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The potential impacts of the Eurozone crisis on the Bangladeshi economy

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Overview

With many European Union countries in a debt crisis provoked economic recession, this analysis asks how the Bangladeshi economy and particularly the export sector might be negatively impacted. The analysis concludes that while there is already evidence of a negative impact, there are compelling reasons to believe that the damage will be fairly contained and that the export sector will continue to grow and develop.

Problem Background

The Eurozone crisis, otherwise known as the European sovereign debt crisis, is an ongoing financial debacle that has made it difficult or impossible for some European countries to re-finance their government debt without the assistance of third parties.[1] The crisis was mainly caused by excessive state borrowing and spending by some European Union countries, like Greece, Ireland and Portugal, leading to unsustainable levels of government debt and deficits.[2]

Although the crisis began in 2009, the situation became particularly tense in 2010 in Greece, where the cost of financing government debt was rising sharply. On 2 May 2010, the Eurozone countries and the International Monetary Fund agreed to a €110 billion loan for Greece, conditional on the implementation of harsh austerity measures.[3] This was followed by a comprehensive rescue package worth €750 billion aimed at ensuring financial stability across Europe.[4]

However, the problem still persists as most countries hit by the crisis continue to face huge debt-GDP ratios and unsustainable fiscal deficits. Downgrades in sovereign credit ratings have already hit nine Eurozone countries, including the Eurozone rescue fund (EFSF) itself.[5] Unemployment in the Eurozone has risen to over 10%, with rates as high as 25% in Spain. The European Commission has estimated that the Eurozone countries' GDP will contract by 0.3% in 2012.[6] In a recent report, the World Bank has downgraded its estimate of global economic expansion in 2012 and has warned that both developed and developing nations will witness the effects of a Eurozone fueled global economic downturn.[7]

Apprehensions for the Developing Economies

In the context of increased global interdependence, developing countries are unlikely to remain immune to the debt crisis in the developed world. There are three primary reasons why the developing world might be negatively impacted:

- **Stalling growth in advanced economies**: Slow growth and austerity packages introduced by European governments are likely to weaken demand for developing country exports and might lead to cuts in aid spending.[8] According to a recent World Bank report on Global Economic Prospects 2012, global trade volumes could decline by more than 7 percent in 2012.[9] In addition, high unemployment rates associated with weak economic activities in developed countries may translate into lower remittances directed to developing economies.[10] As stated by the World Bank report, if the crisis gets severe it could cause remittances to developing countries to decline by 6.3 percent.[11]

- **Financial contagion:** In response to the crisis, European banks are withdrawing credit in order to balance their books.[12] Furthermore, investor confidence has reached panic levels, with the Credit Suisse's Global Risk Appetite Indicator at a 30-year low.[13] A World Bank report states that the capital flows to developing countries weakened sharply in the second half of 2011, with gross capital flows to developing countries plunging by 45% (compared to same period the previous year).[14]

- **Euro depreciation against the dollar**: As the Euro continues to depreciate against the dollar, imports become more expensive for the Euro region, further suppressing demand for exports from the developing countries.[15] In addition, the depreciation will cause remittances from the European countries to diminish in value.[16]

Nonetheless, the extent of the impact will certainly vary from country to country. Countries most at risk include those heavily dependent on European economies and with limited fiscal policy options.

The negative impacts of the Eurozone crisis on Bangladesh

Fall in exports: Given that Eurozone economies form the single largest destination for Bangladeshi exports, it seems inevitable that Bangladesh will be negatively impacted by the crisis. This sentiment was expressed by World Trade Organization (WTO) Director General Pascal Lamy, who mentioned during his visit to Dhaka in May, 2012: "…Macroeconomic development is not looking very good, especially for countries like Bangladesh, whose two-thirds of exports are to Europe.” [17]

In fact, growth in Bangladeshi exports has already slumped, with orders drying up in the key markets of the EU (the largest export destination for Bangladeshi products) and the US (accounting for one-third of the country's total exports). [18]

- The total export figures for March 2012 declined by 7.2%, over the same period last year. While still positive, export growth over the period July 2011 to March 2012 dropped to only 10.36%, compared to a growth of 40.31% over the same period last year.[19]
- Exports are likely to decline further as indicated by a drop in Letters of Credit openings for the import of machinery and raw materials during the first four months of 2012. Letters of Credit for machinery fell by 33.9% and for raw materials by 0.5%.[20]

As, Md Shafiul Islam Mohiuddin, president of the Bangladesh Garment Manufacturers and Exporters Association, concludes “The Eurozone crisis has definitely hit us." [21]

Decline in Foreign Investment and Aids: Experts also believe that the inflow of FDI and foreign aids will decline in 2012 as per the “financial contagion” effect explained above. WTO Director General Lamy cautioned Bangladesh that the availability of trade finance might be low and the price high, especially for poor countries and small businesses.[22] According to one prominent economist of the country, “foreign assistance has dried up and foreign investment is not forthcoming”; another economist raised concerns about “stagnant inflow of foreign aid” and “low FDI inflow at around one percent of GDP”. [23]

Reasons why the damage might still be contained

Although there are already indications of negative impacts on Bangladesh, there are good reasons to believe that the economy will remain fairly insulated, as it was during the global crisis of 2007-2009. In fiscal year 2008-2009, the Bangladesh economy still managed to grow at a rate of 5.7% and economists and the Center for Policy Dialogue estimate that the global downturn only had a -0.59% impact on Bangladesh’s growth.[24] The following factors might work in Bangladesh’s favor:

Competitive advantages in Exports: Though exports are taking a hit, some believe that the crisis can actually open up new opportunities for Bangladesh. Because the country enjoys low cost labor, offers competitive prices, and benefits from favorable trade policies, Bangladeshi producers stands to increase market share. According to a recent report by McKinsey and Co, China is beginning to "lose attractiveness." Due to rising costs, garment sourcing companies are moving to the next "hot spot" - Bangladesh.[25] The report says that 23% of the purchasing companies surveyed want to cut their sourcing from China by more than 10% within five years and believe that Bangladesh's prices will continue to be competitive in comparison.

Financial Insulation: Due to relative insulation from the international financial system, Bangladesh's banking sector continued to earn a profit during the previous global financial crisis. The same trends are expected to continue in 2012.[26] Exposure of the capital market to foreign portfolio investment is also minimal. During fiscal year 2009, when all stock markets across the globe recorded sharp declines in their indices, the general indices in Bangladesh continued to increase.[27] Currently, the problems confronting Bangladesh's capital markets are locally driven.

Improving Remittances: Despite fears of a decline, remittances experienced overall growth of 6% for FY 2011. The previous cycle of the global financial crisis did lead to a reduction in work opportunities in the Middle Eastern construction industry, a major source of remittances; however, more recent demand has actually led to an increase in the number of emigrants.[28]

Conclusion

As the Eurozone debt crisis continues, it appears unlikely that Bangladesh will emerge unscathed. The export sector has already started to feel the impact and inflows of FDI and aid are likely to decline. Nonetheless, Bangladesh's competitive advantage in low-cost exports might cushion it against the full blow of the downturn. Furthermore, the country's financial sector is largely insulated and work remittances have remained resilient.

While these factors suggest that Bangladesh will weather the European storm, the country still confronts a host of internal economic challenges. Poor infrastructure, high inflation, trade imbalances, depreciation of the Taka, problems in the stock market, and poor governance still present considerable challenges for the Bangladeshi economy.

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