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Seventh Plan Strategy for Mobilizing Foreign Resources

GED Background Paper Series

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Acronyms

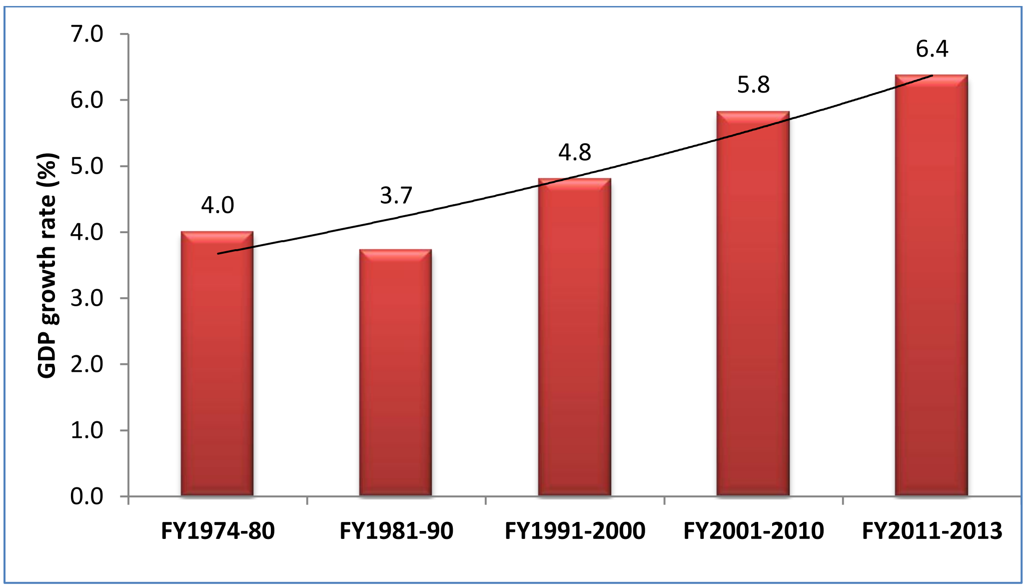
ADP	Annual Development Programme
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BOI	Board of Investment
DCD-DAC	Development Cooperation Directorate
DRS	Debtor Reporting System
DP	Development Partner
DFID	Department for International Development
ED	External Debt
ERD	External Relations Division
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GED	General Economics Division
ICOR	Incremental Capital Output Ratio
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
MoF	Ministry of Finance
NRP	Natural Resources Planners Ltd.
ODA	Official Development Assistance
PPP	Public Private Partnership
PD	Paris Declaration
RMG	Ready-Made-Garments
SFYP	Sixth Five Year Plan
SEC	Securities Commission
TX	Total Exports including Factor Income
XG&S	Exports of Goods and Non-factor Services

Seventh Plan Strategy for Mobilizing Foreign Resources

A. Overview

Since independence Bangladesh has been experiencing a steady increase in the growth rate of real GDP, accelerating from an average of less than 4% per year during 1974-1990 to 6.4% in 2010-13 (Figure 1). This is a remarkable performance, even after allowing for the low initial base. Importantly, this performance is still below true potential, which gives hope that with a stronger performance Bangladesh can expect to attain middle income status by the year 2021 as envisioned in the Government's Vision 2021 and the 20 year Perspective Plan (Government of Bangladesh, 2011a). Indeed, the ongoing Sixth Five Year Plan (Government of Bangladesh 2011b) aimed at achieving an 8% annual rate of GDP growth by 2015 and the Perspective Plan projected to further accelerate this growth to 10% by 2021.

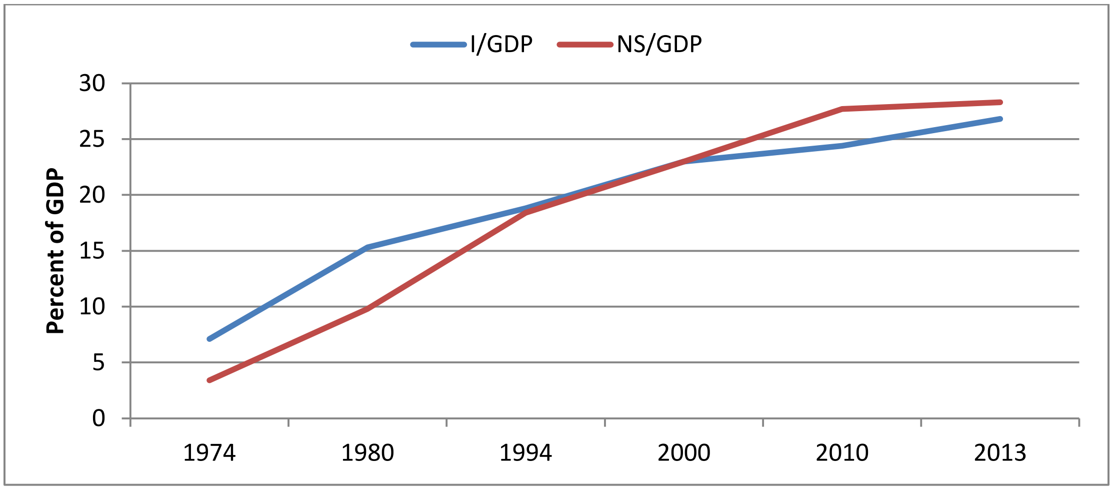
Figure 1: Average growth rate of Real GDP



Source: Bangladesh Bureau of Statistics (BBS)

Research shows that the main driver of growth has been a rapid pace of accumulation of capital (Ahmed 2014). The trend in the rate of investment as a percent of GDP is shown in Figure 2. The investment rate expanded from a low of 10% of GDP in the 1970s to 25% in 2013. This accumulation of capital has been the key driver of growth in Bangladesh so far. The accumulation of capital has allowed the expansion of production capacities in agriculture, in manufacturing, especially in the export-oriented garments sector, in infrastructure and in human development. These in turn have fueled the expansion of economic activities in Bangladesh.

Figure 2: Saving, Investment Rates (% of GDP)

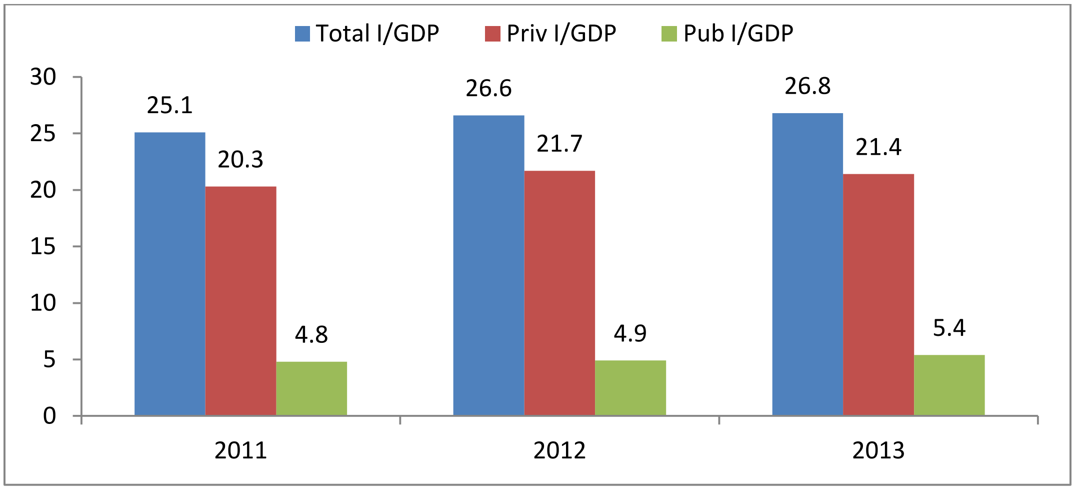


Source: Bangladesh Bureau of Statistics (BBS)

In the early years since independence (1974-1990) the expansion of investment was facilitated by foreign saving mostly in the form of official aid (Figure 2). Since the early 1990s much of the investment has been financed by national saving. This is a remarkable result and somewhat different from the experience of many developing countries that have faced a saving constraint for a fairly long time. Indeed, the expansion of national saving in recent years has exceeded the investment rate thereby contributing to current account surpluses, which is very unusual for a developing country. What this means is that there are other constraints on investment which if removed would allow a greater pace of capital accumulation.

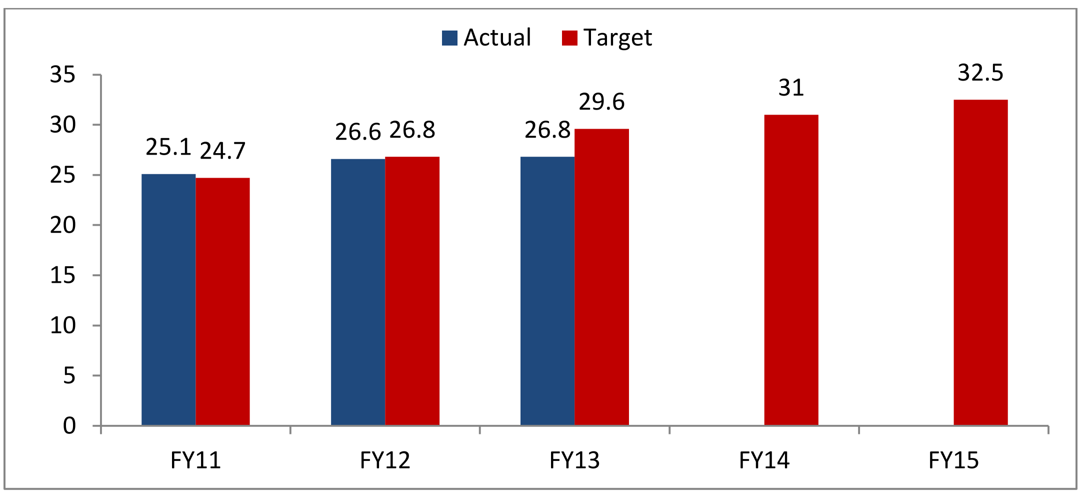
While the long term track record for the role of capital accumulation in driving growth is generally very good, the recent results are worrisome. In the past two years, the investment rate seems to have stagnated, especially the private investment effort (Figure 3). Importantly, the investment rates are much lower than what were projected in the Sixth Plan (Figure 4). It is clear that additional efforts will be necessary during the Seventh Plan to substantially increase the investment rate to the 34-36% of GDP range to achieve 8% and higher average growth rate that is envisaged in the Perspective Plan and Vision 2021. Although the favorable national saving effort is a big plus for policy making, Bangladesh will also need to explore opportunities for attracting foreign financing to meet its growing investment requirements. This will be particularly relevant to meet the massive investment requirements in the area of infrastructure (power, energy, transport). Such investments are not only large and complex they involve highly capital intensive and technology intensive projects that are best done with foreign assistance in terms of both financing and technical assistance. These investments typically are in the public sector. While the public investment effort has slowly been rising in Bangladesh (Figure 3), it is still very low (in the range of 5% of GDP). Raising this effort to the 8-10% of GDP range will require a massive public resource mobilization effort. This effort will benefit substantially from a well articulated and implemented foreign resource mobilization strategy.

Figure 3: Recent Developments in Investment



Source: BBS[1]

Figure 4: Total Investment as percent of GDP -- Actual Vs Target



Source: BBS and National Budget, Ministry of Finance (MoF)

The objective of this paper is to suggest a possible strategy for mobilizing foreign resources for financing the investment requirements of the Seventh Plan. Foreign resources can complement domestic resources for investment in both public and private sector. Accordingly, the paper will look at both foreign resource mobilization for the public sector as well as mobilization of foreign private capital. The paper is organized as follows. After this introduction in Section A, a review of the past foreign resource mobilization effort will be done in Section B. This review is important to lay down the context and lessons of experience for the future foreign resource mobilization strategy. Section C will provide the broad outlines of a strategy for public foreign

[1]The BBS data have been modified to make them consistent with balance of payments data from Bangladesh Bank and public investment data from Ministry of Finance (Ahmed 2014b).

resource mobilization, followed by the suggested approach to the mobilization of private foreign capital in Section D. Finally, some concluding remarks will be provided in Section E.

B. Past Experience with Foreign Resource Mobilization

External debt management

Bangladesh has generally pursued a very cautious approach to foreign resource mobilization. Even during the early years of independence, when reconstructions needs were large and resources were vastly limited, foreign resources were obtained either as grant or on highly concessional terms. The overall stance of macroeconomic management has been prudent that saw modest deficits in the budget and even more conservative management of the balance of payments. Strong control over the capital account restricted foreign private capital flows and much of the foreign capital account resources came in either as official grants or as medium to long-term public loans (MLT) at highly concessional terms. This cautious strategy paid off in terms of a stable balance of payments and external debt situation. This strategy also protected the Bangladesh economy from the onslaughts of global downturns and financial crises.

Table 1 shows the present status of external indebtedness in Bangladesh in comparison to other South Asian countries[2]. As is obvious, Bangladesh performs very well relative to South Asian countries in keeping a low volume of debt in absolute terms as well as in relation to its debt carrying capacity (GDP) and debt servicing capacity (exports). While long-term external debt management has been broadly sound in South Asia, Bangladesh and India are the top performers. Pakistan faced serious debt problems in the 1990s and in the first half of the decade of 2000. Consequentially it had to go through several rounds of debt restructuring including debt forgiveness. External debt management in Pakistan has improved over the past few years.

Table 1: External Debt Indicators in South Asia, 2012

Countries	Total external debt, ($ millions)	Present value of Debt ($ millions)	Ratio of total external debt to exports[3] (%)	Ratio of present value of debt to exports (%)	Ratio of total external debt to GNI (%)	Ratio of present value of debt to GNI (%)
Bangladesh[4]	27,687	16,856	100	61	22	13
India	379,099	324,340	84	71	21	18
Nepal	3,818	2,351	175	108	20	12
Pakistan	61,867	46,279	194	145	26	19
Sri Lanka	25,382	19,287	189	140	44	33

Source: World Bank, International Debt Statistics 2014

[2] Table 2 uses the latest available external debt indicators prepared by the Debtor Reporting System (DRS) of the World Bank and reported in its publication World Bank (2014).
[3] DRS Export's definition includes goods, non-factor services and primary income but exclude worker remittances.
[4] The World Bank DRS does not include private non-guaranteed long-term debt for Bangladesh. The data reported here for Bangladesh was adjusted to include this.

The structure of Bangladesh external debt is shown in Table 2. Much of the debt (90%) is long-term. The remaining 10% comprises of short-term debt (6%) and use of IMF resources (4%). Among long-term, some 94% is public debt, much of which is owed to multilateral agencies. Traditionally, Bangladesh has been very conservative in managing the capital account and restraining private borrowing. Only recently, the Bangladesh Bank has taken a somewhat flexible approach to long-term private foreign borrowing and allowed this to happen under strict supervision of the Bangladesh Bank. Hence the outstanding stock on long-term non-guaranteed private borrowing is very limited.

Table 2: Structure of Bangladesh External Debt, 2012

Debt Indicator	Stock (US$ millions)	Share in total debt (%)
Total External Debt	27,687	100.0
Long-term	24,805	90.0
Public and publicly guaranteed	23,251	83.1
(of which Multilateral)	(19,249)	(69.1)
Private non-guaranteed[5]	1554	5.6
Use of IMF credit	1,213	4.4
Short-term	1,669	6.1

Source: World Bank, International Debt Statistics (IDS) 2014 and Bangladesh Bank (BB).

The term structure of debt and its servicing cost are shown in Table 3. The average interest cost is very low and annual debt servicing burden (interest cost plus amortization) is also low. This is partly due to the rapidly growing export receipts, but also a reflection of a very conservative management of the external debt. In the early years of independence, Bangladesh got a substantial part of assistance in the form of grant. The share of grants fell considerably over the years and the share of grants in total ODA is very small now. Nevertheless, Bangladesh has mostly relied on concessional sources of funding from multilateral and bilateral sources with immensely favorable repayment framework in terms of cost, grace period and number of years for repayment.

Table 3: External Debt Service Indicators

Debt service indicator[6]	Percent
Average interest cost of debt	1.1
Interest payment/exports (Goods, non-factor services and primary income)	1.1
Amortization/exports (goods, non-factor services and primary income)	3.6
Total debt Service (interest plus amortization)	4.7

Source: World Bank, IDS 2014

[5] World Bank Debtor Reporting System (DRS) does not show any private debt stock. The private debt data is obtained from the Bangladesh Bank (BB). Total debt is adjusted to include private non-guaranteed debt

[6] Excludes private non-guaranteed debt.

Trends in External Borrowing

In the early years after independence, Bangladesh had to rely heavily on foreign assistance for financing the balance of payments and its development budget. Food and commodity aid dominated the aid profile. This changed over time as Bangladesh economy recovered, exports boomed and prudent management of the budget contained fiscal deficits. The consequence was a sharp improvement in the balance of payments (bop) and associated low dependence on foreign borrowings. The changing nature of the bop is illustrated in Table 4. The transformation of the bop on aggregate has been truly remarkable. Exports as a share of GDP soared from less than 7% of GDP in the 1970s to 20% range in the FY2006-14 period. Remittance inflows soared from 1% of GDP in the mid 1990s to 8-10% of GDP over the same period. These achievements not only allowed a growing import inflow to support the expansion of investment and GDP but also caused Bangladesh to run a substantial annual surplus in the balance of payments, which is an uncommon event for a low-income developing economy.

Table 4: Summary Balance of Payments (US$ millions)[7]

Items/Year	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14
Exports of goods & Svs.	6647	7275	6844	7443	8508	9866	11888	13781	16045	17510	18759	25697	26871	29517	33001
Imports of goods & Svs.	9459	10544	9513	10707	12075	14713	16502	19399	24116	25200	26635	36777	38940	42057	46366
Current Transfers	2394	2171	2826	3440	3743	4290	5438	6554	8743	10226	11610	12075	13699	14928	14912
(of which Remittances)	1949	1882	2848	3062	3372	3848	4802	5979	7915	9689	10987	11650	12843	14338	14114
Current Account Balance	-418	-1098	157	176	176	-557	824	936	672	2536	3734	995	1630	2388	1547
Net capital inflows	498	803	119	711	59	782	-270	657	400	-1214	-455	-833	-2178	2563	4646
(of which net MLT)	448	438	435	452	423	473	502	540	586	656	686	729	770	908	1087
(of which FDI)	383	563	391	379	284	800	743	793	768	961	913	768	995	1726	1550
Change in Reserves	80	-295	276	887	235	225	554	1593	1072	1322	3279	162	-548	4951	6193
Foreign Reserves	1602	1307	1583	2470	2705	2930	3484	5077	6149	7471	10750	10912	10364	15315	21508
Memo Items															
CAB/GDP (%)	-0.89	-2.34	0.33	0.34	0.31	-0.92	1.33	1.37	0.84	2.84	3.24	0.77	1.22	1.59	0.89
XGS/GDP (%)	14.1	15.5	14.4	14.3	15.0	16.4	19.2	20.1	20.2	19.6	16.3	20.0	20.1	19.7	19.0
MGS/GDP (%)	20.1	22.4	20.0	20.6	21.3	24.4	26.7	28.4	30.3	28.2	23.1	28.6	29.2	28.0	26.7
Remittances/GDP (%)	4.1	4.0	6.0	5.9	6.0	6.4	7.8	8.7	9.9	10.8	9.5	9.1	9.6	9.6	8.1

Source: BB

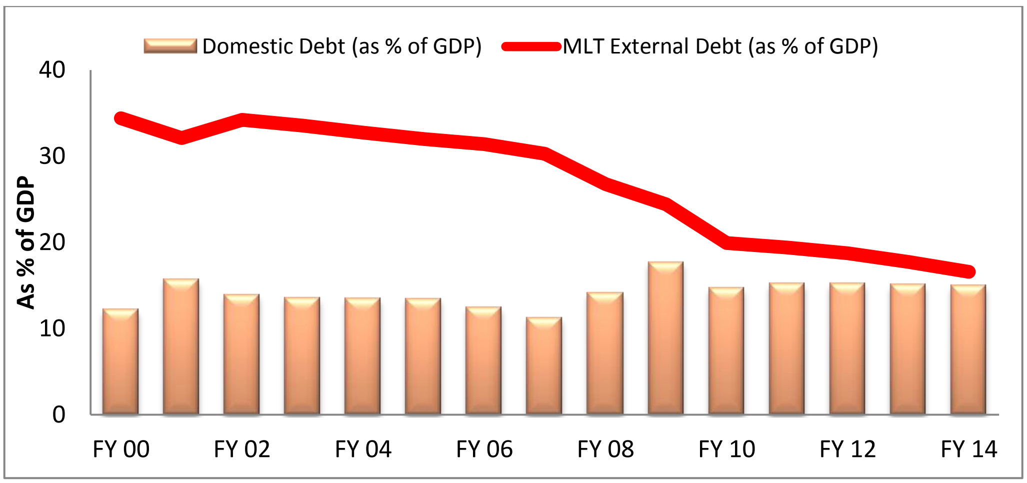
Official Development Assistance (ODA)

This highly favorable bop outturn supported the implementation of a very conservative external debt strategy. The transformation of the current account from a deficit position to a surplus position over the past 14 years implied that the government did not face any pressure to mobilize foreign resources to manage the exchange rate or the balance of payments. As a result, its policy became very cautious and selective. Thus, most of the official assistance came in as grants or

[7] Data on Net MLT is obtained from the External Relations Division (ERD) of the Ministry of Finance. Net capital inflows are derived as a residual to ensure the consistency of the balance of payments with the reserve build up. The "Errors and omissions" item reported in the bop therefore become a part of capital inflows/outflows not properly recorded due to reporting problems and various non-bank transactions.

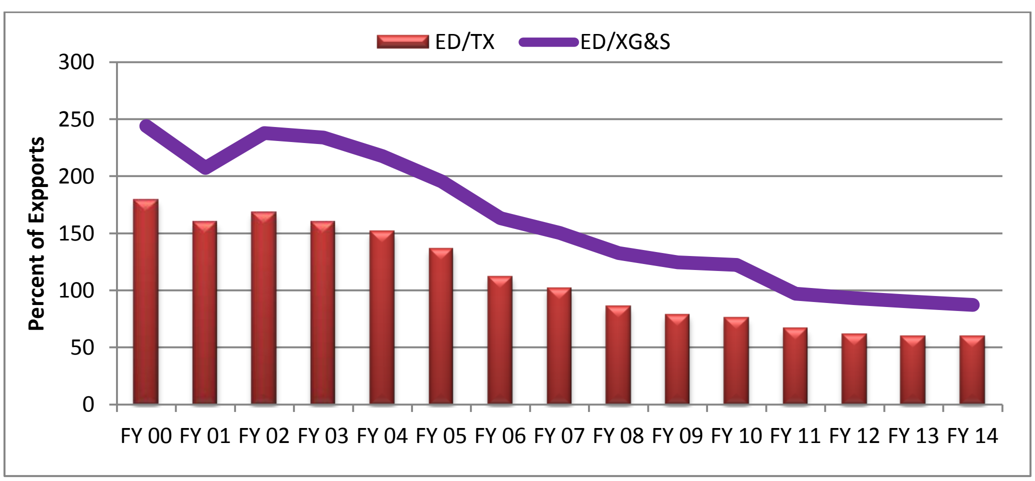
highly concessional loans, mostly from multilateral sources. The effects of this highly favorable bop situation and cautious external borrowing strategy on debt outcomes are illustrated in figures 5 and 6. Total external debt (ED) to GDP fell dramatically from 34% in FY2000 to less than 17% in FY2014. Supported by a conservative fiscal management, domestic debt to GDP was kept at a moderate level. However, there has been a moderate increase in domestic debt to GDP ratio suggesting a substitution of foreign financing with domestic financing of the budget deficit. Even so, total public debt to GDP fell from 47% of GDP in FY2000 to 32% in FY2014. Remarkably, the external debt servicing capacity expanded substantially as exports grew rapidly. This is true of both measures of debt servicing capacity: the traditional measure of debt to exports (goods and non-factor services XG&S) ratio, which fell from 244% to only 87%, and the broader measure of total export earnings (TX) that includes private transfers (especially workers' remittances), which fell from 179% to 60% over the same period.

Figure 5: Bangladesh Public Debt as a Share of GDP



Source: External Relations Division (ERD), MoF

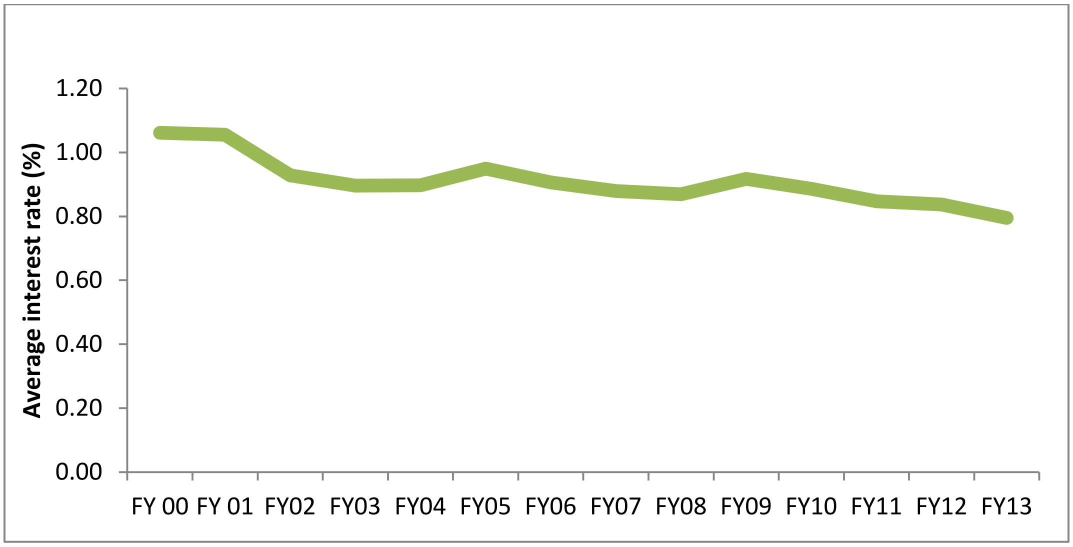
Figure 6: External Debt to Export Ratios



Source: ERD, MoF

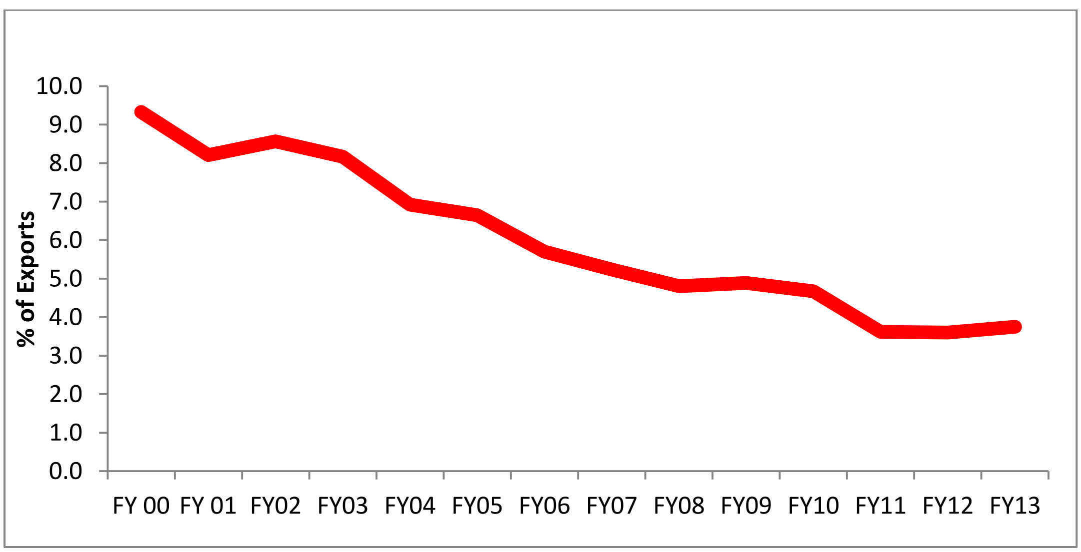
Commensurate with these favorable bop outcomes and cautious external borrowing characterized by reliance on concessional assistance, total debt service on foreign debt has been low and declining. The average interest rate on external debt has basically remained flat at around 1% rate with a slight downward trend (Figure 7), while debt service cost (total debt service as a share of exports of goods and services) has fallen from 9 % in FY 2000 to less than 5% in FY 2013 (Figure 8).

Figure 7: Average Interest Rate of Public MLT Debt



Source: ERD, MoF

Figure 8: Total External Debt Service (% of Exports)



Source: ERD, MoF and BB

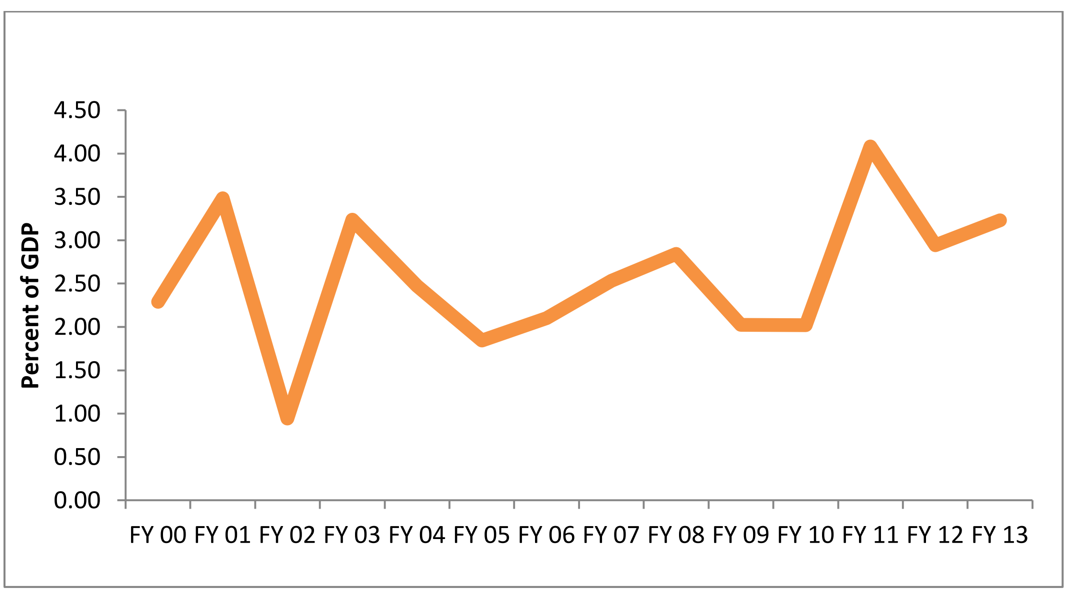
Composition of Official Development Assistance (ODA)

An important change in the pattern of aid inflows in Bangladesh is the virtual elimination of food and commodity aid. During the first 10 years after independence, food and commodity aid accounted for 53-90% of total ODA. Commensurate with this nature of ODA, bilateral assistance accounted for 68-89% of total ODA. Over the years these patterns changed. As Bangladesh developed its agriculture with strong emphasis on food production, the share of food aid declined rapidly and by FY2000 it became negligent. Similarly, the recovery of the economy and progress with industrialization saw the death of commodity aid and it vanished in FY2006. Almost all ODA is now project assistance mostly to finance investment (over 98% in FY2013). In line with this changing pattern of aid composition, the share of multilateral sources of ODA has increased to 63% while ODA assistance from bilateral sources declined to 37% over the same period.

ODA commitments, disbursement and pipeline

In spite of its status as a member of the least developed country group, Bangladesh's reliance on official development assistance (ODA) has declined very significantly since independence. The country was heavily dependent on aid during the first two decades of independence. Even during 1980-90 new net commitment of ODA was around 8% of GDP. Since then, ODA as a share of GDP has declined rapidly, falling to a low of 2% of GDP in FY09 (Figure 9). It is important to note though that although the reliance on ODA has fallen progressively, ODA continues to be the main source of funding for public investment. Therefore with a recovery of public investment during FY10-FY14, there has been a turn-around in net ODA commitments during the Sixth Plan period, with net commitments recovering to the 3-4% of GDP.

Figure 9: Net New Commitments as percent of GDP

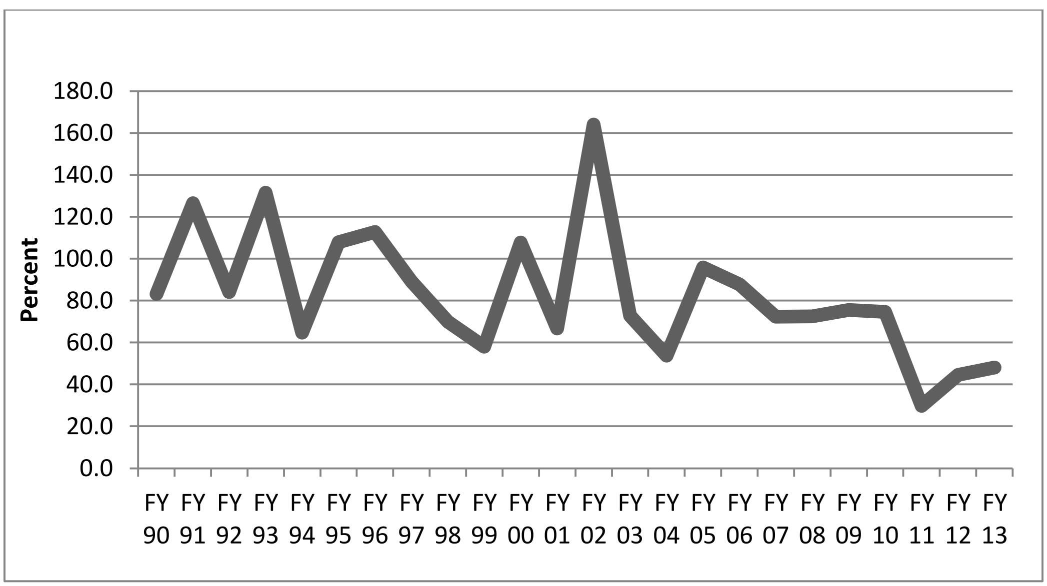


Source: ERD, MoF

A major issue in ODA management is the consistently wide gap between disbursements and commitments. This was less of a problem in the 1990s but has become a serious challenge over the past 10 years (Figure 10). Owing to the persistently large gap in commitments and disbursements, the stock of unused ODA (the aide pipeline) has grown persistently, reaching a whopping $ 15.4 billion at the beginning of July 2012 (10.3% of GDP). This is a huge challenge for Bangladesh. At a time when there are major investment needs and the growth of GDP is constrained by investment, especially in infrastructure and human development, it is most unfortunate that such a huge ODA pipeline is sitting there unused.

The explanations for the observed mismatch are to be found in the discussion on aid effectiveness that has now taken centre stage. According to an independent Evaluation Group Survey carried out in mid 2008, Development Partners are critical of the way in which aid is spent in Bangladesh and consider governance and weak quality of country systems, especially procurement, as main impediments to realizing development potential[8]. Weaknesses also emanate from the development partner (DP) side. Delays caused by DP's difficult forms, procedures and paperwork and enforcement of the donor agenda also contribute to lower disbursement of ODA than planned.

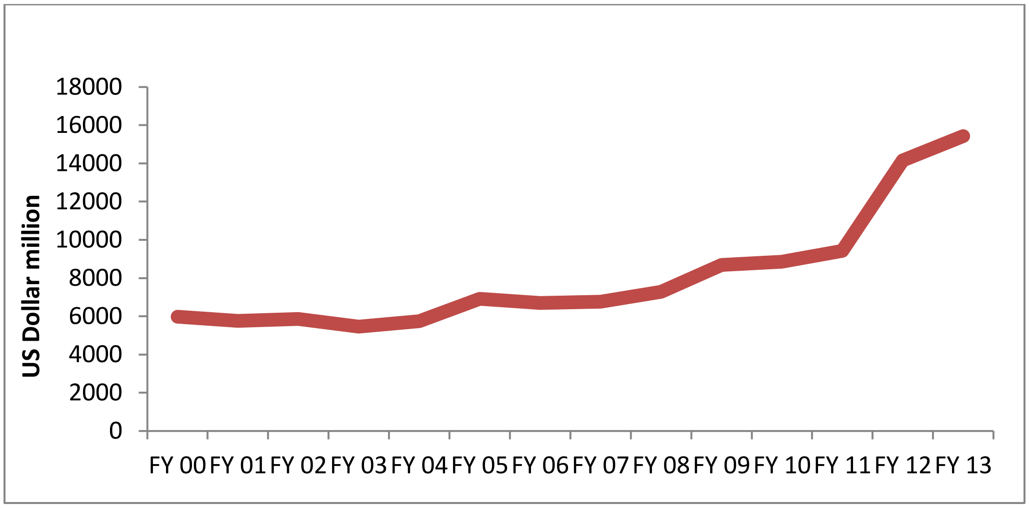
Figure 10: Disbursement to Commitment Ratio (%)



Source: ERD, MoF

[8] Development Partners (ADB, DFID, JICA, World Bank) (2009)

Figure 11: Undisbursed ODA Pipeline ($ ml)



Source: ERD, MoF

One added complication is that the value and effectiveness of foreign assistance is frequently undermined by a high degree of aid fragmentation. The ODA environment is becoming ever more complex due to the growing importance and role of non-DAC emerging DPs. These present challenges to harmonizing and aligning aid, increasing transaction costs for both DPs and recipients and creating duplication in delivery that is wasteful. Increasing fragmentation in sectors could also lead to rising competition between DPs that could lead to greater focus on results of own projects rather than on broader national priorities, posing coordination challenges[9].

Progress with ODA Coordination

Bangladesh is aware of the challenges it faces and is attempting to come to grips with the issues. Bangladesh has participated in all initiatives of the Development Cooperation Directorate (DCD-DAC) to enhance aid effectiveness including the Paris Declaration of Aid Effectiveness (2005), the Accra Agenda for Action (2008) and the Busan Partnership (2011)[10]. The Paris Declaration (PD) stipulates that new partnership relationships and ways of working between developed countries and partner countries are essential if development results are to be assured, aid well spent and aid volumes maintained. Since then the Government has taken significant steps to promote all the Paris Principles – ownership, alignment, harmonization, managing for results and mutual accountability. The 2011 independent evaluation of the PD assessed Bangladesh's

[9] Nadoll, J. and N. Hussain (2008).

[10] The DAC initiative is an effort by Development Partners to increase the effectiveness of its foreign aid. It currently has 29 members. Candidate countries are assessed in terms of the following criteria: the existence of appropriate strategies, policies and institutional frameworks that ensure capacity to deliver a development co-operation programme; an accepted measure of effort; and the existence of a system of performance monitoring and evaluation.

progress against these 5 principles of the PD and the evaluation report [11] noted improvements in the above five areas.

A particularly notable action is the establishment of Joint Cooperation Strategy (JCS) in 2010 that serves as a formal mechanism of partnership with DPs working in Bangladesh. The primary aim of the JCS is to help implement international commitments on aid effectiveness. The Local Consultative Group (LCG), which is anchored on the JCS, is the main coordination platform between DPs and Bangladesh. To strengthen aid coordination and effectiveness, LCG now includes 18 working groups focused on a specific development priority. These working groups are trying to establish a better link between ODA and results.

Nevertheless, the growing ODA undisbursed pipeline suggests that there is substantial room for improvement. The External Relations Division (ERD) has identified the following challenges: (1) continued proliferation of stand-alone projects and aid fragmentation; (2) inadequate aid coordination at the sectoral level; (3) weak progress with harmonization of policies and procedures and low use of country systems; (4) low aid predictability despite progress; and (5) weak coordination between government agencies. A particularly big challenge is the procurement problem that continues to constrain proper aid utilization.

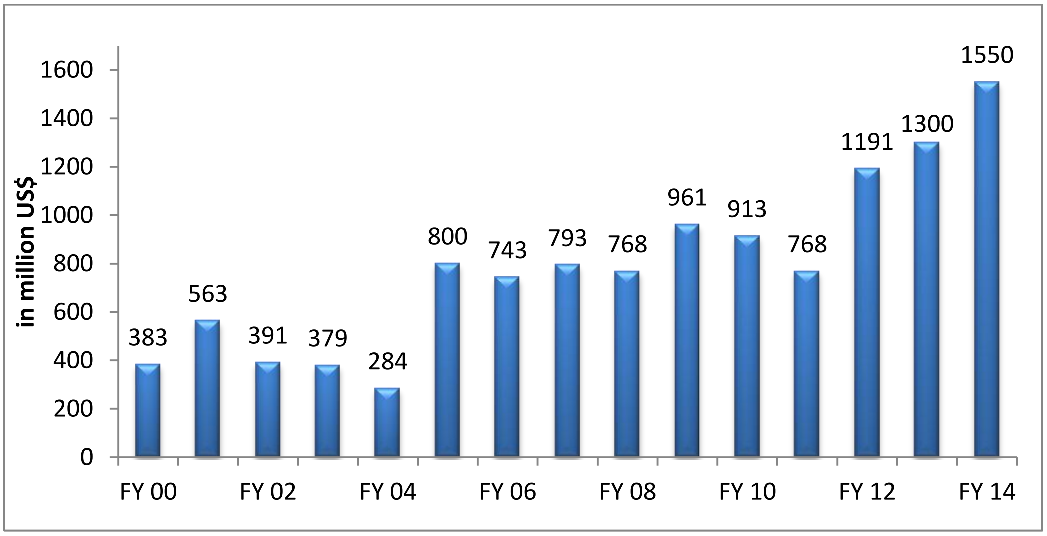
Private Capital Flows

As a part of the cautious foreign borrowing policy and the absence of bop pressure led Bangladesh to pursue a very restrained attitude to private capital flows. Although, foreign direct investment (FDI) was encouraged, private foreign borrowing was not until very recently. Despite the positive attitude towards FDI, these inflows have been very limited in relation to the global supply and even in comparison to many other developing countries. Private foreign borrowing has been restricted by a spate of foreign currency regulations, which have been partially modified in the recent years by the BB in view of growing demand and a comfortable reserve situation.

Foreign direct investment: The inflow of FDI has historically been low in Bangladesh. Data from the BB show that the inflow of FDI increased very slowly over the years and remained below US$1.0 billion well until FY2011, suggesting that foreign investors did not find Bangladesh as an attractive destination for their investments (Figure 5). There were somewhat higher inflows in FY12, approaching the $1.0 billion mark for the first time in the history of Bangladesh. Regarding portfolio flows, these are even more limited and of very recent origin. It amounted to only $368 million in FY2013; however, here was a sharp increase in portfolio inflows in FY2014, reaching $ 825 million.

[11] Danish Institute for International Studies (2011)

Figure 12: Flow of FDI ($ millions)



***Source: BB*.**

The meager amount of private equity capital flows in Bangladesh relative to other countries is indicated in Table 5. For the developing countries as whole, total equity inflows amounted to $710 billion in 2012, of which some $612 billion was FDI. As compared to this Bangladesh received a mere $1.6 billion, of which $1.2 billion was FDI inflow. China was by far the largest recipient of private equity inflows, especially FDI that amounted to an amazing $255 billion in 2012. In South Asia, India has the best performance at $47 billion ($24 billion equity and $ 23 billion in portfolio investment). These figures are an obvious indicator of a huge challenge ahead for Bangladesh, especially in the matter of attracting FDI.

Table 5: Foreign Private Equity Flows, 2012 ($ billions)

Region/Countries	**DFI**	**Portfolio**	**Total Equity**
Developing Economies	612.2	97.6	709.8
China	254.5	29.9	284.8
India	24.0	22.8	46.8
Vietnam	8.4	1.9	10.3
Bangladesh	1.2	0.4	1.6

***Source: World Bank IDS 2014*.**

Public-private partnership in infrastructure: It was expected that FDI will receive an impetus from the launching of the government's much-heralded public private partnership (PPP) strategy for financing infrastructure. The Sixth Plan expected that the share of PPP financing in total investment will grow from the 0.5% of GDP level in FY10 to 2.5% of GDP by the end of the plan period (FY2015). In practice, there has been hardly much dent in implementing this initiative.

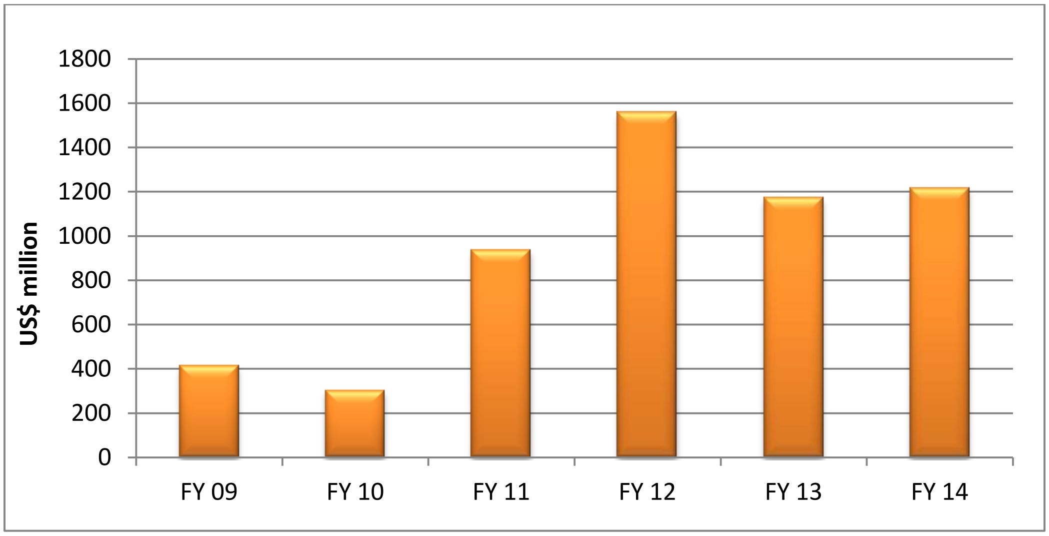
More specifically, although, the Government allocated funds in FY2010 - FY2012 budgets and established a PPP cell in the Prime Minister's Office in 2010 to operationalize the PPP initiative, little progress has been achieved so far in terms of actual results due to several implementation challenges. These include pricing and financing aspects, regulatory and legal frameworks, competitiveness in the bidding process and a careful match between assets, liabilities and cash flow. Additionally, lack of leadership and technical staff has constrained progress. The government review of the financial and economic viability of PPP projects is crucial because success depends largely on costing and pricing issues, as well as generation of the revenue stream. The legal framework must lay down obligations of the government to private sector partners, keep provisions for cost recovery and address issues of compensation and redress mechanisms. Imminent actions are required to establish a comprehensive policy and regulatory framework to ensure competitive and transparent bidding, sharing of risks and rewards and dispute settlement mechanisms.

The inability to attract much larger FDI and the lack of progress with the PPP strategy are missed opportunities that need to be corrected quickly to support higher growth, investment and exports.

Private foreign borrowing: As noted earlier, Bangladesh traditionally has taken a restrained attitude towards private foreign borrowings. This is partly the fear of instability in the bop, reinforced by the adverse experience of the East Asian Financial Crisis of 1998. A spate of foreign exchange controls administered by the BB has restricted foreign borrowings for most of the years since independence. More recently buoyed by the sharp improvement in the balance of payments and buoyed by rapid reserve build-up the BB has selectively lowered the restrictions on foreign borrowing. The favorable global environment of foreign private capital flows in terms of both availability and low interest cost has led to a growing demand in Bangladesh for this facility. In particular, the interest cost differential in favor of foreign borrowing (after allowing for currency depreciation risk premium) has created a strong incentive for foreign borrowing to finance investment. The BB, nevertheless, screens all requests for private foreign borrowing and has a strict approval process that involves a combination of interest cost and other prudential norms.

The trend of approved foreign borrowing is very encouraging (Figure 13). While terms vary by borrower and by the source of the loan, they normally involve 3-5 year maturity and 5-6% interest rate. Because of the relatively short maturity and low annual disbursement, the stock of these unguaranteed private borrowing is small ($2150 million as of December 2013).

Figure 13: Foreign Private Borrowing Approvals



Source: BB

Floating of Bangladesh Bond: Buoyed by relatively favorable rating by international credit rating agencies (Standard and Poor's and Moody's), Bangladesh is preparing to float a sovereign bond to the initial tune of $500 million. This is consistent with the Sixth Plan strategy to diversify the sources of foreign resources within the framework of a prudent debt management. The borrowing environment for Bangladesh is relatively comfortable and competitive with countries like Sri Lanka and Pakistan that already have a market presence. However, the actual outturn once Bangladesh goes to the market will provide more insights on the prospects of this source of external financing. So the implementation remains incomplete.

C. The External Resource Mobilization Strategy for the Seventh Plan

Lessons of past experience

The review of past experience with managing external resources suggests a number of important lessons that will be helpful in guiding the strategy for the Seventh Plan. Some of the lessons are sources of strength that can be preserved and built upon. In other areas there are missed opportunities that need to be evaluated and taken advantage of during the Seventh Plan period.

Areas of strength:

On the positive side, the most important lesson is the role of prudent management of foreign resource mobilization, especially external borrowings. The ability to reduce the dependence on external financing by raising the national saving effort in line with investment requirements has been a hallmark of Bangladesh macroeconomic management that has served the country well.

An additional strength has been the use of mostly concessional sources of ODA. Together these two aspects have helped support a strong balance of payments outcome and avoid any kind of external pressure on economic management. This is a strength that is not usually achieved by many developing countries.

A third strength is the rapid expansion of exports. As a result, the external debt servicing capacity has improved tremendously that provides a substantial flexibility to the management of foreign resource mobilization that is not usually available to most developing countries.

Areas for development:

Notwithstanding the progress made in increasing per capita income and reducing poverty, Bangladesh still is a low-income economy with a substantial poverty challenge. The growth performance of Bangladesh during the Sixth Plan (around 6% per year), while solid by international standards, falls short of the potential and substantially below the 8-10% growth rate envisaged under Vision 2021 and the Perspective Plan. Ability to increase the average GDP growth rate from 6 percent to 8 percent per year will require a major effort to increase both public and private investment. The financing of this investment will largely come from domestic resources; yet foreign financing will need to play a complementary role. This strategic view was clearly recognized in the Sixth Plan and the underlying resource mobilization strategy was built around this. Four years of implementation record show that there have been shortfalls in both domestic and foreign financing front that has constrained the ability to increase domestic investment. In particular, shortfalls in mobilizing foreign financing including limited progress with the public-private-partnership (ppp) strategy has constrained the implementation of the government's ambitious infrastructure upgrading strategy. Shortage of infrastructure services in power and transport continue to hamper the ability to increase the growth rate to 7% and above. Policy actions need to be taken immediately to reverse this pattern and increase the domestic and foreign financing of investment.

On the foreign financing front, the Sixth Plan adopted a sound external resource strategy that sought to diversify the sources of financing with a more healthy mix of ODA and private sources of finance, but it has met with serious implementation shortfalls. Efforts now need to focus on addressing those implementation constraints during the Seventh Plan. The three main areas where policy efforts should be concentrated are: the need to jump-start the stalled ppp strategy; considerably strengthen the effort to mobilize FDI; and allow private enterprises greater flexibility to take advantage of favorable sources of external financing for expanding business. Some of these are missed opportunities, especially FDI. The availability of FDI resources is substantial and Bangladesh is virtually absent from this market (as shown in Table 5, it accounts for a mere 0.2% of total FDI flows to developing economies).

The rapid build-up of the ODA pipeline suggests a serious constraint on aid utilization that must be addressed firmly and progress needs to be sustained. This is particularly a problem because the future availability of such highly concessional sources of investment funding is seriously constrained while at the same time the investment needs of Bangladesh are tremendous.

The proposed strategy

The main elements of the external financing strategy for the Seventh Plan involve the following basic pillars: (a) Continue the prudent management of foreign resource mobilization by increasing national saving; (b) Continue to strengthen debt servicing capacity by expanding and diversifying exports; (c) Make the best use of existing ODA pipeline; (d) In view of the growing shortage of ODA funding, diversify the sources of financing with a gradually increasing funding from private creditors; (e) Strengthen the focus on FDI; (f) Strengthen the PPP strategy; (g) Develop and launch the Bangladesh Sovereign Bond; and (h) Increase the flexibility for credit-worthy private enterprises to use high-quality foreign financing to support private investment.

a) Continue the prudent management of foreign resource mobilization: The experience of the dynamic East Asian economies suggest that the capital intensity of production tends to increase as the economy transits from low income towards middle income (Ahmed 2014). It is likely that Bangladesh will face a similar path of increasing capital intensity during the Seventh Plan. The capital input requirements per unit of GDP growth will therefore likely increase. During the Sixth Plan, the average annual investment requirements of GDP growth were estimated by using an incremental capital output ratio (ICOR) of 4. The ICOR will likely grow in the Seventh Plan to reflect the increasing capital intensity of growth. For illustrative purposes, an ICOR of 4.5 is assumed. The investment requirements for the Seventh Plan using target growth rates are illustrated in Table 6.

Table 6: Indicative Investment Requirements for the Seventh Plan

Items	Est. av. GDP growth Sixth Plan: 6.0% p.a.	Average GDP Growth : 7% p.a.	Average GDP Growth : 8% p.a.	Average GDP Growth : 9% p.a.
Average ICOR	4.2	4.5	4.5	4.5
Investment Requirements (% of GDP	25	31.5	36.0	40.5
National Savings (% of GDP)	26	30	34	38
Foreign Savings (% of GDP)	(-) 1	1.5	2.0	2.5

The investment challenge is obvious. Going from 6% average GDP growth to 8% average GDP growth will require investment rate to increase from 25% of GDP presently to 34% of GDP, which entails a 9 percentage point increase in the investment rate. Going further to 9% of growth rate will require the investment rate to climb up to 40% of GDP. Associated with this is the saving challenge. The suggested external resource mobilization strategy assumes that Bangladesh will continue to prudently manage the bop and external financing. As indicated in Table 6, it assumes a modest scope for expanding the current account deficit (foreign savings).

These deficits are in turn fully consistent with debt sustainability. Based on this assumption, the average projected national saving effort needs to increase from 26% of GDP presently to 34% to achieve 8% average growth and to 38% to achieve 9% average GDP growth.

While Bangladesh has demonstrated a strong capacity to mobilize national saving, the financing requirements of moving to 7% average GDP growth and beyond are substantial and will present a strong challenge. In addition to continued prudent macroeconomic management involving low inflation and low fiscal deficits, efforts to mobilize remittances will be important. Stable political environment and confidence in the national economy will also be important factors to keep resources in Bangladesh and avoid capital flights. Sound investment climate will create incentives for corporate savings and reinvestment. Efforts will also be needed to boost public savings. These will include strengthening tax effort, improving the performance of public enterprises and containing energy subsidies.

b) **Strengthening debt-servicing capacity:** As noted, this has been an area of strength. For the Seventh Plan the main challenge will be to build on this and sustain the effort. While the growth rate of exports (12% per year in US dollars during 2000-14) has been substantial, much of this has come from one product group: ready-made-garments (RMG). In fact, contrary to the Sixth Plan objective for broadening the export base, the share of RMG in commodity exports has further grown (from 75% in FY10 to 80% in FY14). For the Seventh Plan an important challenge will be to diversify the export base. There are several promising opportunities for expanding exports beyond RMG, including processed food, leather products, pharmaceuticals and IT based services.

c) Make the best use of aid pipeline: As illustrated in Figure 11, some $15 billion of unused ODA is available for use by Bangladesh. This stock of committed but undisbursed ODA involves highly concessional terms (long gestation and low interest cost, estimated at about 1% on average). This is a huge opportunity for Bangladesh to accelerate the use of these resources. A strategic review of the main constraints can be used to inform the main policy needs for unlocking a more rapid use of these resources to serve the investment and development needs of Bangladesh. From past experience, government procurement and implementation capacities are likely to be critical issues that require quick resolution. The Annual Development Programs (ADP) should also need to be made consistent with the availability of the ODA pipeline. Where the constraint involves Development Partner policies, the government should engage in an open and constructive dialogue to resolve them. Finally, donor-funded older projects that no longer serve the development needs of Bangladesh could be restructured and the saved resources recycled to serve the current investment priorities.

d) Diversifying the sources of foreign financing: The global environment for foreign resource availability for developing countries has been changing dramatically over the past several years. The supply of concessional ODA is sharply declining owing mainly to tight budgetary constraints of the donor countries but also a growing suspicion among the citizens of these countries that these resources may not be serving genuine development needs. Given this changing global pattern of supply of external financing, it is important for Bangladesh to prepare ahead and gradually adjust the sources of financing to avoid any disrupting situation and maintain its flexibility.

The changing pattern of supply of foreign financing for developing countries is indicated in Table 7. The total supply of long-term foreign resources to developing countries amounted to $1019 billion, of which 30% was debt and 70% equity. Importantly a mere 3% was made available as ODA loans. The remaining 97% was provided by the private suppliers (27% debt and 70% equity). This situation is in sharp contrast to the foreign resource inflow profile of Bangladesh, where some 42% of net capital inflows in 2012 came from ODA.

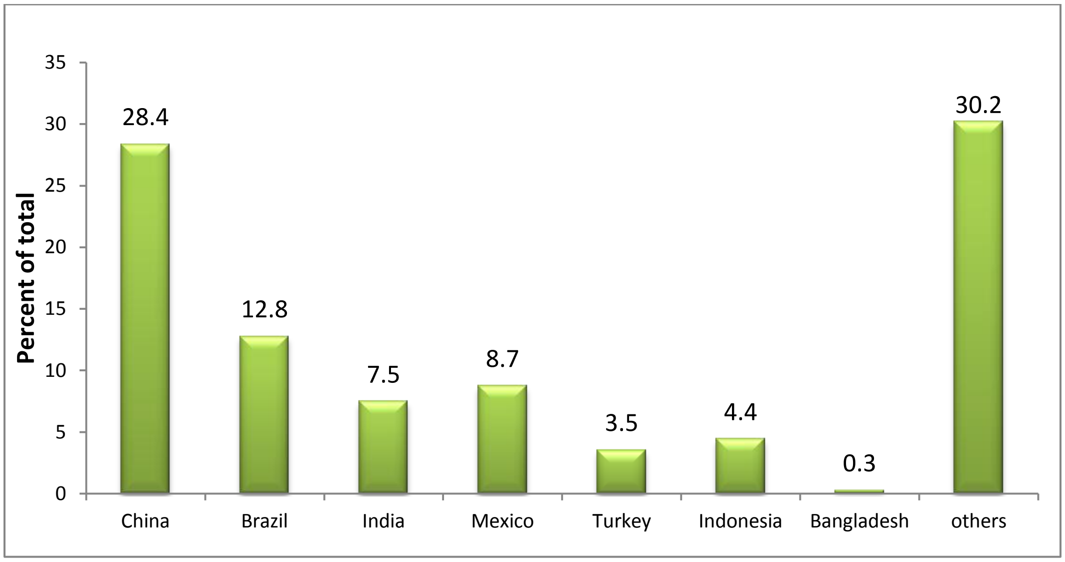
Table 7: Sources of Long-Term Net Capital Inflows to Developing Countries, 2012

Sources of Supply	**Amount ($ billions)**	**Percent share**
Total Long Term Capital Inflows	1019	100.0
Of which: Debt	309	(30.0)
Equity	710	(70.0)
Official ODA	28	(3.0)
Private Sources of Debt and Equity Supply	991	(97)

Source: World Bank IDS 2014

Quite apart from the issue of diversifying the sources of foreign resource supply, a major policy question is the amount of foreign resources flowing into Bangladesh in comparison to total supply in developing countries. This is illustrated in Figure 14. The four countries of China, Brazil, India and Mexico alone accounted for some 58% of total net capital inflows to developing countries in 2012. China is the largest user of foreign resources available to developing countries, accounting for 28% of total resources in 2012, followed by Brazil (13%), Mexico (9%) and India (8%). Bangladesh is barely present in this global financial market accounting for a mere 0.3% of total supply of foreign financing to developing countries. Clearly, there is a substantial challenge for Bangladesh both to attract more foreign capital as well as to diversify the sources of capital, especially to attract equity capital.

Figure 14: Share of Developing Country Foreign Capital Flows (%)



Source: World Bank IDS 2014

e) Renewed efforts to mobilize FDI: The biggest potential is to mobilize much more FDI. The size of the FDI global market is large and the examples of China, India and Vietnam show that a hospitable investment climate can make Bangladesh a major destination of FDI. The constraints to the investment climate have been well researched and well known and include such issues as power supply, transport bottlenecks, land procurement, corporate taxes and simplification of business procedures. A serious and concerted effort to address these long-standing issues is now essential. The absence of even- handed and non-discretionary implementation of FDI policies are also of concern and these must be ensured. Furthermore, the foreign exchange regulatory regime needs further simplification to allow smooth international financial transactions for the private investors.

f) Strengthen the PPP strategy: A major instrument for attracting private foreign capital, both debt and equity, is through an effective PPP strategy. If done well, this can be a major win-win in terms of attracting foreign investment for financing essential infrastructure. There is a strong interest in the international market for financing infrastructure and several countries including Brazil, China, India and Indonesia have successfully used this instrument. Bangladesh has a long way to go. So, there is an urgent need to jump start the stalled ppp strategy through a more thoughtful and realistic approach that involves the participation of internationally competent staff with a proven track record for managing ppp program implementation. Most countries engaged in a broad-based PPP program have felt the need to develop a cross sectoral pool of expertise in a dedicated PPP unit to supplement capacities in the line agencies that contract for PPPs. These fulfill different roles depending on the needs of the situation. In some cases their role is limited to disseminating information on PPPs and providing broad guidance on good practices. In others they have an active role in helping line agencies and ministries successfully contract for PPPs, and in yet others they play a role in approving PPPs developed by other government agencies. In the case of Bangladesh, the reconstitution of the PPP cell as an autonomous body would allow it to attract a cross sectoral pool of expertise to supplement capacities in the line agencies that contract for PPPs. These experts could also play a substantive role in developing PPP projects and attracting foreign financing.

(g) Develop and launch the Bangladesh Sovereign Bond: Following the global financial crisis of 2008-09, there has been a substantial change in the flow of foreign resources to developing countries. In this context, one important change is the expansion of bond financing by private investors in emerging economies. Faced with very low yields on US treasury bonds and the high risk in Europe owing to the European Debt Crisis, private investors have turned their interest to emerging economies of the developing world. Based on the substantially stronger economic performance in these economies, reflected in rapid GDP growth as well as stable macroeconomic environment including low debt/GDP ratios, investors have found the much better yields on local as well as foreign bonds floated by these economies as highly attractive. The additional risks of these economies compared with USA and other advanced economies have been more than offset by the better yields offered by their bonds. Accordingly, there has been a substantial increase in bond financing in developing economies from foreign private creditors (Table 8).

Table 8: Private Supply of Debt 2012 (US$ billions)

Type of Private Creditors	2009	2010	2011	2012
Total Long-Term Private Creditors	66	145	245	281
---Bonds	16	115	121	179
---Banks and Others	50	30	124	102

Source: World Bank IDS 2014

The demand for bond financing emerges from both the government (also known as sovereign bond) and private issuers. Sovereign bonds generally tend to be more attractive to foreign investors because of lower risk of default and also they tend to be more liquid (secondary market trade). Moreover, they are helpful to provide a reference point for private bond issuers. With improving macroeconomic performance in Bangladesh, especially on the external front, the sovereign credit rating has been favorable. This has motivated the government to prepare to launch a sovereign bond. Even though this has been on the cards for a while and there are indications from potential market makers that such a launch will be favorably received in the global market, the actual launching has not yet happened. The government may want to complete this launch in the near future. Although there is no urgency from a bop point of view, it is always useful to enter the market from a position of strength as presently. The initial float may be of a limited amount (around US$ 500 million or so) with 5-10 year duration. Given the current global market considerations the offer rate could be in the 4.5 -5.5% range for the 5-10 year maturity. The initial float will provide an important signal of the foreign investor perception of Bangladesh economy. Furthermore, this will set up a reference point for Bangladeshi corporate sector for possible venture in the global bond market.

j) Private Non-Guaranteed Borrowing: The cautious approach to managing the capital account of the bop and specifically control over foreign borrowing of the private sector has been broadly appropriate during the formative years of economic development of Bangladesh. This has helped Bangladesh avoid bop difficulties and insulated the economy from international financial shocks. Over the years as Bangladesh has strengthened its macroeconomy and substantially improved foreign reserves and exports, it is appropriate the BB has taken a more relaxed attitude towards foreign private borrowing as means for financing investments in worthwhile enterprises. BB needs to balance prudential considerations with flexibility in allowing creditworthy private enterprises to take advantage of the presently favorable foreign financing environment. This can be very important for promoting investments and exports. In today's globally integrated world, the access to internationally attractive sources of financing can provide a significant competitive edge, contributing to higher investment, exports and GDP growth. BB should engage in proper dialogue with investors and improve the implementation of this liberalization policy based on this dialogue.

Implementation Arrangements

The implementation of the above strategy requires strengthening the existing institutions and coordination arrangements. The Finance Ministry has overall responsibility for managing the public debt strategy for both domestic and external debt. This is appropriate. Yet, in view of the strong link of public debt for both monetary policy and the balance of payments, a strong and continuous coordination with the Bangladesh Bank is critical.

Presently, the External Relations Division of the MoF is responsible for managing official foreign borrowings. This works well because all ODA is coordinated here. However, the management of private sources of financing, both debt and equity, is somewhat fragmented. The BB manages the private debt component and does a competent job. But equity inflows require inputs from three agencies: FDI is managed by the Board of Investment (BOI); portfolio inflows require involvement of the Securities Commission (SEC) and since both involve foreign currency transactions clearances are needed form BB. The process can become complicated and increase transaction costs. Efforts are needed to simplify procedures and lower transaction costs. The BOI and the SEC also need to be considerably strengthened with expert staff to both attract and facilitate foreign equity flows.

Efficient and timely use of the ODA pipeline is a serious challenge. The ongoing initiatives to implement the Paris Declaration commitments are welcome. The establishment of the JCS and Working Groups under the LCG provide useful institutional mechanisms for aid coordination and for achieving results. Yet, as noted earlier, there are serious outstanding issues including process harmonization, aid fragmentation and weak linkage between project aide and sectoral plans and priorities. The ERD plans to convert the Aid Effectiveness Unit (AEU) to Development Effectiveness Wing (DEW) is a welcome idea that should be implemented soon. Efforts to streamline aid flows to government development priorities reflected in the five year development plans are also helpful. Yet, the weak linkage between projects and sectoral strategies is partly the result of the absence of well articulated sectoral strategies. The line Ministries dealing with core sectoral issues (health, education, social protection, transport, urban, agriculture, water and climate change and environment) should be required to prepare medium term (5 year) sectoral targets and strategies that should be the basis for aid negotiation with concerned group of DPs. These then become program-type projects funded by multi-donors in support of implementation of approved sectoral strategies. Continued efforts are needed to improve procurement and implementation capacities of line Ministries. The procurement challenge is immense and it constitutes the single biggest hurdle underlying slow aid disbursement and use. Turn-key type project financing arrangements might be helpful in addressing this concern. Strengthened dialogue with DPs is needed to do systematic pipeline review and agree on time-bound action plans to address the constraints that impede the use of ODA resources.

A big effort is needed to overhaul and establish a strong professionally managed PPP cell. This unit cannot be managed as a part of the bureaucracy no matter where it is located. Foreign resource mobilization through the PPP requires a unit that has internationally competent experts who can facilitate transactions with globally known firms. The legal framework and incentive policies need to be well-defined and are made comparable with PPP policies globally elsewhere. This is an urgent reform.

The external resource mobilization strategy needs to be evaluated regularly in line with implementation experience and changing global environment. This requires a competent monitoring team. It also requires a solid database of all foreign transactions. While there is good monitoring of ODA and there is a solid database on public debt, private debt needs to be incorporated into the total debt figures and reported in its consolidated form. The BB does monitor private debt and has created a database on private debt. However, a consolidated database of total debt is yet to emerge. Importantly, there is little analytical work done on foreign resource mobilization, external debt management and aid effectiveness. There is a need for doing systematic research and analysis on this subject. This can be done jointly between the MoF, the BB and local research institutions that have competence in this area.

D. Concluding Remarks

Bangladesh has a solid track record in managing its external debt that has served the country well. The rapid growth of national savings and exports have allowed Bangladesh to reduce reliance on foreign borrowings, improve debt servicing capacity, build up reserves and have a very comfortable balance of payments even as investment and GDP growth have increased. Looking forward, the investment requirements will sharply increase to finance a more rapid pace of GDP growth than in the past. While much of the additional resources will need to come from additional national saving, there will be a modest increase in reliance on foreign savings.

The solid platform of sound macroeconomic management and the comfortable debt, bop and foreign reserve situation will be very helpful to help Bangladesh move forward. Nevertheless, the increased requirements of foreign resources will present a challenge for Bangladesh during the Seventh Plan and beyond. It is therefore important to take early measures to prepare for this challenge. The foreign resource strategy proposed here calls for strong efforts to improve the utilization of the large unused aid pipeline while also taking policy actions to mobilize additional debt and equity foreign financing. In view of the changed global sources of supply of foreign resources, the reliance on concessional ODA will need to fall and a larger share of additional funding will need to come from private creditors at market based costs. The required strategy calls for a judicious mix of debt and equity. The opportunities for equity financing are substantial and strong efforts will be needed to sharply increase equity financing, especially based on FDI. The revamping of the PPP initiative can be especially useful in attracting additional FDI, particularly for financing infrastructure. Greater use of non-guaranteed private borrowing by creditworthy private enterprises will also provide flexibility in mobilizing foreign funding for private investment. In this regard, the launching of the proposed Bangladesh Sovereign Bond can be instrumental in supporting bond-financing by private enterprises.

While the average cost of debt will likely increase, overall debt service should remain manageable and will not present a debt sustainability issue. The Bangladesh debt indicators are highly favorable and modest increases in external debt along with higher GDP growth and exports should continue to keep Bangladesh in a comfortable situation. The credit rating for private borrowings is also favorable at present owing to good GDP growth and sound macroeconomic management. Mobilization of private debt from the international market will likely increase the interest cost from the present 1% average to 3-4%. Yet, this will keep debt servicing comfortable provided additional borrowings are used to finance productive investments.

The institutional arrangements for foreign borrowing are generally solid, but further efforts are needed to improve inter-agency coordination, especially in the area of equity resource mobilization. Along with consolidated debt and equity data and constant monitoring, efforts are needed to improve debt research and analysis on a regular basis to inform the debt strategy and improve its implementation.

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