bangladesh started as an exporter of shirts, and has subsequently diversified into trousers, jackets, T-shirt and sweaters. The share of shirts declined sharply, offset largely by rising contribution from trousers. The shift was made on the back of the emerging backward-linkage primary textile sector. Since 2006-07, jackets have emerged as a significant product and may start to replace trousers in the future. Within knitwear, both T-shirt and sweaters started to grow after 2005. Thus, the trend in the last few years is towards greater diversification and a distinct shift away from the lower end of the low end product range towards the upper end of the lower range - indicating Bangladesh's emerging confidence and competitiveness in the market.

### II.1 RMG Export Expansion in the Face of Retail Slump in US

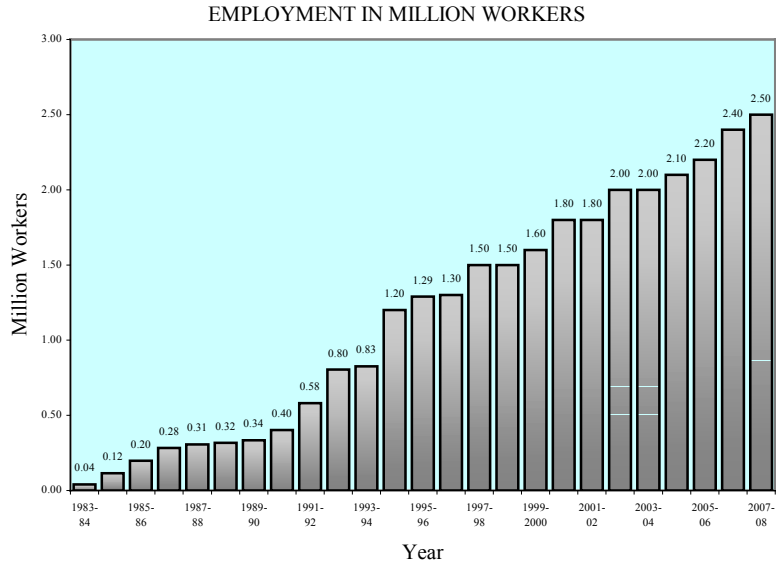
Figures 2.4 and 2.5 indicate that the financial crisis started to have a negative impact on US clothing sales from 2007. The growth of retail sales fell from 10.75 percent in the first quarter to 2.48 percent in the last quarter of 2007. In December 2007, retail-clothing sales declined by 1.24 percent. Moreover during the second and third quarter of 2008 there was no growth, while in the last quarter retail sales declined by 8 percent translating into falling apparel imports to the US. The drop in imports in absolute terms has sent shock waves across Asian RMG suppliers who are greatly dependent on the US market.

Figure 2.1: Trends of Garment Factories in Bangladesh



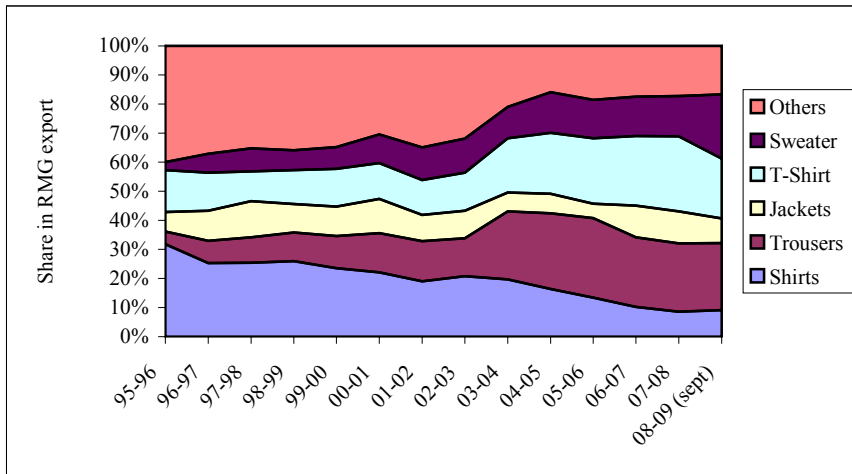
Source: BGMEA

**Figure 2.2 Trends of Garments Worker in Bangladesh**



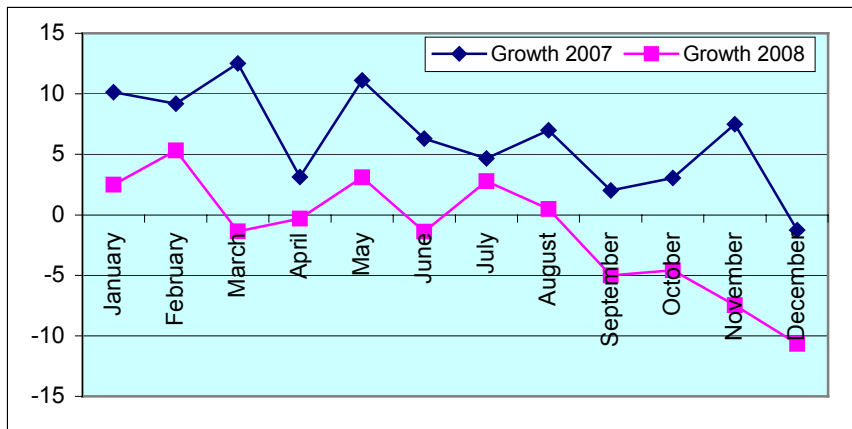
Source: BGMEA

**Figure 2.3: Product share in RMG export**



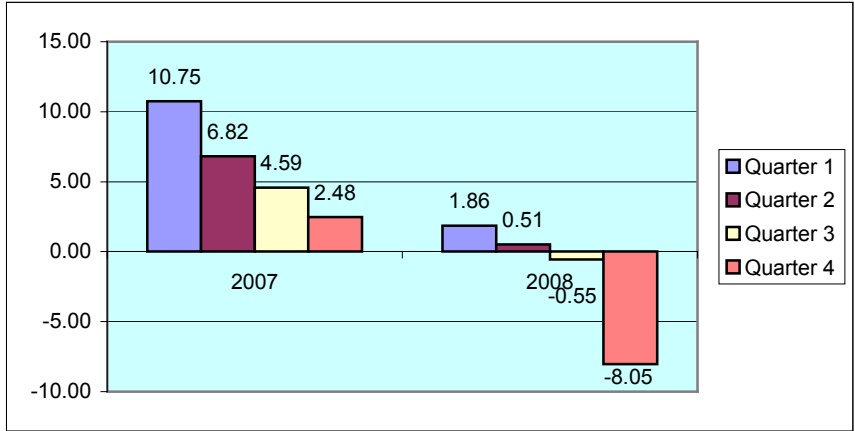
Source: Compiled data from EPB

**Figure 2.4: Trends in US Retail Clothing Sale, 2007 and 2008**



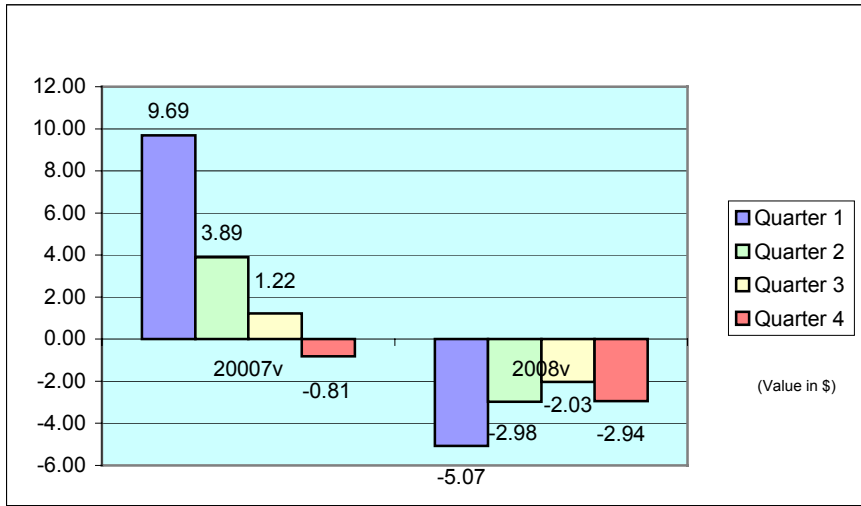
Source: US Census Bureau

**Figure 2.5: Quarterly Trends in US Retail Clothing Sale, 2007 and 2008**



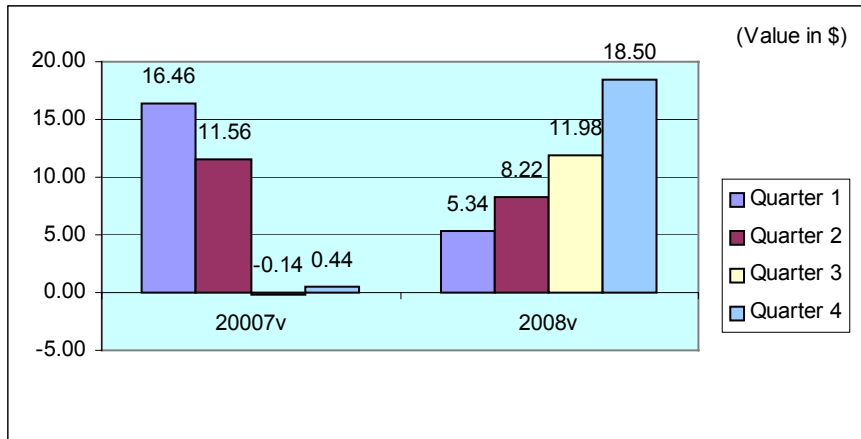
Source: US Census Bureau

**Figure 2.6 Quarterly Trend in US import of Apparel, 2007-08**



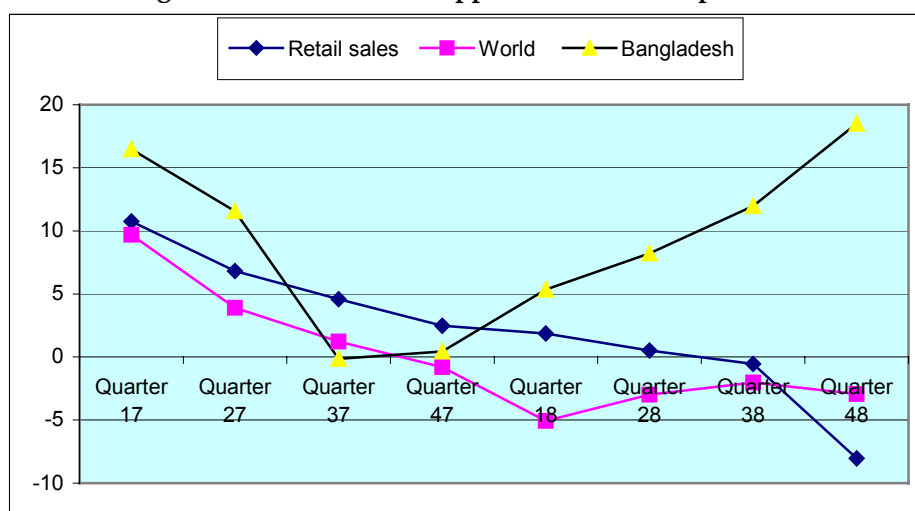
Source: OTEXA

**Figure 2.7: Quarterly Trend in US import of Apparel from Bangladesh, 2007-08**



Source: OTEXA

**Figure 2.8: Trends in US Apparel Sales and Imports**



Source: OTEXA

The importers responded to the reduction in clothing sales with a search for low cost producers. As RMG is a buyers market, the buyers' strategy was price reduction to boost sales volume. Due to this strategy, it may be noted that far from plunging, Bangladesh clothing exports was very strong in 2008. This was partly due to product relocation from China as US importers were buying more from low-cost sources.

US retail clothing sales declined by 8.05 percent in the fourth quarter of 2008, and consequently US imports of apparel declined by 3 percent. But US imports from Bangladesh increased by 18.5 percent during the fourth quarter raising its market share from 4 to 5 percent in 2008.

## II.2 Can this growth be sustained in 2009

The 7.5 percent cap on growth on Chinese apparel exports to the US has been lifted from January 1, 2009. About 34 categories of RMG products faced such a cap since 2006. Of these, 29 categories overlap with those that Bangladesh produces. These account for 80 percent of Bangladeshi exports to the US. Thus, there is a serious potential for this to affect Bangladesh which may face stiff competition from China. The table below shows that Bangladesh has benefited from the safeguard on China where out of the top ten products of interest to Bangladesh in 2007, seven had a quota (table 2.1). The closest competitor of Bangladesh is Pakistan in terms of price, but Bangladesh much greater stability compared to Pakistan. China and India are high-end producers, and as restrictions are withdrawn on exports from China, Bangladesh will come under pressure. In this context, duty free access to Bangladesh as an LDC would enormously help Bangladesh to retain its market share.

### Box: 1 Trend in US market: Trousers and Shirts

#### *Cotton Trousers (347/348)*

With the end of quotas in USA, Bangladesh was the main winner, as cotton trousers (347/348) were restricted from China. Chinese prices rose by no less than 37 percent between 2005 and 2008, as suppliers were shifting to the higher part of the market in order to take full advantage of the US quotas. The rise in production costs in China is also a cause for rise in prices. During the same period Bangladesh and Mexican prices declined by 7 percent, while that of Vietnam and Cambodia declined by 14 and 19 percent respectively. Chinese and Mexican trousers are at the top end of the US import market—US\$80 and US\$86 per dozen respectively, while the low cost segments are Bangladesh (US\$52), Vietnam (US\$58), Cambodia (US\$57) and Pakistan (US\$53). In terms of volume Bangladesh had the highest share in Jan-Aug 2008, of 14 percent of trousers import of US, while that of China was 12 percent. This was followed by Mexico (10 percent), Vietnam (9 percent) and Cambodia (7 percent). The share of other South Asian countries were India (4 percent), Pakistan (4 percent) and Sri Lanka (3 percent). Price competitiveness has been the main

criteria for getting the market share. Now the question is, will US imports of cotton trousers from China surge in 2009, after quotas have been eliminated, effective from 1st January 2009? The removal of quota costs may result in a fall in import prices from China. Mexico may lose its market share to China.

Trouser exporters in Bangladesh feel that GFC will have marginal effect on the demand for trousers. As purchasing power will decline, the demand for low valued products will increase. Bangladesh produces low to middle valued products whose demand is likely to increase. Competing countries like India, China, Pakistan and Turkey are facing problems. A small diversion from China will be a big gain for Bangladesh. The strength of Bangladesh is language, backward linkages and low wages. A major importer suggested that wastage needs to be reduced. There is a need for increasing stonewashed denim and more new varieties in denim.

#### Shirts ( 340/640)

As Americans are spending less, the market for major apparel brands worth \$3.2 billion are scaling back their sales. US demand for imported clothing, both in value and volume terms have been on a downturn. US imports of men's and boy's woven shirt fell across the board in 2008 by 8.45 percent in value terms and 14.44 percent in volume terms, except from China—where it increased by 16.27 percent in value terms. This indicates that China is likely to gain a greater share of the US import market in 2009. Competitors from Bangladesh, India, Indonesia and Vietnam may find it difficult to compete, even with higher Chinese prices in the future. Bangladesh has lost its position as the leading supplier in volume terms and is now ranking second behind China in 2008, as shipments declined by 17 percent and earnings by 14 percent. The average world price is US\$76 per doz. China, India and Indonesia are at similar price level of around US\$ 70-80 per dozen on average, followed by Vietnam at US\$59, while Bangladesh and Pakistan prices are US\$49 and US\$ 39 per dozen respectively. Major importers in Bangladesh suggested that there has been a change in fashion from “dress shirts” to “casual shirts” and “polo shirts”. Bangladesh has specialized in producing “dress shirts” and now needs to adapt quickly to casual clothing.

Table 2.1: Price per dozen in selected Asian countries: first half 2008

Categories	Quota on China	World	Bang	China	India	Pakistan	Vietnam
347 Cotton M/B Trousers	Q	70.44	<b>52.54</b>	85.50	82.85	<b>55.18</b>	61.86
340 Woven Shirts, M/B	Q	80.50	<b>47.68</b>	83.40	63.61	<b>23.59</b>	61.11
348 W/G Slacks	Q	60.08	<b>47.76</b>	85.50	82.85	55.18	<b>54.17</b>
338 Knit Shirts, M/B	Q	30.64	<b>22.12</b>	60.41	42.73	<b>33.18</b>	45.24
647 Trousers M/B	Q	53.73	<b>35.17</b>	73.20	84.44	<b>32.46</b>	64.10
659 Other MMF							
352 Cotton underwear	Q	10.88	<b>8.69</b>	17.93	12.88	<b>10.79</b>	11.95
341 W/G woven blouse		62.15	<b>38.82</b>	61.56	63.61	<b>23.59</b>	42.73
339 W/G knit blouse	Q	33.84	<b>22.36</b>	55.22	37.51	<b>20.95</b>	34.83
239 Baby garments							

Source: emerging textiles.

## II.3 Challenges in EU: Currency devaluation and safeguard on China

The Bangladesh RMG sector was faced with several challenges in EU in 2008:

- Global financial crisis and world wide recession
- Currency depreciation of major currencies including the Euro and Indian Rupee
- Removal of safeguard on China in EU from January 2008

The EU became the largest single market for clothing imports in 2007, surpassing the US. The end of quotas on China from January 1, 2008 brought downward pressure on prices in the EU clothing market and required the suppliers to become more efficient. Among the Asian countries, the main suppliers are China, Bangladesh and India. For all Asian suppliers except China and Vietnam, there was a decline in woven imports from August 2008. Woven exports from Bangladesh declined by 16 percent while knitwear exports declined by 9 percent in August.

During the period July-Oct, 2008, imports of woven dropped by 0.71 percent over the previous year from the world as a whole, but imports from Bangladesh declined by 2.2 percent (table 2.2).

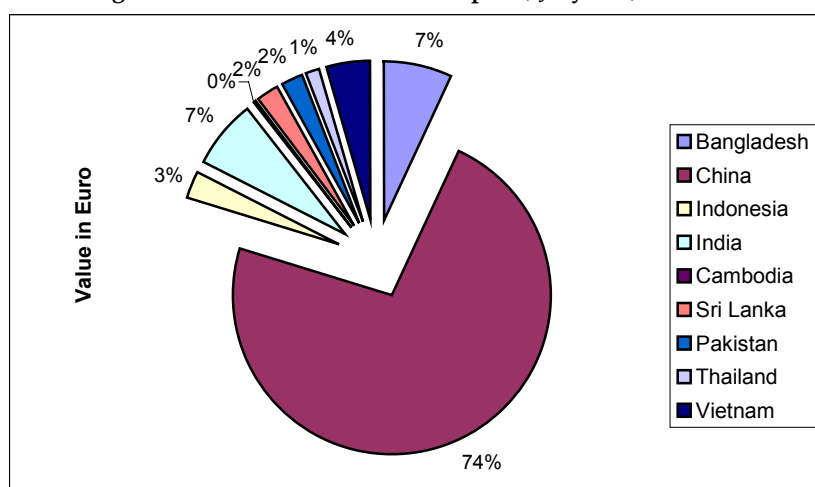
**Table 2.2: Growth in EU 27 Imports for Apparel, 2008**

Country	July	August	September	October	July-Oct
<b>Knitwear</b>					
Bangladesh	21.08	-9.04	3.97	17.46	6.95
China	34.70	18.52	42.55	37.67	32.58
Indonesia	-7.88	-30.94	-17.41	-19.72	-19.73
India	2.02	-14.73	3.51	-5.21	-4.14
Cambodia	-10.88	-7.89	4.80	-27.05	-10.49
Sri Lanka	2.11	-3.14	-10.19	21.27	2.60
Pakistan	0.54	-4.39	-2.25	3.22	-0.69
Thailand	8.72	-0.55	11.66	-0.01	4.83
Vietnam	7.06	9.80	21.02	9.40	11.88
<b>Woven</b>					
Bangladesh	12.33	-16.25	-7.41	9.32	-2.23
China	9.53	-2.83	11.49	10.88	6.76
Indonesia	6.39	-7.29	-1.11	0.86	-0.59
India	11.29	-7.65	12.19	5.63	4.89
Cambodia	0.77	-28.55	-12.44	13.36	-8.84
Sri Lanka	2.72	-11.06	3.40	23.83	3.50
Pakistan	6.66	-5.63	0.38	8.19	2.12
Thailand	-8.80	-16.18	-3.26	-4.68	-8.66
Vietnam	8.03	5.63	6.82	12.05	7.85

*Source: Eurostat*

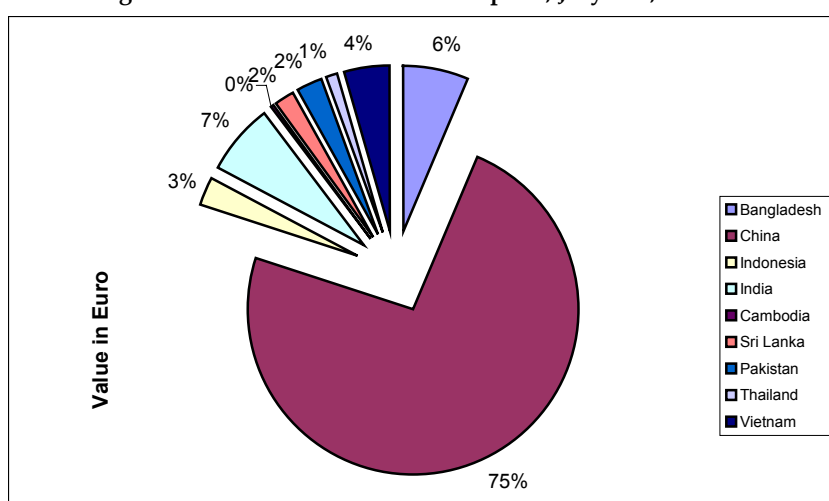
However, competitors like China, India, Sri Lanka, Vietnam and Pakistan had positive growth in the same period. Negative growth of woven garment exports from Bangladesh was as follows: UK (7.17 percent), Denmark (15.80 percent), Belgium (13.05 percent), Sweden (13.34 percent), Ireland (14.51 percent), Greece (30.38 percent) and Austria (45.62 percent). Among Asian suppliers, share of China increased from 74 to 75 percent, and that of Bangladesh declined from 7 to 6 percent, while that of India remained the same at 7 percent.

**Figure 2.9: Shares of EU Woven Imports, July-Oct, 2007**



Source: Calculated from Eurostat data

**Figure 2.10: Shares of EU Woven Imports, July-Oct, 2008**



Source: Calculated from Eurostat data

In the case of knitwear products, world exports increased by 2.3 percent while Bangladesh exports grew by almost 7 percent over July-December 2008. China posted a massive growth, with exports growing by 32.58 percent, followed by Vietnam (11.88 percent). But among the Asian suppliers, share of China in knitwear exports increased from 50 percent in 2007 to 62 percent in 2008, while that of Bangladesh and India fell. The share of Bangladesh fell from 17 to 15 percent while of India declined from 10 to 8 percent during this period. UK, one of the largest importers from Bangladesh posted a 2.72 percent fall with UK's imports of sweaters declining by more than 7 percent in 2008, compared to 2007. Our exports also marked a drop in Austria, Finland, Hungary and Ireland.

Bangladesh enjoys preferential access to EU under EBA. Duty free access offered to Bangladeshi products continued to boost EU demand for knit clothing, which can easily comply with rules of origin. But the situation is difficult for woven exports. EU imports from Bangladesh fell 5.27 percent in chapter 62 (woven clothing) in the first half of 2008, in euro terms. Weaker retail sales in the EU and a rising taka against euro may result in lower orders from EU buyers in 2009. Demand from Europe may be less strong in the near future, due to the appreciation of the taka against the Euro and the British pound. However, as the Euro and British pound becomes stronger against the greenback, this will situation will be slowly reversed.

The EU is currently reviewing its rules of origin, as many LDCs are unable to comply with the so-called, two-stage transformation. Most of the export shipment of woven does not enjoy GSP facilities. Canada's GSP scheme for LDCs requires only 25 percent value addition, and almost all exports from Bangladesh to Canada enjoy duty-free access. Hence, it would be in the interest of LDCs to lobby for a low value-added rule, along with cumulative value across the world. The EU is likely to implement its single value added rule sometime in 2010. Under the new scheme, local dyeing facilities will enjoy GSP facilities for knitwear and sweater items.

## **II.4 Stakeholder Perceptions**

### *China: An important factor*

Discussion with the key exporters and importers suggest that China has been an important factor due to which the global financial crisis has been an opportunity for Bangladesh to expand export to US and EU as well as diversify to new markets.

Sourcing from China has become expensive as the Chinese currency appreciated and labour laws were being strictly implemented. Textile products are generally considered to be low price and low valued item in China and a major shift could occur to Bangladesh in the future. Hong Kong based buyers consider Bangladesh a more reliable, cheaper supplier compared to many other countries. A small diversion from China can be a big gain for Bangladesh. Indeed, the high growth of knitwear in 2008 has been due to diversion from China. The increase in demand for knitwear has been less than 5 percent but the growth in knitwear was more than 35 percent. Bangladesh has assumed a strong position in the clothing export market, and has benefited from the safeguard measure against China in both EU and US. This enabled Bangladesh to develop a large capacity base for RMG exports.

### *Diversifying to new markets*

RMG is a buyers market. Suppliers in Bangladesh have been trying to enter the high quality Japanese market but have not been able to do so. This is because of the fact that culturally, Japanese were more comfortable with China. About 80 percent of the clothing export to Japan is from China. The other major supplier to Japan is Vietnam. By the end of 2008, Japanese buyers were searching for sourcing from other low cost countries. A major Japanese buyer, "Uniqlo" has already expressed an interest in procuring \$600 million worth of apparels from Bangladesh, indicating that Bangladesh is well poised to enter the Japanese market.

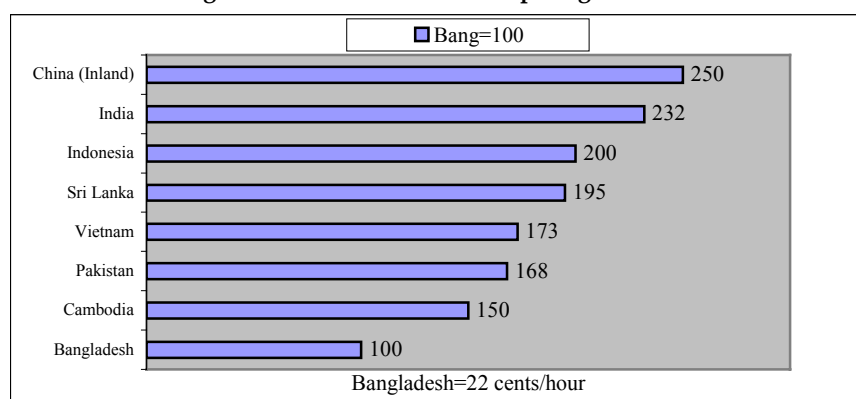
### *Diversification to higher-end products*

By the end of 2008, the buyers started to search for new, lower cost suppliers for outerwear including jackets and men's suits, in a bid to relocate away from China. For sweater, polo shirt, trousers (especially denim) and home textiles Bangladesh has a strong comparative advantage. Bangladesh is considered better than India in T-shirts and polo shirts. On the other hand, Vietnam and Cambodia do not have backward linkages for knitwear. Thus, Bangladesh has emerged as a strong contender based on its good quality yarn and a short lead time for export, in addition to its low cost advantage and good quality workmanship.

### *Labour costs*

China's production costs is rising in yuan and in US\$ terms. The table shows that seven Asian countries are now offering lower labour costs than China. According to Jassin O'Rourke, lowest labour costs are still in Bangladesh, at 22 US cents per hour or 2.5 times of that in China (Inland). The Labour cost includes wages, social charges, and a series of bonuses. Other low wage exporters are Cambodia, Pakistan and Vietnam, where labour costs are at 33 cents, 37 cents and 38 cents respectively (table below). Low labour cost along with efficient producers and good needlework has made Bangladesh an attractive destination for major buyers of apparel.

**Figure 2.11: Labour cost in competing countries**



Source: Jassin O'Rourke, 2008

**Table 2.3: Apparel Manufacturing Labour Cost in 2008**

	US\$/hour	Bang=100
Bangladesh	0.22	100
Cambodia	0.33	150
Pakistan	0.37	168
Vietnam	0.38	173
Sri Lanka	0.43	195
Indonesia	0.44	200
India	0.51	232
China (Inland)	0.55	250

Source: Jassin O'Rourke, 2008

### ***Bangladesh is not in cut-down list***

Major international buyers of Bangladeshi clothing include H&M, Tesco, Zara, Marks & Spencer, Carrefour, Gap, Wal-Mart, JC Penny and C&A. The Textile and clothing industry is characterized as a buyer-driven commodity chain, in which retailers and branded marketers play the lead roles rather than manufacturers themselves. There have been several changes in buyers' strategy to reduce transactions cost. (a) Brand name importers such as GUCCI and Ralph Laurane did not have outlets, while retailers like Wal-Mart did not have a brand name. Now both brand name and retailers have their own brands and outlets; (b) Wal-Mart is set to increase sourcing from Bangladesh. Bangladesh is already the largest sourcing country for C&A, who are the largest importers for EU except UK. Germany and Holland are the main importing countries buying through C&A from Bangladesh. Among EU countries, export from Bangladesh to Germany is the largest. Bangladesh is the third largest sourcing country for H&M, after China and Turkey; (c) Buyers does not want to put all eggs in one basket. There will be a long-term benefit for Bangladesh as it is a mature supplier as well as price competitive. Small producers from Africa may close down but the more mature firms will survive. There have been some new trends noticeable in buyers sourcing patterns. In 2004 the number of sourcing countries was 60, declining to 30 in 2005-06 and is projected to decline to 15 by 2010. Buyers are reducing the number of sourcing countries, so that they can reduce their management cost. Discussion with the buyers suggests that Bangladesh is not in the "cut down" list of firms/countries.

### ***Incentive package of competing countries***

Bangladesh has one of the highest costs of finance. The entrepreneurs opined that the interest rate is over 14 percent, and this is increasing cost of production. On the other hand the competitors in other countries have access to various incentive packages. China has been increasing the tax rebate for textile and clothing industry, from 11 percent to 14 percent. Interest rates have been reduced from 6.93 percent to 6.66 percent. Pakistan has also proposed a package for its textile industry: devaluation of currency by 30 percent, a fund for research and development, withdrawal of 15 percent sale tax on ginned cotton, reduced interest rates (from 17.14 percent to 3.5 percent), provision of 1.5 percent subsidy for export, and total withdrawal of VAT and Tax for imports of some machineries and dice chemicals. India has devalued its currency by 25 percent, provided 50,000 crore

(Indian Rupee) under the Technology Upgradation Fund, reduced interest rates from 17 percent to 6 percent, provided 60000 crore rupees for increasing cotton production, and added 10% capital subsidy for extra grant, and had not withdraw 5% interest subsidy under the TUF, and withdrew import Tax for some machineries and chemicals used in clothing sector.

### ***RMG export and the banking sector***

The buyer's perception is that in the last six months, effect of GFC was worse than was expected. Banks in developed countries have cut down on credit. One of the key instruments used to overcome the financing constraint in the RMG has been the use of back-to-back letter of credit (L/C). Based on the mother L/C from the importer, the banks in Bangladesh provide another letter of credit whose value is limited to 75 percent of the value of the mother L/C for import of raw materials. Bank default in US will affect banks in Hong Kong and this will affect banks in Bangladesh – hence bank default is likely to increase. Medium good companies were finding it difficult to survive. Many outlets have closed down in Europe and US.

### ***Increase in contract arrangement***

Bangladesh has been using the back-to-back L/C in order to meet the financial constraint since 1986. This has proved to be a useful mechanism also to monitor the two-stage cumulation for availing of GSP facilities in EU under the EBA. During the last three years, the use of mother L/Cs from importers has declined, replaced by direct bilateral contracts. Under this arrangement, the exporters and importers sign a contract based on which the bank in Bangladesh opens a back-to-back L/C. Thus, the exporters have to finance the raw material cost resulting in increased demand for credit.

### ***Buyers pay “when goods are sold”***

The exporters opined that the L/C is in favour of the buyers. After the goods have been shipped, some buyers negotiate to pay 30 percent and only if the goods are sold the rest of the payment would be made or else they would return the goods.

### ***Request to delay shipment***

Even after orders have been confirmed, buyers are requesting for delaying shipments. Importers are shifting delivery by up to two months, causing warehousing problems, problems with timely repayment to banks and even payment of wages to workers. Even reputed buyers like H&M had placed orders and confirmed and then asked to wait. Industry insiders estimated that up to 3 percent of orders will be cancelled.

### **Box:2 General incentive package for RMG**

<b>Type of incentive</b>	<b>Measures</b>
Technology up gradation fund	- Incentives for capital machinery imports - Incentives for effluent treatment plant and dyeing facilities for all firms within the industrial clusters.
Banking support	- Low interest rates as support for working capital so that salaries to workers can be paid. - Bangladesh Bank: - Monitor SMA loans of commercial banks. - Camel rating of classified and industrial loans.
Increasing market share in US: Cotton trousers were restricted in China so Bangladesh is the main winner and became the highest share in Jan-Aug 2008, 14% of trousers import of US but competition from China is increased due to end of quota from January 2008.	- Seek duty free access in US for all LCDs under NPDA.
Increasing market share in EU: The market share of knitwear, in particular sweater, has increased in Jul-Oct 2008 but currency devaluation of competing countries is a major problem.	- Need to examine exchange rate support to exporters in EU market.
Diversifying to new markets (Japan, China, Australia, India etc.)	- Provide reasonable (e.g. 10-15% cash incentive) for market diversification.

## II.5 Short-term Outlook and Opportunities

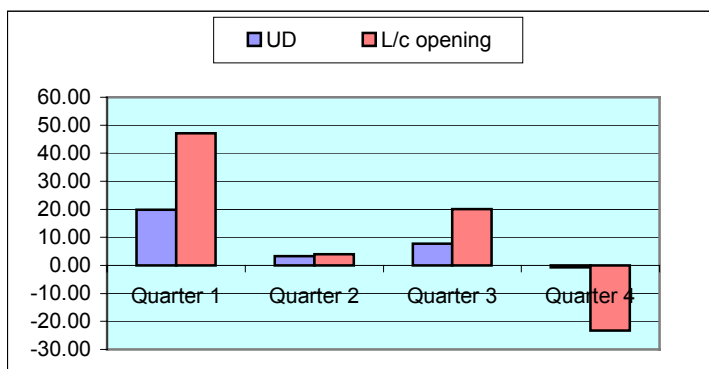
### *Survival of some firms at stake*

- Those firms who have good reputation will survive and expand.
- There will be cash flow problem for some small firms
- Manufacturing firms will face problems related to storage, disrupted project planning due to delayed orders, declining production, and cash flow
- Banks will have problems as (a) goods already exported, but payment not received; (b) goods produced but not shipped (c) goods produced but payment renegotiated
- Impact on wage payment: Firms will find it difficult to pay salary to workers

### *Outlook for export in first quarter 2009*

The BGMEA and BKMEA provide Utilization Declaration certificates. According to BGMEA data, there has been a decline in Utilization Declaration. Moreover data on L/C opening of a reputed private bank (main branch) similarly shows a decline in the L/C opening in the last quarter of 2008. Orders were low from October to December and hence there will be a decline in exports till March 2009. The stakeholders expected a 40 percent decline in production for spring and summer. The stakeholders wanted to “*Wait and see*” till March.

Figure 2.12: Quarterly Growth in UD and L/C opening



Source: Calculated data from BGMEA and Bangladesh Bank

### *Direct marketing*

China and India are becoming expensive. Vietnam is also expanding its exports. The buyers are seeking to expand sourcing from experienced countries that can produce quality products at lower prices. Direct retailers in Germany such as S Oliver and Tom Tailor do not have offices in Dhaka. Those firms who are producing directly for retailers can afford to bear the increase in cost and reduction in prices as they have a better margin. But most firms are producing for importers such as H&M and Li Fung. There is a need to go for forward linkages with retailers. Moving upscale can get better price, better quality and produce smaller quantity with skilled labour.

### *Seize Opportunities*

Bangladesh has coped well and the challenge is to retain and indeed, expand market share, exploit opportunities to enter new markets, diversify products, and position the sector for the fight for markets once the world economy begins to pick up speed. Some short term costs and a degree of adjustment pain will be experienced but in the longer run, the sector is likely to emerge much stronger and more competitive. The entrepreneurs should continue to offer low prices for their products and deliver on time. The top exporters should be the trendsetters and diversify to Japan and other emerging markets with higher-value products. As “buyers are coming to us”, the producers need to grab this opportunity with open arms.

### III IMPACT ON REMITTANCES

#### III.1 Introduction

Remittance flows to Bangladesh have grown rapidly over the last ten years from around 3 percent of GDP in 1995 to around 9.5 percent today. A total of some five million Bangladeshis are estimated to be resident overseas. While initially most of the migrant labour went to the Middle East, mainly to Saudi Arabia, there has been considerable diversification of destination countries in more recent years. Today, migrants are found in significant concentration all over the Far East and Europe, including Malaysia, South Korea and Japan and in Germany and Italy. Other traditional destinations (USA and UK) also remain very important both as a source of remittance and a favoured destination.

Remittances play a crucial role in the Bangladesh economy today. At the macro level, it has helped to ease our foreign exchange constraint, stabilizing the exchange rate and allowing Bangladesh to import much needed raw materials, intermediate goods and capital equipment. Comfortable reserves of foreign exchange have also contributed to overall macro stability and have reduced aid dependency, along with rapid growth of our export sector.

At the micro level, remittances have had a beneficial impact on household consumption, reducing poverty and creating jobs. Returned migrants have also brought with them new ideas and knowledge, along with seed capital, often making a significant contribution to the local economy. The local economy has also benefited indirectly as large out-migration, especially from some parts of the country led to localized labour scarcity, causing wages to rise. Inevitably, there are costs as well, which unfortunately have not been adequately assessed. These relate to the hardships and deprivations that migrants face both during the risky process of migration and while staying in the host country. Both social and economic costs are faced by families of migrants, especially when heavy debts have to be incurred and remain unpaid for long periods of time. Another well-known impact has been on land and real estate demand both in urban and rural areas, especially from where migration has been particularly large. Thus, migration and remittances are not unmixed blessings although the popular view tends to highlight the positive aspects only.

Given the GFC and the worsening situation widely forecast for 2009-10, there is every reason to be worried about the demand for migrant labour in host countries and the possible impact on remittance flows back to Bangladesh. There have been well-publicized incidents of migrants being sent back home or visas being cancelled even before visa-recipients were able to leave for their destinations. In many cases, these incidents were not directly related to the GFC but were rooted in domestic problems in the host countries. Nevertheless, there is a sense that the situation could worsen quickly as the recession deepens. It is therefore crucial that a holistic and objective assessment be made to arrive at the likely scenarios that may be unfolding over the next 12-18 months in the global labour market.

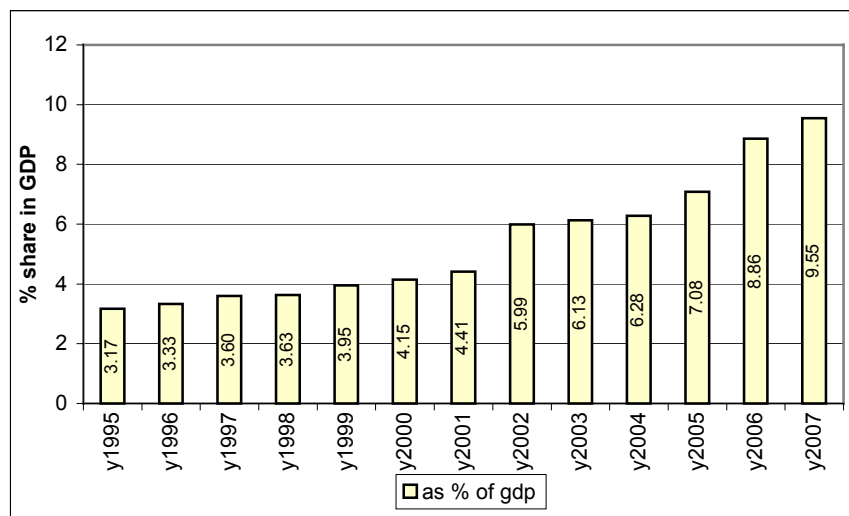
#### III.2 Overview of remittance inflows to Bangladesh

From 2003 to 2008, worldwide flow of remittances (i.e. the global remittance market) almost doubled (from USD 206 billion to USD 375 billion). A similar trend is observed in the case of developing countries (from USD 143 billion to 283 billion). In other words, the GFC has not dampened remittance flows, at least until 2008. This is also the experience of Bangladesh which posted a dramatic rise in remittance growth in 2008. Figure 3.1 shows the rapid rise in remittances as a proportion of GDP, from around 3.2 percent to 9.6 percent over a period of 12 years.

It is well-known that formal remittances account for 50-60 percent of total remittances with the remaining being channeled informally through various means, including *hundi*. A recent study suggests that almost 50 percent of the total remittance inflows are transacted through informal channels and are therefore unrecorded (World Bank Global Economic Prospects, 2006). The proportion may be slightly higher for Bangladesh given the concerted efforts being made by the Bangladesh Bank to encourage remittances through formal channels. Bangladesh's share of the world remittance market was around 2.4 percent in

2008, marking a slight increase from 2006 when it was 1.8 percent. It is difficult to know whether this increase is 'real' or due to a larger share of formal flows diverted away from the *hundi* market.

**Figure 3.1: Remittance as % of Current GDP**



Source: World Development Indicator-2008

There has been a gradual change in the share of remittance flows by regions. From 1980 to 2006, the inflow of remittances from the Middle-East remained above 70 percent. However, since 2006, there appears to have been a shift that is taking place with remittances increasingly coming from new sources, like USA, Canada, UK, Germany, Italy, Malaysia, and Japan reflecting considerable diversification of labour flows.

The Kingdom of Saudi Arabia (K.S.A.) is the most important source of remittances for Bangladesh, followed by the U.A.E, U.S.A and U.K. The USA, KSA and UK account for almost 60 percent of total remittances (table 3.4). Germany, Italy and Malaysia have also become important labour destination countries for Bangladesh.

While remittance flows did exceedingly well in 2008, by the end of the year there is a hint that deceleration in growth may have begun. It may be noted that remittances from Malaysia increased by a huge 455 percent in 2008 over 2007, although starting from a low base, while the worst performance is noted for the UK, registering a negative growth in remittances. However, the UK performance underlies the sharp drop in the sterling-USD exchange rate, resulting in the negative growth in USD terms.

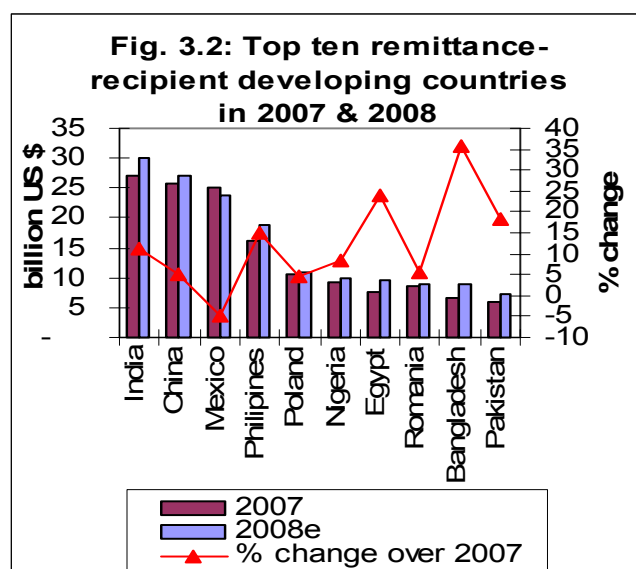
India attracts the largest share of remittances among all developing countries (USD 30 billion), followed by China (USD 27 billion). Over time the inflow of remittances to developing countries has been increasing (with the exception of Mexico). Even in the year 2008, when GDP growth rates in most countries of the world have been slowing down, often markedly, remittance flows to developing countries has been rising. In the case of Bangladesh is growth rate was striking, especially in 2008 (figure 3.2). In 2008, Bangladesh posted the highest growth rate in remittances amongst top remittance receiving countries (35.6 percent over 2007).

Nevertheless, any adverse impact of the world recession on the destination countries may well get translated into reduced remittance flows to Bangladesh. Given the overall economic outlook for 2009 and 2010, there are serious reasons for worry.

Table 3.1: Global flows of international migrant remittances (\$ million)

	2003	2004	2005	2006	2007	2008e	Remittances as a share of GDP, 2007 (percent)
<b>All developing countries</b>	143,345	163,535	194,174	228,800	264,896	282,793	2.0percent
Low-income countries	16,659	20,040	24,481	31,544	40,560	45,756	6.0percent
Middle-income	126,686	143,495	169,693	197,256	224,336	237,037	1.8percent
Lower MICs	88,593	94,891	110,032	127,221	146,575	157,997	2.3percent
Upper MICs	38,093	48,603	59,660	70,036	77,761	79,040	1.3percent
East Asia and Pacific	35,402	39,077	46,586	52,841	57,988	62,307	1.4percent
Europe and Central Asia	16,027	22,556	31,660	38,830	50,804	53,530	1.8percent
Latin America and Caribbean	35,219	41,728	48,716	57,384	61,000	61,095	1.7percent
Middle-East and North Africa	20,361	23,034	24,150	26,656	32,075	34,500	4.6percent
South Asia	30,366	28,694	33,092	39,615	43,824	50,942	3.1percent
Sub-Saharan Africa	5,970	8,445	9,969	13,475	19,204	20,418	2.6percent
<b>High income OECD</b>	60,697	67,134	69,210	73,783	86,128	87,653	0.2percent
<b>High income non-OECD</b>	2,327	3,387	3,871	4,099	4,415	4,569	0.5percent
<b>World</b>	206,369	234,056	267,255	306,682	355,438	375,015	0.7percent
LDCs (UN-classification)	9,608	11,216	12,523	14,996	17,934	21,191	6.0percent

Source: World Bank staff estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2008.



**Table 3.2: Top remittance recipient developing countries (million US \$)**

Country	year			percent change over 2007
	2006	2007	2008e	
India	25,426	27,000	30000	11.11
China	23,319	25,703	27000	5.05
Mexico	25,052	25,037	23800	-4.94
Philippines	15,251	16,291	18700	14.79
Poland	8,496	10,496	11000	4.80
Nigeria	5,435	9,221	10000	8.45
Egypt	5,330	7,656	9500	24.09
Romania	6,718	8,533	9000	5.47
<b>Bangladesh</b>	<b>5,428</b>	<b>6,562</b>	<b>8900</b>	<b>35.62</b>
Pakistan	5,121	5,998	7100	18.37

Source: World Bank staff estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2008.

**Table 3.3: Intensity of remittance inflow by region (percent)**

Area	Year							
	1980-85	1985-90	1990-1995	1995-2000	2000-06	2006-07	2007-08	2008-09 (July-October)
Middle east	72	70	75	74	73	66	63	64
ROW	28	30	25	26	27	34	37	36
Total	100	100	100	100	100	100	100	100

Source: Bangladesh Bank

**Table 3.4: Inflow of remittance in million US \$ by sending country**

Country	Remittance inflow from all countries		percent change (y-o-y)
	2007	2008	
U.S.A	1086.88	1582.49	45.60
U.K	889.74	823.42	-7.45
Kuwait	768	949.53	23.51
K.S.A	1788.28	2733.69	52.87
U.A.E	938.15	1379.54	47.04
Malaysia	29.71	165.03	455.47
Total	6568.03	9019.6	37.33

Source: Bangladesh Bank

### III.3 Likely future trend of remittance inflows

Uncertainty in remittance flows to Bangladesh stems from several sources:

- The economic slowdown (as mainly indicated by poor GDP growth rates and high unemployment levels), in two of the major remittance source countries, namely the U.S.A and U.K (which account for almost 28 percent of remittance flows to Bangladesh);
- The fall in oil prices and the magnitude of impact on the economy of GCC countries (which accounts for 63 percent of our total remittance earnings)
- Uncertainty about exchange rates.

The brunt of the world recession is being felt in the USA and EU, including UK, so that any adverse effects on remittances are likely to originate in those countries or regions. The Middle East is also likely to be affected by declining oil prices, and more importantly, by an expectation of slowing external demand. This has already led to some major investments to be put on hold, e.g. major construction works in UAE catering largely to foreign demand.

Remittances are shaped by complex factors present in both host countries and sending countries. In addition, it is also determined by individual characteristics like gender, skill, and socio-economic circumstances of the family back home. The main determinants of remittances are thought to be the bilateral exchange rate, economic conditions or GDP of the host country, the total stock of migrants<sup>2</sup>. In Bangladesh, the inflation rate is not an important determinant as the bulk of the remittance earnings are used to meet consumption expenditures.

<sup>2</sup> Using a balanced panel dataset of bilateral remittance flows from 10 major host countries (of Bangladeshi migrants') to Bangladesh over the 1993 to 2005 period., Shubhasish Barua et al (2007) found that income differential between host and home country is positively correlated with the inflow of remittances while inflation differential between home and host country is also found to be negatively correlated with the inflow of remittances, indicating that higher inflation in home country relative to host country may have exerted some negative effect on workers' remittances and devaluation of domestic currency or (increase in exchange rate) is positively correlated with the flow of workers' remittances in Bangladesh.

Table 3.5: Unemployment rate of major OECD countries (percent)

Country	2007	2008	2009	2010
United States	4.6	5.7	7.3	7.5
Japan	3.9	4.1	4.4	4.4
United Kingdom	5.4	5.5	6.8	8.2
Germany	8.3	7.4	8.1	8.6
Euro area	7.4	7.6	8.3	
Korea	3.2	3.2	3.6	3.6

Source: OECD Economic Outlook No.84

The rising unemployment rate in the major economies signals a discouraging picture (table 3.6). In the U.K, the unemployment rate was 6.1 percent for the three months to November 2008, up 0.4 percent over the previous quarter and up 0.9 percent over the year. The last time the rate was higher was in the three months to April 1999 (when it was 6.2 percent). The number of unemployed people increased by 131,000 over the quarter and by 290,000 over the year, to reach 1.92 million (the highest figure since the three months to September 1997). Total unemployment has shot up close to 2 million. Manufacturing output proved to be the biggest drag on the economy, plummeting by 4.6 percent in the fourth quarter. The service sector slumped by 1 percent, driven by a 2.4 percent drop in hotels and restaurants.

Based on the survey conducted by The National Association of Business Economics' (NABE) it was found that US firms are experiencing the worst business conditions in 27 years as the year-long recession worsens. The U.S. economy tipped into recession in December 2007 and there are worries that the downturn could be the worst since World War Two. The global credit crisis has eroded household wealth, causing sharp cut backs on spending and severely depressing demand. Sluggish demand was more pronounced in the goods-producing sector, where 79 percent of the firms reported falling demand - its lowest level in the history of the survey. The Job loss in U.S market was 2.9 million in 2008, with 1 million in the construction sector alone.

According to NABE, job losses were expected to continue during the first half of 2009, with most of the layoffs seen in sectors such as goods-producing, finance, real estate, transport, utilities and communications. Real gross domestic product in U.S decreased at an annual rate of 3.8 percent in the fourth quarter of 2008 compared to 3rd quarter of the same year.

The economy of the Middle East is heavily dependent on oil export earnings. Oil exporting countries in the Gulf region are expected to grow at an average rate of 6.1 percent in 2009, lower than in 2008, On the other hand, consumer price inflation (CPI) in oil exporting countries is projected to rise to 15.7 percent in 2008 from 10.0 percent in 2007 and ease to 13.6 percent in 2009. Though the recent global financial crisis will lower the growth of oil exporting countries, growth rates will remain moderately good at over 5 percent for the region as a whole. The two countries that are of particular importance to Bangladesh are Saudi Arabia and U.A.E where GDP growth rates are expected to be 4.3 and 6.0 percent respectively, in 2009 (table 3.5).

Remittance inflows from Saudi Arab are unlikely to be seriously affected because of the huge budget surplus that it has managed to build up in the face of high oil prices. It is using these resources now to undertake counter-cyclical policies, intended to off-set any adverse effects of the world recession.<sup>3</sup> Other oil-exporting countries in the region also appear to have adopted similar policies. These developments bode well for our migrant labour and may serve to counter expected losses elsewhere.

<sup>3</sup> In 2008 the budget and current account surplus of Saudi Arab was 385 SR billion and 162 billion US \$. In one forecasts done by Jadwa investment group has shown that in 2009 the budget balance will be negative and current account balance will lower to 34.6 billion \$, which indicate the government will probably undertake huge fiscal expansionary policy.

**Reasons for cautious optimism**

There are a number of factors that tend to provide some grounds for cautious optimism. These include amongst others, the following:

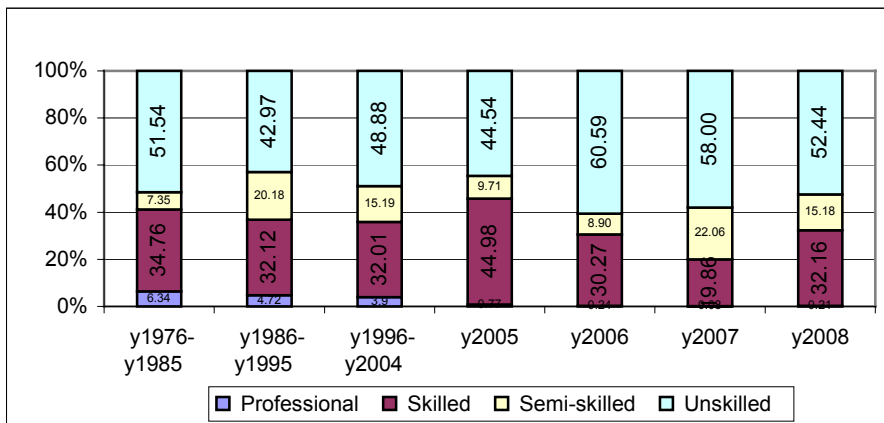
- A rising share of skilled labor in total overseas employment of Bangladeshi workers in 2008 over 2007;
- A stable exchange rate: better than volatility;
- Remittance flows do not seem to be influenced by GDP growth rates of host countries;
- We have a large accumulated stock of migrants already in place;
- The rising trend of remittance inflows in most developing countries including Bangladesh in the last year – and increasing share of Bangladesh in the world remittance market.

**Skill composition of Bangladeshi migrant labour**

Figure 2.5 portrays the changing skill mix of migrant labour over 1976 to 2008. It will be observed that the migrants are largely unskilled or semi-skilled. However, over time some changes have taken place in the skill composition of migrants. Thus, in the period 1976-85, about 40 percent of the migrant workers were in the ‘professional’ or ‘skilled’ category. This trend held until around 2005 but dropped sharply in the next two years. From 2007 onwards, once again we see a rising share of skilled workers.

It is argued that unskilled workers tend to send a higher proportion of their (low) incomes home (GEP 2006, WB). On the other hand, a negative relationship between unskilled workers and remittances is also likely, resulting from the positive relationship between income and human capital (Schiopu and Siegfried, 2006)<sup>4</sup>. The latter found that a higher share of unskilled labor reduces the average remittance size, which they interpreted as a reflection of small earnings of unskilled workers from which to remit. Thus, the more favourable skill mix seen in 2008 bodes well for remittances, and needs to be accelerated through a greater emphasis on human development and skills training.

**Figure 3.5: Distribution of overseas employment by different profession**



Source: BMET

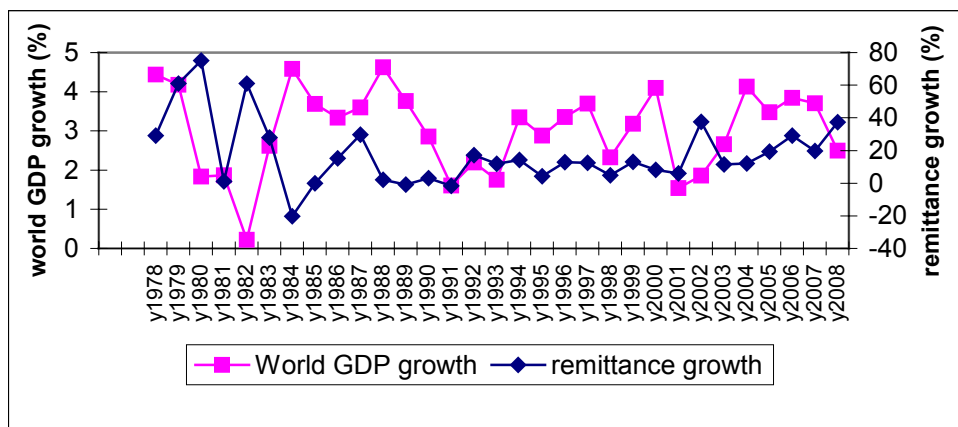
**Remittance earnings are not influenced by real World GDP growth rate**

From figure 3.6 it is difficult to discern a long term or short-term relationship between world (real) GDP and remittances. In 1991 the world GDP growth declined significantly, but remittance earnings did not. Similarly, just after 1/11, world growth declined sharply to 1.5 percent compared to over 4 percent in 2000, while remittance growth rates continued to climb. It may also be observed that the volatility of GDP

<sup>4</sup> Schiopu, I. and N. Siegfried (2006), *Determinants of Workers’ Remittances: Evidence from The European Neighbouring Region*, Working Paper No. 688 European Central Bank.

is much higher than that of remittances. Thus, a relationship between remittance and real GDP seems weak, if not non-existent.

Figure 3.6: Comparison of remittance growth with world real GDP growth



Source: World development indicator-2008 and World Bank staff estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2008.

### Steps taken by Bangladesh Bank to discourage hundi

A high proportion of remittances are sent home to Bangladesh through informal channels or *hundi*. A household survey by World Bank (2005) suggests that formal remittance constitutes about 54 percent of the total, implying that if appropriate incentives to use formal channels can be developed, this figure could go up quickly. The Bangladesh Bank suggests that its policies have resulted in further improvement of performance, with formal remittances now at 60 percent. The reasons for increasing share of formal channel appear to be related to tax exemption of remittance and interest earnings from non-resident foreign currency deposit account and permission of banks in Bangladesh to establish drawing arrangements with foreign banks and exchange houses for facilitating remittance by Bangladeshi nationals living abroad. Further measures are on the cards to stimulate formal flows including establishment of innovative mechanisms to bridge the 'last mile' in reaching remittances to the door in partnerships involving banks, NGOs or the postal system.

### Remittance out flows from Saudi Arabia are not influenced by oil prices

It is argued that the decline of crude oil prices will lower remittance outflows from GCC countries whose economies are heavily dependent on earnings from oil exports. Figure 3.7 plots oil prices against remittance flows from Saudi Arabia, and indicate that these variables are not positively correlated. If anything, the relationship seems to be inverse with rising remittances even in the face of falling oil prices. The same seems to be true for remittances to Bangladesh from Saudi Arabia.

### Accumulated stock of migrants large and rising

It is interesting to note that from 1995 to 2001, number of migrants increased more quickly than remittances. From 2001 to 2006, remittance growth overtook migrant growth while since 2007 this trend was reversed once again. Since remittance flows are expected to occur with a lag, it would appear that the initial build up of migrants in the 1990s led subsequently to the spurt in remittance growth. By the same token, we can argue that the spurt in labour migration over 2006-08 will result in another burst in remittance flows over the next few years. This trend could be moderated by the world recession if a large number of migrants have to come back home.

We wanted to check if there was indeed a staggered effect or lag in the migration-remittance relationship through a simple, one period regression. It was found that in fact migration has both a short-term impact as well as very significant long-term impacts on remittances, lending further credibility to the argument made above (table 3.7).

Figure 3.7: Remittance outflows from Saudi Arabia do not influence by oil prices

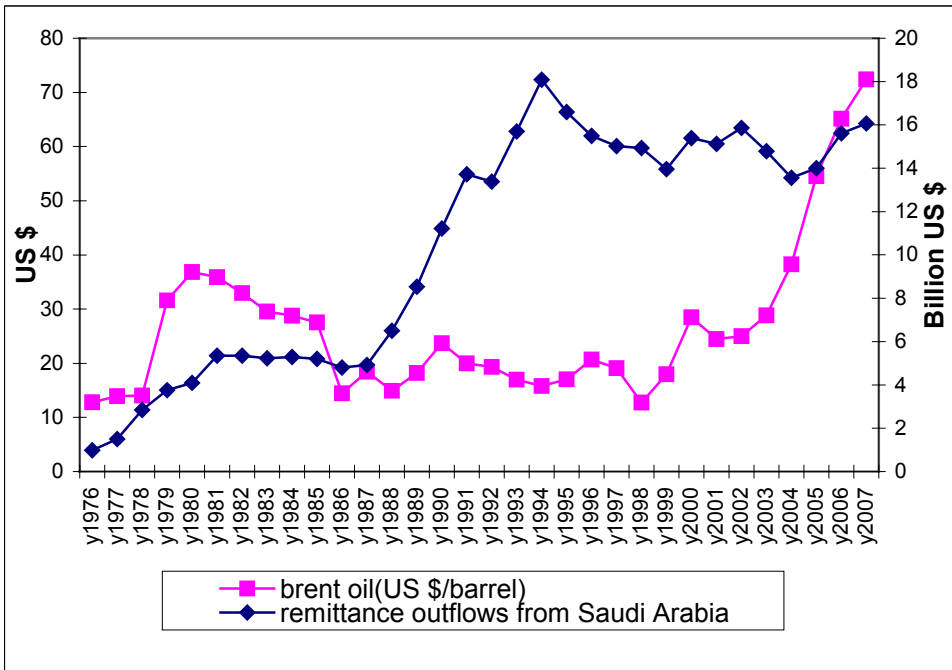
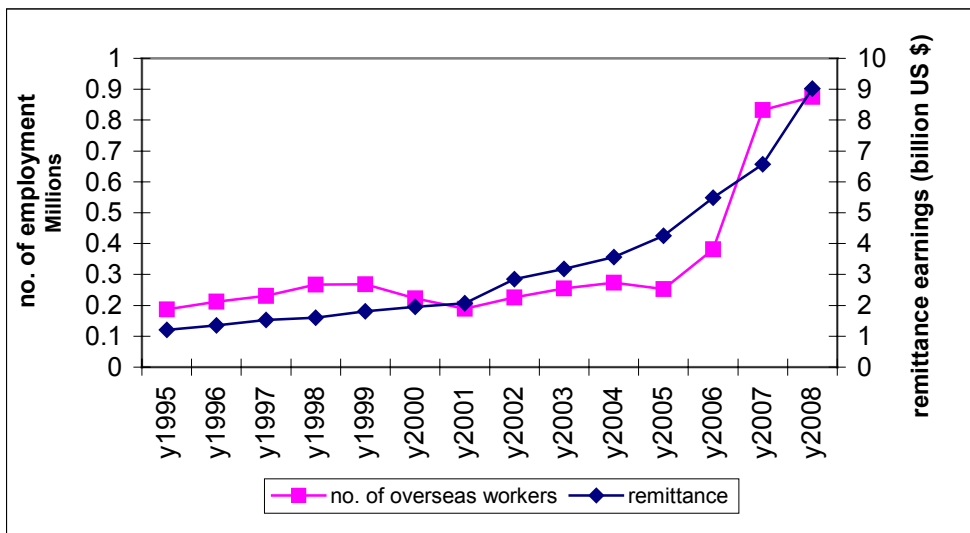


Table 3.7: Remittance regression

Dependent variable: Log of Remittance inflows		
Explanatory variables	Coefficient	t-value
Exchange rate	0.04*	6.38
Log of no. of overseas workers (t)	0.64*	2.65
Log of no. of overseas workers(lagged by one year), t+1	0.43*	1.94

\* indicates significance at the 5 percent level

Figure 3.8: Growth comparison-Remittance earnings vs. no. of overseas employment

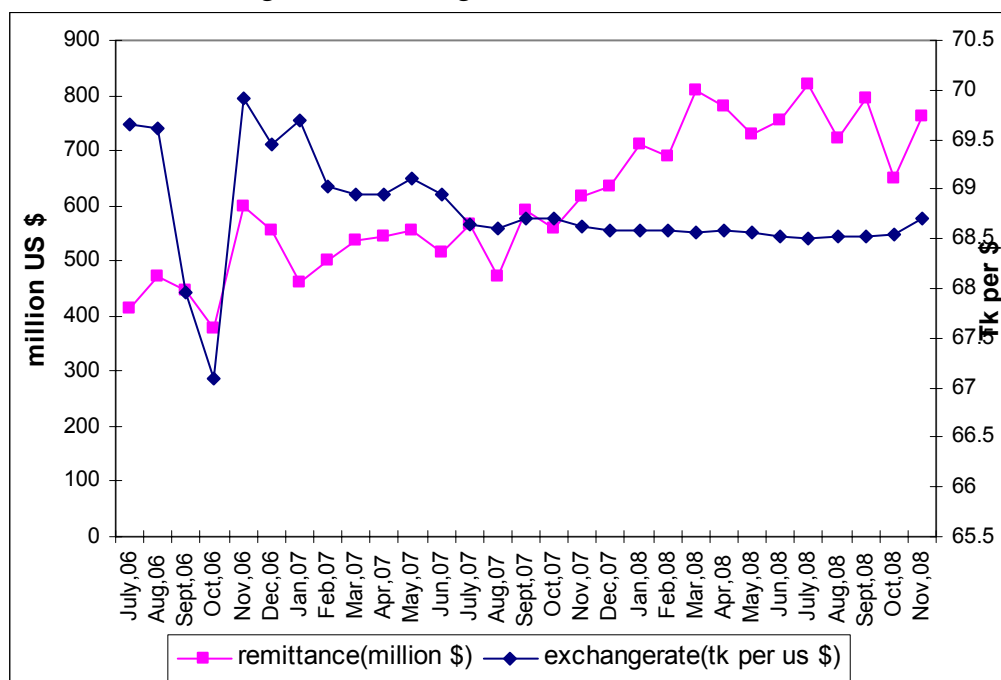


Source: World development indicator-2008 & BMET.

### Exchange rate effect: Is stability good for remittances?

Depreciation or devaluation of home currency reduces the prices of goods and services in the foreign currency, which allows a remitter to buy more foreign goods rather than domestic ones. On the other hand, the remitter is better-off as her income increases in the domestic currency, thereby encouraging her to buy more goods (including real estate) and services in the home country. From figure 2.9, we see that before September 2007, remittances and the exchange rate tended to move together. During this period, the exchange rate also displayed considerable volatility on a month-to-month basis. During the period after September, 2007 the exchange rate remained virtually static but remittances rose quite dramatically. It would appear that exchange rate stability was not a constraint to remittance growth.

Figure 3.9: Exchange rate effect on remittance



### III.4 Major Findings

- Remittances have increased for most developing countries despite the recession
- The share of Bangladesh has increased in the world remittance market
- Remittance outflow from Saudi Arabia do not seem to depend on oil prices – at least in the short-run
- Remittance flows closely track total number of migrants although remittances are more stable
- Remittance flows operate with a significant lag in the face of migration
- Exchange rate stability is likely to encourage remittances.
- All these indicators suggest that remittance flows to Bangladesh will remain strong in the next few years unless large number of migrants are forced back home.
- The counter-cyclical policies adopted in some key host destinations are expected to benefit Bangladesh.

### *Some reasons for concern*

- New visas are not being issued by Saudi Arabia (but this does not seem to be related to the world recession)
- Kuwait has not been issuing new visas to Bangladesh in the last 3 years (but again, this is not related to the recession)
- U.A.E, Qatar, Malaysia Singapore, Bahrain remain risky destinations – visas could be stopped at any time. In part this could be related to the recession but compounded by domestic policies and bi-lateral problems
- U.A.E has stopped or suspended many construction projects worth of \$582 billion – this is definitely related to recession.

According to BMET each day about 6000 clearances were given in early 2007 – this dropped to 3000 in 2008. In December 2007, 77977 clearances issued whereas in 2008 it fell to 44378. Can we wholly attribute this to the GFC? At any rate, these are worrying trends that we would need to consider carefully. A two-pronged attack seems to be in order: at the home front, we need better supervision of the migration process to prevent corruption and reduce widespread malpractice engaged in by private manpower agents in collaboration with host-country operatives. The role and capacities of public bodies entrusted with key roles also require investigation and reforms. At the same time, a massive diplomatic effort needs to be put in motion to assuage concerns in host countries that have sometimes led to extreme actions in the past by some.

## *IV IMPLICATIONS FOR IMPORTS*

### **IV.1 Introduction**

Bangladesh's imports as a share of GDP have been rising steadily over the past three decades. A valuable portion – about 27 percent of GDP was spent on import payments in 2007-08. Around 76 percent of export earnings originate in the RMG sector, of which 54 percent goes into imports of inputs needed for the RMG industry. Given the importance of imports for Bangladesh's economic growth and development, the implications for the balance of trade and payments, it is important to assess the likely impact of the world recession on the volume, structure and of imports, and the terms of trade. Import based revenues also comprise of a significant part of the national budget and could be cause for concern.

The sharp fall in energy and food prices in the world market has benefited Bangladesh immensely. The country is dependent on POL imports from the world market and is also a significant importer of food. The domestic economy is therefore quite sensitive to movements in the world price of these key commodities.

Before the onset of the recession, Bangladesh was reeling under the price pressures in the world market, leading to a high (double-digit) domestic inflation rate and fears of an impending food crisis. The advent of the recession brought prices down drastically, and as an importer, Bangladesh benefited hugely with domestic price pressures falling quickly, and the government making large savings from reduced subsidies, especially on diesel.

### **IV.2 Overall imports and its composition**

The total import payments in 2008 (January-November) amounted to US\$ 22260.7 million, which is 31 percent higher than import payments in the previous year. Total merchandise imports showed a robust 35 percent growth (on adjusted fob basis) during July-October 2008 despite a sharp decline in imports of food grains over the corresponding period of the previous fiscal year (table 3.1). In case of L/C settlements, except for food grains all other categories of import show positive growth in the face of falling prices in international markets (table 4.2 & 4.3).

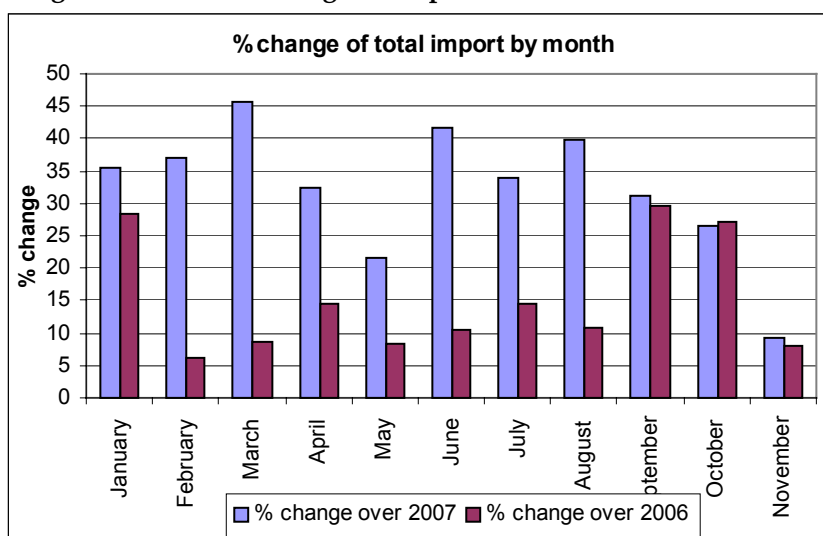
In order to understand the nature of impact of increased imports in the economy, it is important to take a more disaggregated view. From the composition of imports it is clear that capital machinery, crude petroleum products, cotton, yarn and fertilizer, textiles and articles, were the key commodities whose imports increased significantly. In other words, the nature of imports suggests that these were meant either to increase production or raise productivity in manufacturing industry and agriculture.

In July-November, 2008 food grain imports declined by around 25 percent compared to the same period of the previous year. In November '08 the wheat price per metric ton was US \$227 compared to \$321 in the same month in 2007. Rice price also declined significantly from \$1015 to \$563 per metric ton from March'08 to November'08. In terms of volume, food grain imports stood at 11.7 lakh metric tons during July-December, 2008 compared to 20.7 lakh metric tons in the same period in 2007. The slide in food imports was due to good domestic production and a respectable public stock level. Public food stocks stood at 13.2 lakh metric tons at the end of December, 2008 compared to 7.1 lakh metric tons at the end of December, 2007.

### **IV.3 Implication of financial crisis in case of imports: Inflation**

The recent commodity price boom has been supported by strong growth in global demand, primarily from developing countries. In agriculture, higher oil and fertilizer prices, along with increased demand for bio-fuels and feed leading to a reduction in grain stocks, have been more important than fast growth per se (Global economic prospects-2008, World Bank). This happened even as agricultural production increased, stimulated by large subsidies given to agriculture by the USA and EU.

Figure 4.1: Percent Change in imports in 2008 over 2007 and 2006



Source: Bangladesh Bank

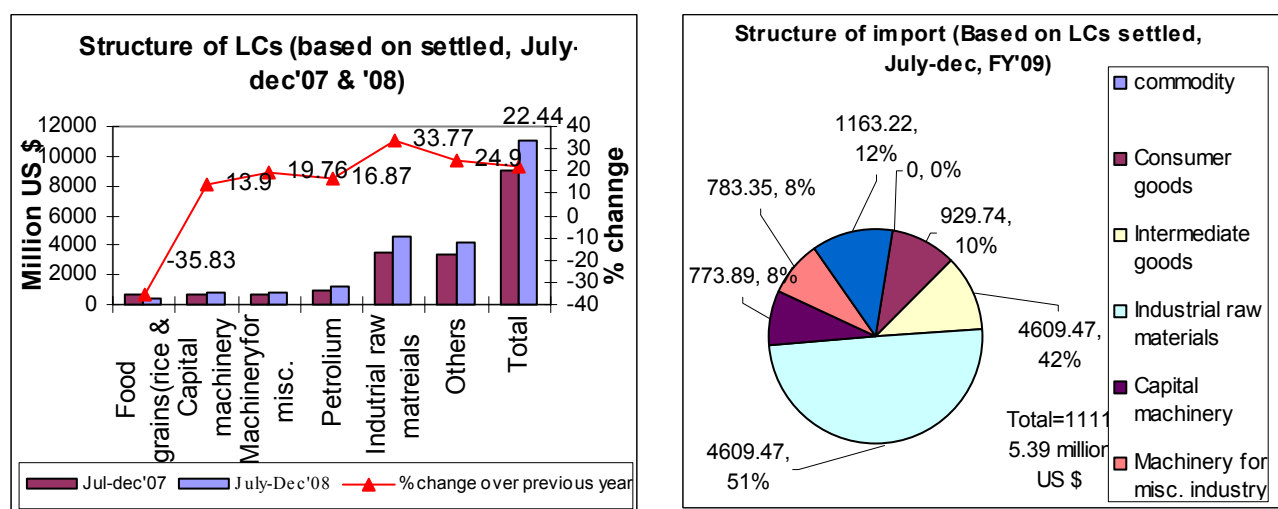
Table 4.1: Composition of imports (In million US dollar)

Items	2007	2008		percent change (4 over 2)
	July-Nov	July-Oct	July-Nov	
1	2	3	4	5
A. Food Grains	492.2	239.7	367.2	<b>-25.4</b>
Rice	252.3	158.5	187.5	-25.68
Wheat	239.9	81.2	179.7	-25.09
Edible oil	411.1	311.6	368.9	-10.27
Sugar	130	156.4	182.9	40.69
C. Consumer & Intermediate Goods	3465	4365.4	5162.9	<b>49</b>
Clinker	137.3	97.4	119.8	-12.75
Crude petroleum	219.7	403.1	403.1	<b>83.48</b>
Fertilizer	196.9	597.5	694.1	<b>252.51</b>
Dyeing and tanning materials	84.2	112	129	<b>53.21</b>
Raw cotton	425.3	460.1	563.7	<b>32.54</b>
Yarn	260.6	305.5	366.4	<b>40.6</b>
Textile and articles thereof	785.1	747.5	905.7	15.36
D. Capital Goods & Others	2740.6	2762.9	3439.7	25.51
Capital machinery	752.2	541.5	661.9	-12
Grand Total (A+B+C+D)	7999.4	8417.9	10231.1	27.9

**Table 4.2: Statement of import L/C settlement and import LCs opened & settled**

Commodity	L/C Opening and Settlement (million US\$)	July-Dec. 2007-08		July-Dec. 2008-09	
		Opening	Settlement	Opening	Settlement
Food grains (rice & wheat)	Value	1018.79	617.12	448.42	396.03
	percent change	256.47	164.48	-55.99	-35.83
Capital machinery	Value	792.83	679.43	628.87	773.89
	percent change	-3.4	-7.74	-20.68	<b>13.9</b>
Machinery for misc. industry	Value	748.63	654.09	865.11	783.35
	percent change			15.56	<b>19.76</b>
Petroleum	Value	1000.87	995.3	1163.49	1163.22
	percent change	-23.99	6.17	16.25	<b>16.87</b>
Industrial raw materials	Value	4086.31	3445.75	4587.58	4609.47
	percent change	28.13	15.33	12.27	<b>33.77</b>
Others	Value	3823.29	3340.77	4348.29	4172.78
	percent change	18.69	17.32	13.73	24.9
Total	Value	10722.09	9078.37	11176.65	11115.39
	percent change	21.37	17.25	4.24	22.44

**Figure 4.2:**



Source: Bangladesh Bank

There are other factors that can affect commodity prices. One such crucial factor is the price of crude oil. On the demand side, crude oil prices affect the price of other commodities by entering into the aggregate production function of primary commodities through the use of various energy-intensive inputs and, through transportation over long distances - an energy-demanding process. Further, some commodities compete directly with synthetic products, which are produced from crude oil (cotton with man-made fibers, natural rubber with synthetic rubber)<sup>5</sup>.

It is in the nature of commodities for their prices to show pronounced cyclical behavior. Indeed, some of the most influential early insights about the role of expectations in pricing behavior derived from observations of how the interaction between prices and quantities in agricultural markets tended to

<sup>5</sup>World Bank has shown that the crude oil price affects significantly the price of primary commodities (Global economic prospects-2008, World Bank)

generate price cycles (Kaldor 1934). It would seem that just as high demand levels for food, feed, and bio-fuels led to high world prices of commodities, the sharp fall in demand in the wake of the global recession has had a dramatic effect in the opposite direction, leading to rock bottom prices. Much of the emerging trend will depend crucially on the nature of expectations that are being formed.

The benefits of lower world prices are already being felt in Bangladesh, especially through lower inflation, including lower food and energy prices.<sup>6</sup> Another channel that can help lower the inflation rate of Bangladesh is the declining trend of inflation in major trading partners. The headline inflation rate of Bangladesh already started to decline from 10.82 percent in July'08 to 6.03 percent in December'08. The inflation rate of the major trading partners like India, China, and Hong Kong has declined significantly in recent months as well (See CEIC database & ADB website)<sup>7</sup>.

It is expected that the lower price of imports, especially of industrial raw materials, intermediate goods and capital machinery in the international market will make imports cheaper, resulting in higher volumes. The recent trends in imports of raw materials and capital goods support this observation (Tables 4.1 and 4.2). The correlation coefficient between growth of manufactures and imported raw materials is 0.15 (significant at the 5 percent level).

**Table 4.3: World commodity prices:**

	percent Change of in commodity price index			
	Dec/Nov	Dec 08/Dec 07	Jan/Dec	Jan 09/Jan '08
Commodity	-14.1	-36.4	4.1	-37
Non-Energy	-6.8	18.4	4.2	-25.5
Energy	-18.5	-42.7	4	-43
Crude	-23.2	-53.6	5.7	-51.6
Agriculture*	-4.0	na	7.7	na
Food	-2.7	-18.4	6.4	-16.8
Corn	-3.0	-40.3	9.5	-16.1
Wheat	-3.6	-23.2	8.7	-35.2
Soybean Oil	-6.5	-33.7	10.8	-34
Sugar	-4.0	-1.7	7.1	na
Industrial Metals	-10.9	-36.4	1	-41.4
Gold*	7.3	na	5.2	na
Fertilizers*	-10.9	na	-3	na

Sources: IMF; Estimations based on data provided by the IMF.

\* World Bank Index

#### IV.4 Concluding remarks

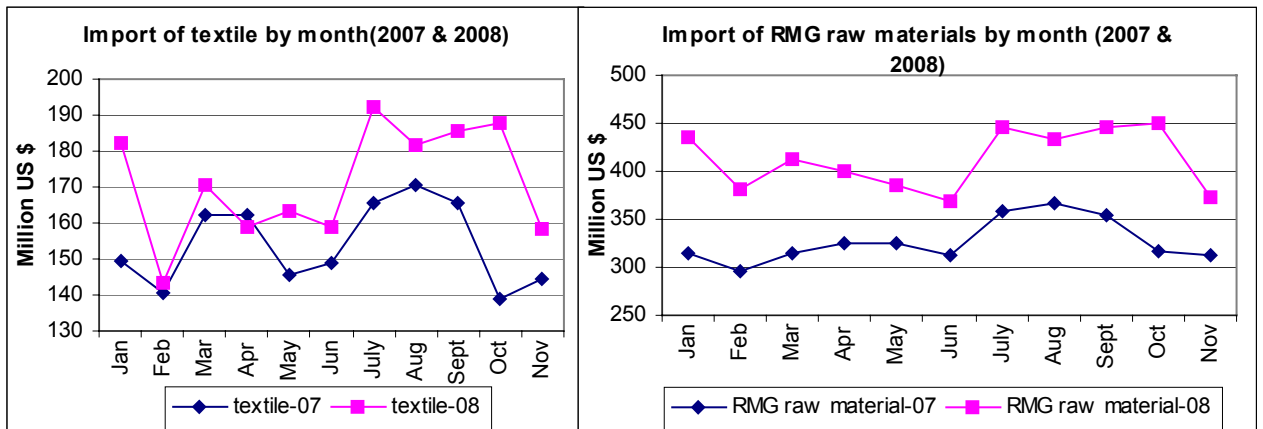
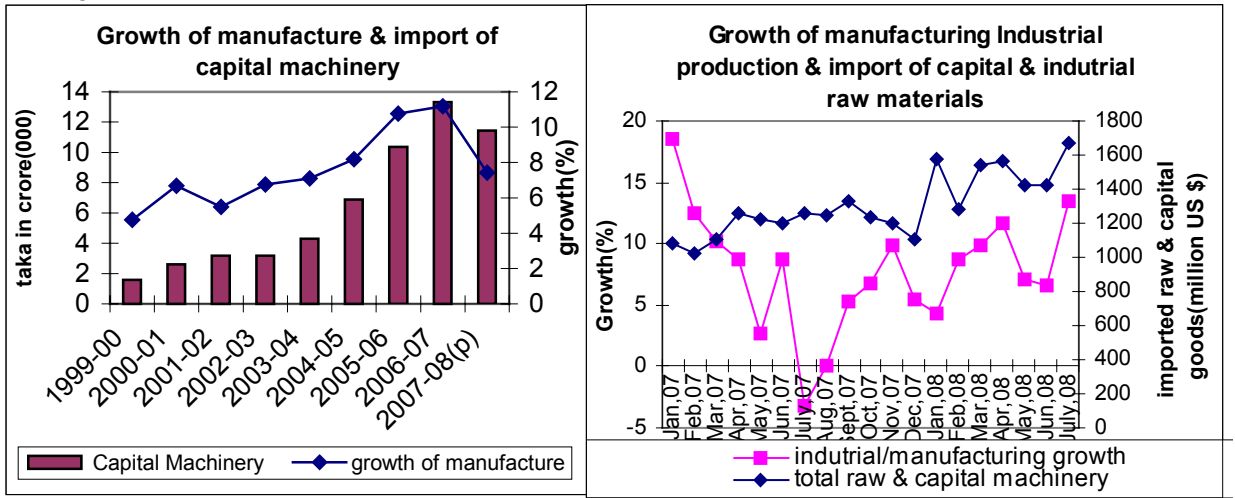
- Overall imports have increased by 31 percent in 2008 over 2007
- Total merchandise imports showed a robust 35 percent growth during July-October 2008 despite a sharp decline in imports of food grains over the corresponding period of the previous fiscal year
- Non-food imports, especially fertilizer, crude and raw materials expanded quickly
- Intermediate and capital goods imports also expanded significantly

<sup>6</sup> In the case of Bangladesh, one study finds that the change in international prices of rice and wheat affect domestic prices with minimal effect; while, a relatively significant relationship is observed between international edible oil prices and its domestic prices (M. Golam Mortaza and Habibour Rahman, 2008, Bangladesh Bank). However, other studies report a close cointegration between rice prices in Bangladesh and in India (Murshid et al).

<sup>7</sup> IMF expects world inflation to fall 2.8 percent in 2009 from 6.01 percent in 2008 with advance economies to 0.32 from 3.48 and developing economies to 5.76 from 9.17 in the same period.

- Much of the imports seem to have gone to productive, capacity enhancing sectors. This will put us in a better position to address any adverse effects of the GFC

Figure 4.3:



## V Policy Conclusion and Recommendations

### Exports

Despite fears of markets drying up, factories closing down and large-scale bankruptcies in the wake of the global recession, Bangladesh has coped well, especially in the US market. Market share in the EU however has taken a hit in the face of stiff competition from China on the back of withdrawal of quotas on the Chinese and a sharp depreciation of the Euro against the Taka.

On the positive side, the reputation of Bangladesh as a low-cost, reliable source in the RMG market has been established and a foothold has been gained in the huge Chinese market. Local firms also seem poised to break into the \$12 billion Japanese market. China and India have become increasingly expensive, especially for lower end products, prompting buyers to search out lower cost sources that are reliable and can meet their stringent quality standards. It is in this context that buyers have been looking closely at Bangladesh.

Local firms have also been engaged in chalking out a more competitive strategy: larger firms have tended to increasingly tie up directly with retailers, and have thereby reaped a huge advantage. Smaller operators find this difficult and continue to rely on buying houses, placing them at a much greater risk. The other strategy has been to diversify products where some gains have been made, as producers moved up to the higher end of the low-end spectrum. There is a long way to go in this direction as well as distinct opportunities that seem to be opening up. An example is the increasing demand for outer-wear garments like jackets and sweaters that low-cost sources like Bangladesh could target. Low import prices for capital goods, intermediate goods, and raw materials provide an excellent opportunity to rebuild inventories and stocks, expand the productive base and upgrade technology.

The primary textile industry or backward-linked industries that have grown on the back of the RMG success, adds distinct strength and competitiveness to the RMG sector, serving to reduce lead time. It also acts as a check against Indian textile prices, which in its absence, would certainly use its quasi-monopoly status to raise import prices to a much higher level. If really needed, this sector should be given assistance to remain afloat in the wake of the deepening recession.

Specific sectors have already been hit by the recession, including leather, frozen fish and jute. In the case of frozen fish, dwindling demand has been compounded by questionable phyto-sanitary standards that have hurt our reputation. Given the current market situation, it is imperative that Bangladesh competes in terms of price and quality, including bio-security considerations, if markets are to be retained.

### Remittances

There is little doubt that the recession has affected labour market prospects abroad adversely. However, a greater problem lies in the corruption and malpractices that have plagued the sector for years. The two are of course inter-related. No one wants to see the plight of labourers languishing in their airports or open spaces. There are also reports of increasing involvement in crime engaged in by migrant workers. The recession provides us with an opportunity to address urgent concerns of the sector to rid it off corruption and develop a strategy to deal with labour issues both in their home and destination countries. There is an urgent need for pre-departure orientation of workers as long as detailed briefing about rights and obligations.

As far as the immediate short run problems are concerned, remittances are unlikely to be seriously affected over 2009-10. There was an unprecedented wave of migration over 2007 and 2008 so that the full impact of that on remittances is yet to be felt. The central bank should continue to think of innovative ways to draw more remittances away from the *hundi* channel.

For the longer term, a concerted effort is required to build up a skilled labour force for export including skilled manpower in security and related services, under a strict institutional framework, perhaps somewhat along the lines of the peace keeping forces sent out under the UN.

## **Imports**

We have benefited enormously from cheap food, fuel and other crucial imports due to the recession. As recovery starts, this situation will also be slowly reversed so that we need to make the most of this situation. We should reduce import taxes and encourage a massive build up of inventories, spares, capital so that we can take full advantage of the recovery when it occurs. Given the fact that we have been barely hit by the recession, we are in a perfect position to be able to do so.

Finally, we should aggressively pursue an expansionary monetary and fiscal policy, encourage consumption of domestically produced goods, inject purchasing power in the farm sector and reduce the cost of retailing credit. An expansionary policy will lead to some inflationary pressures which however, would not pose any serious threat.

However if Bangladesh is to gain a significant competitive edge in trade, basic structural constraints have to be removed. This includes gas and electricity supplies, reduced cost of borrowing, attention to labour and environmental standards, continued improvement in port handling and related costs, and improvement in law and order. If the government wants to help industry, especially the exports industries, these are the key areas that it should mark out for massive investments. Providing one time cash hand-outs will do nothing for us in the long run.

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