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Aid, Debt, and Development in Bangladesh: Synergies or Contradictions

Bernhard G. Gunter
A. F. M. Ataur Rahman
and
Jesmin Rahman

Abstract

This paper examines past and future aid allocations to Bangladesh and her debt sustainability, paying special attention to recent international debt relief initiatives and the possible fast-tracking of Bangladesh's poverty reduction strategy to achieve the Millennium Development Goals (MDGs). It shows that aid allocations as well as the donors' influence increased sharply during the 1970s, leading to criticism of aid in Bangladesh that largely remains today even though aid allocations to Bangladesh decreased in relative terms at least since 1987. Among countries with similar income per capita levels, Bangladesh currently receives the second lowest amount of aid per capita amounting to \$9. This is about one fifth of what comparable African countries receive in terms of per capita aid. While lower levels of aid imply lower external debt levels, as aid has mostly been provided via external loans, Bangladesh also substituted external borrowing with domestic borrowing and is therefore today one of the most indebted low-income countries today in terms of public debt service to government revenues.

*“Due to lack of a comprehensive foreign aid policy, the country fails to prioritize its requirement.”
Debapriya Bhattacharya (January 2, 2008)*

Introduction

Some 30 years ago, Bangladesh was one of the poorest countries of the world. It was openly referred to as an international basket case. Today, there are some 40 countries that are poorer in terms of both income per capita and human development.¹ A recent World Bank (2007, p. xv) report has even stated that Bangladesh “could join the ranks of middle-income countries (MICs) within a decade (by 2016) or sometime soon after.” While living conditions have improved considerably and poverty declined drastically, especially in the last few years, there are still about 40 million people living below \$1-a-day in Bangladesh and inequality is rising. There are more poor people in Bangladesh than there are in the nine Sahelian countries (Burkina Faso, Cape Verde, Chad, Gambia, Guinea-Bissau, Mali, Mauritania, Niger and Senegal).² Like the Sahelian countries, Bangladesh has been officially identified by the United Nations (UN) as a least developed country (LDC), reflecting its low income, weak human assets, and high economic vulnerability. Bangladesh is also recognized worldwide as one of the most vulnerable countries to the impacts of climate change.³

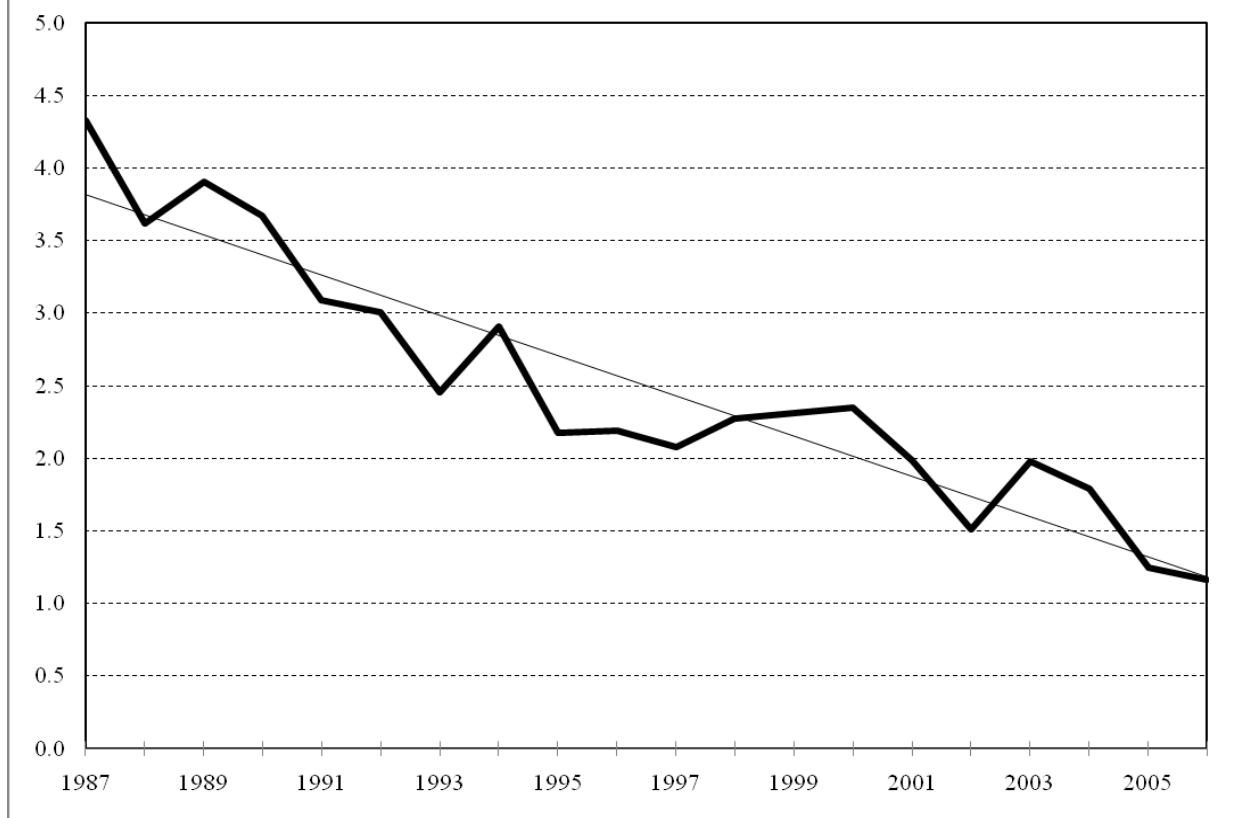
While the amount of net official development assistance (ODA) to Bangladesh was about the same as the sum of net ODA to the nine Sahelian countries

during 1972-1982 (US\$9.3 billion compared to US\$9.6 billion, respectively), Bangladesh has received less ODA than these nine Sahelian countries for every year since 1983.⁴ From 2000 to 2006, Bangladesh received less than half of the net ODA the nine Sahelian countries received (US\$8.5 billion versus US\$19.0 billion, respectively). While debt relief—provided to most Sahelian countries, though not to Bangladesh—has contributed to the divergence in aid allocations between the Sahelian countries and Bangladesh, there remain substantial reallocations in aid away from Bangladesh even after excluding debt relief.

The dismal provision of ODA to Bangladesh compared to the Sahelian countries is not an exceptional case but the result of a steady reduction in Bangladesh's share of net ODA to all developing countries, which has decreased considerably during the last 20 years, from 4.4 percent in 1987 to 1.2 percent in 2006, see Figure 1. While it is well known that aid flows are typically highly volatile and that aid flows are declining once a country has reached a certain level of income per capita, the trend shown in Figure 1 is not due to aid volatility, nor has Bangladesh reached an income per capita level that would justify the decline in aid.

While the reduction in Bangladesh's share of ODA

**Figure 1: Net ODA to Bangladesh, 1987-2006
(as % of Net ODA to all developing countries)**



had contributed to the fact that Bangladesh never defaulted on her external debt service payments, there are signs that recent changes in international aid and debt sustainability frameworks will further reduce aid allocations to Bangladesh despite its impressive record of achievement, especially in harnessing sound economic and social policies. This paper analyzes to what degree aid and debt have been--as well as might be -- helpful or detrimental to Bangladesh's development, keeping in mind that additional investments needed to achieve the MDGs in Bangladesh are estimated to amount to about US\$8 billion per year.⁵

With regard to aid, the paper first reviews the Bangladeshi aid impact literature and examines how the current aid allocation mechanism guided by recent debates on aid effectiveness seems to have reduced aid allocations to Bangladesh. It also details the likely negative distributional implications of recent debt relief initiatives and the Bretton Woods institutions' new debt sustainability framework on aid allocations to Bangladesh. With regards to debt, the paper analyzes the sustainability of Bangladesh's public debt and shows how the debt sustainability

framework could be enhanced to allow Bangladesh to debt-finance development expenditures on a temporary basis to achieve the MDGs if the preferable grant-financing is not provided. The paper is structured as follows. Following this introduction, the next section (Section 2) will deal with the above described aid issues, Section 3 with the above described debt issues, while Section 4 provides conclusions and recommendations.

Impact, Effectiveness, and Future Aid to Bangladesh

The impact of aid has been analyzed in numerous contributions, including many concentrating specifically on Bangladesh. While there is broad agreement that aid allows a country to reduce its savings and trade gaps, at least in the short-term, the long-term impact of aid on growth is highly controversial, especially in Bangladesh. The dominant view among Bangladeshi development economists that aid has a negative impact on growth has been influenced by the fact that the inequality of economic power between the international donors and the emerging Bangladeshi government permitted the donors to impose their will on an increasingly aid

dependent country during the 1970s and 1980s.⁶ The increasing role of the donors is reflected in Figure 2, showing the amount of net ODA provided to Bangladesh from 1971 to 1987 in billions of current US\$.

The first seminal assessment of the impact of aid in Bangladesh has been provided by Rehman Sobhan (1982). He draws a frustrated picture on the impact of aid in Bangladesh, demonstrating how aid has contributed among others to a decline in savings, a reduction in the government's incentive to promote exports, an increase in domestic capitalism, and the creation and sustenance of rural and urban elites. Sobhan's analysis has been reconfirmed by a collection of papers that had been prepared in 1984/85 by the Bangladesh Institute of Development Studies (BIDS), though the papers were formally published only a few years later in a volume edited by Sobhan (1990). Another 14 years later, the Centre for Policy Dialogue (2004) published another comprehensive review of the impact of aid in Bangladesh, reflecting that the volume, focus, magnitude, composition and operational modalities of foreign aid has undergone important changes in Bangladesh. Yet, the overall assessment of the impact of aid remained about the same. Indeed, the volume makes clear that the range of policy conditionalities imposed on the recipients has been extended to areas far beyond the traditional structural adjustment policies derived from the so-called Washington Consensus and that the reconstruction of the aid agenda has been incorporated into the design of so-called Poverty Reduction Strategy Papers (PRSP), where aid recipients are expected to assume ownership over the marriage between the Washington Consensus with the donor's newer aid priorities.

On the other hand, there is only one comprehensive review (Rahman, 1984) that comes to the conclusion that aid had an overall positive impact on growth and development in Bangladesh. Evaluating the effects of foreign aid on Bangladesh's economic development during the first decade of her existence with an analytical economic model, Rahman (1984, pp. 95-96) concludes that "foreign aid did make an undeniable contribution to the economic development of Bangladesh", though he also points out that Bangladesh's achievements "would have been far greater had government efforts in planning and resource mobilization been more adequate, consistent, and systematic."

Two other major reviews of the impact of aid in Bangladesh are largely inconclusive. White and

Dijkstra with van Donge (2003) conclude that while the donors' policy influence had a positive impact on Bangladesh's economic stabilization and liberalisation, it is difficult to trace a direct causal connection between liberalisation and growth. Furthermore, they point out that the link between poverty reduction and economic reforms pushed through by the donors is less obvious, partly as inequality has risen sharply. Quazi (2005) estimates an aid-growth model and an aid-fiscal model to quantify the effects of foreign aid on GDP growth and fiscal behavior in Bangladesh over the 1973-1999 period. The aid-growth model applies the cointegration method to a neoclassical growth model and finds that aid has marginal effects on GDP growth, but when aid is disaggregated into loans and grants, it is found that loans significantly raise GDP growth, while grants do not. The aid-fiscal model employs a non-linear simultaneous model and finds that foreign grants mostly finance non-productive civil expenditures, but foreign loans generally finance public investment projects and human capital building programs, which eventually lead to higher output growth.

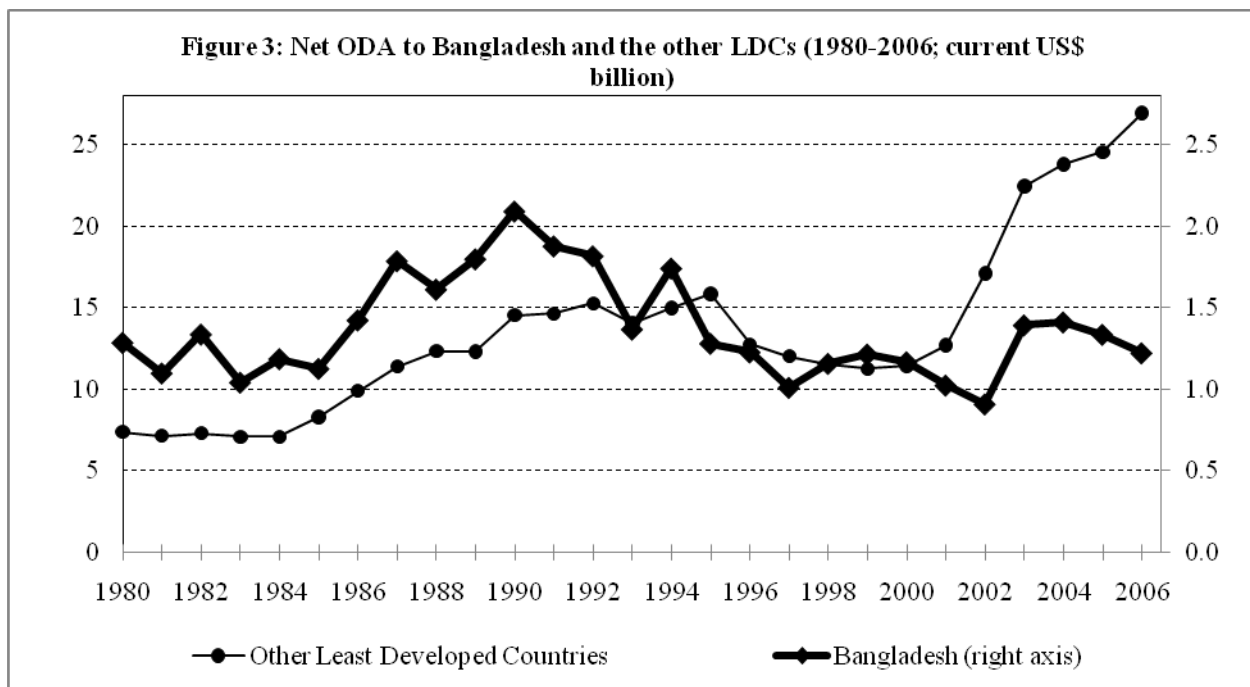
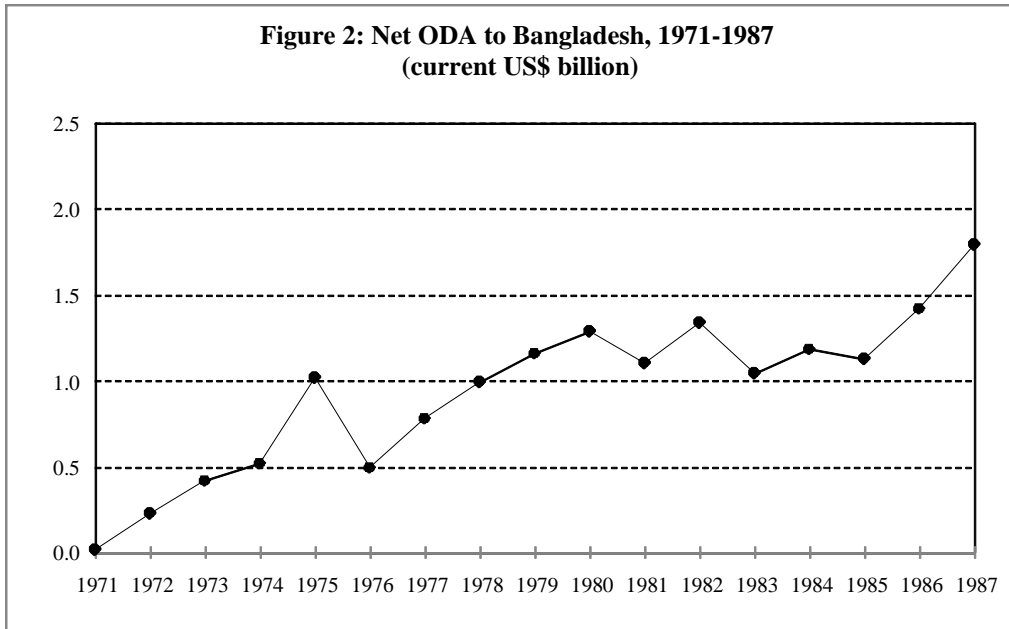
The conclusion that can be drawn from this review of the literature is that some aid provided in the past may have been detrimental to Bangladesh's development. However, important lessons have been learnt from the past and, properly provided, aid could be highly effective in reducing poverty in Bangladesh.

Effectiveness of Aid in Bangladesh

We differentiate between the impact and effectiveness of aid based on the distinction that has been made in the literature, whereby the recent aid effectiveness debate focuses on (a) the allocation of scarce aid resources and (b) the capacity to absorb aid in terms of possible losses to a country's competitiveness and in terms of domestic capacity constraints.

Allocation of Scarce Aid Resources

Criticized from the right as well as from the left, aid had been falling worldwide during the second half of the 1990s. However, as Figure 3 shows, the decline in aid to Bangladesh began about 5 years before the overall decrease in aid. Even more important is the different evolution of aid provided to Bangladesh and to other least developed countries since 1999. While aid to Bangladesh continued to decrease from 1999 to 2002, it started to increase in the group of the other least developed countries. The rising gap between aid



allocations to Bangladesh and other least developed countries can be attributed to two main factors: (i) the shift of aid to the Heavily Indebted Poor Countries (HIPCs), largely due to these countries' debt relief, and (ii) shortcomings in the donor's aid allocation mechanism, which will be discussed in more details in the following paragraphs.

Following the aid fatigue of the mid-1990s, the consensus grew during the late 1990s that aid can

only be effective in an enabling environment. This has been claimed and illustrated in a highly influential World Bank (1998) research report, entitled "Assessing Aid: What Works, What Doesn't and Why". It pointed out that aid is as much a matter of knowledge as it is about money and that aid has a large impact, but only in low-income countries with sound management. According to the report, without a reform policy, aid has little impact.

Even though Bangladesh has followed nearly all of the donors' demands in terms of economic stabilization and external liberalization, the policy dialogue has been stuck for some years with regards to reforms in the banking sector and the privatization of state-owned enterprises. Many donors also considered Bangladesh to lack respect for democratic procedures and human rights. Furthermore, Bangladesh made headlines as the world's most corrupt country,⁷ after having been added to Transparency International's corruption perception ranking in 2001. These factors hampered the aid allocation to Bangladesh and while all Bangladeshi governments were at least formally interested in getting more aid, the majority of intellectual circles seemed either ignorant to or approving the reduction in aid flows as aid was typically associated with negative influence. Looking at Bangladesh's recent economic success, those critical of aid might even say that Bangladesh benefited from the reduced influence of the mostly western donors.

Whatever the reasons might be, it is clear that the recent aid allocation mechanism (which was supposed to allocate aid to countries that are able to reduce poverty) has been biased against Bangladesh. The degree to which Bangladesh has been discriminated in terms of aid allocation becomes clear if looking at aid provided in terms of per capita aid. First, while net ODA per capita amounted to only US\$9 for Bangladesh in 2005, it amounted to an average of \$197 (more than 20 times the Bangladeshi level) for the 37 countries with populations of less than one million. This huge discrepancy is even less comprehensible if considering that Bangladesh's 2005 gross national income (GNI) per capita (US\$470) was less than one sixth of the income per capita of these 37 small states (US\$3,055). Second, even if comparing Bangladesh with more populous countries (see Table 1), there remains a huge discrepancy in net ODA per capita levels, which—with the exception of Nigeria—is far beyond the impact of debt relief.

The conclusion that the current aid allocation mechanism is negatively biased against Bangladesh is shared by various studies. For example, Cogneau and Naudet (2007) reviewed the question of who deserves aid in which they refer to (a) the groundbreaking suggestion of Collier and Dollar (2001, henceforth CD), that aid be allocated to maximize poverty reduction and (b) their own approach that distinguishes between the impact of efforts and disadvantage. They suggest that aid should compensate for the disadvantages while

allowing efforts to be rewarded and come to the conclusion (p. 114) that “in line with CD's main results, an allocation according to equal opportunity could very well call for redirecting a large part of international aid to Bangladesh and India, where poverty is as high as in Africa.”

In addition to the negative bias against large countries, there also seem to be some problems related to the donors' assessment of recipient's performance, especially the failure to distinguish between different forms of corruption and governance deficiencies. To avoid any misunderstanding, corruption is a cancer on development. However, as Siddique and Ghosh (2007) have shown, it is possible to distinguish between 'petty' corruption and 'big time' corruption. In other words, a bribe that makes an official do *'what s/he is supposed to do'* is different from a bribe that makes an official do *'something s/he is not supposed to do'*. To use the words of de Haan and Everest-Phillips (2007, p. 11), “donors are struggling with the potential dangers of normative approach to governance, and the use and abuse of governance indicators to justify aid allocations and aid modalities that will doubtless remain much more political.”

The principles of aid effectiveness as they are enshrined in the Paris Declaration, especially the criteria of ownership, would contribute much to make aid more effective.⁸ However, as recent reviews have shown, the reality of aid provision lags behind its rhetoric. For example, the OECD's (2007b) Bangladesh chapter of the 2006 survey on monitoring the Paris Declaration demonstrates that while some progress has been made towards meeting the standards of aid effectiveness, significant challenges remain in Bangladesh. Similarly, the preliminary results available from an ongoing evaluation of the implementation of the Paris Declaration in Bangladesh draws an overall positive picture, though it also points out that “the main constraints for GoB to take leadership are the capacity limitations of GoB officials, rigid procedures of some development partners and reluctance on the part of some of them to change the mindset.”⁹

Capacity to Absorb Aid

Within the last few years, the aid effectiveness literature has also included a critical debate on the macroeconomic implications of aid surges. Aid pessimists have warned that aid inflows could have systematic adverse effects on a country's competitiveness, stemming mostly from a real

Table 1: Net ODA to all countries with income per capita levels between US\$350-US\$660 in 2005
(i.e., 10 countries richer than Bangladesh and 10 countries poorer than Bangladesh)

	Net ODA per capita	Net ODA / GNI	Memorandum items	
			GNI per capita	Population
			US\$	millions
Zambia	100	14.2	490	12
Mauritania	61	10.4	560	3
Ghana	55	10.6	450	22
Kyrgyz Republic	54	11.4	440	5
Haiti	52	12.1	450	9
Laos	52	11.2	440	6
Mali	52	14.1	380	14
Nigeria	47	7.4	560	132
Papua New Guinea	46	6.6	660	6
Sudan	45	7.1	640	36
Benin	44	8.2	510	8
Cambodia	37	10.4	380	14
Burkina Faso	35	12.8	400	13
Chad	34	8.6	400	10
Central African Republic	28	7.0	350	4
Kenya	23	4.3	530	34
Guinea	22	6.9	370	9
Viet Nam	22	3.7	620	83
Yemen	14	2.6	600	21
Bangladesh	9	2.1	470	142
Uzbekistan	7	1.3	510	27
Average excluding Bangladesh	37	6.7		

Source: Calculations by authors based on OECD (2007a) and World Bank, World Development Indicators, CD-Rom.

exchange rate overvaluation and capacity constraints, similar to what is known as Dutch disease. However, the subsequent analysis—based on African countries that experienced considerably more aid inflows than Bangladesh—came to the conclusion (see IMF, 2006, p.1) that “there is currently little evidence that large aid inflows have significantly reduced the competitiveness.” Table 1 above shows that nine countries (with comparable income per capita levels as Bangladesh) received at least 5 times more aid per GNI than Bangladesh, yet there is no evidence that any of them suffers from the Dutch disease.

The recent literature has also shown that Dutch disease effects can be minimized if governments and central banks coordinate fiscal, monetary and exchange rate policies.¹⁰ Governments should try to both ‘spend’ aid in order to finance larger government programs and ‘absorb’ aid in order to import more real resources. Often, governments that receive foreign aid neither spend nor absorb it fully, defeating the basic purpose of development

assistance. Instead of adhering to restrictive macroeconomic policies, governments could target their increased spending on productivity enhancing public investment and central banks could amplify the flow of low-cost credit to stimulate private investment. Unlike in cases where a central bank attempts to avoid a depreciation of the currency, it usually has ample means to prevent an exchange rate appreciation. It is difficult to see why Bangladesh, which has a large pool of highly qualified economists and a record of good macroeconomic management, would be unable to absorb much larger aid inflows.

Looking at the impact of aid on inflation, it is important to take other factors that influence inflation into account. For example, given that aid increases are many times based on the provision of emergency aid in the aftermath of natural disasters (like floods, droughts, cyclones) that typically have a negative impact on subsequent harvests, it is not surprising that there is some correlation between aid inflows and accelerated inflation, including in Bangladesh.

Another concern frequently raised is that aid-receiving countries face domestic capacity constraints to effectively use aid increases. However, these capacity constraints can be minimized by removing specific supply bottlenecks, like lacks of infrastructure and skilled personnel. Again, public investment can play a central role in this effort.

Future Aid Allocation in Bangladesh

Preliminary estimates for 2007 indicate that the share of aid allocated to Bangladesh has further decreased, possibly dropping below one percent of net ODA to all developing countries. Aid flows to Bangladesh may increase temporarily in 2008 due to the provision of emergency aid after cyclone Sidr hit Bangladesh on November 15, 2007; yet, the financial implications of recent debt relief initiatives are likely to cause a further decline in aid allocations to Bangladesh. This section provides some calculations of possible reductions in future aid flows to Bangladesh based on the costs of recent debt relief initiatives and the allocations of these costs according to benchmarks provided by Gunter, Rahman and Wodon (2008). They calculated how much the recent debt relief initiatives (including HIPC, post-HIPC Paris Club, and the Multilateral Debt Relief Initiative) will cost (see Table 2 above) and then allocated these costs to each country based on four benchmark scenarios. The four benchmark scenarios (see Table 3) reflect the four possible combinations derived from the answers to two major questions: 1.) is debt relief additional to donors' traditional aid budgets?,¹¹ and 2.) will donors make reallocations of their traditional aid budgets to HIPCs due to debt relief provided to them?¹²

We simplify the scenarios here by assuming that debt relief will—in the long run—not be additional, that the costs of the three debt relief initiatives are equally distributed over 40 years (in reality they are hump-shaped), and that the concessionality level of the cancelled debts is 40 percent. This would imply that Bangladesh's aid levels would decrease between zero and US\$580 million for every year over the next 40 years. The case of zero costs for Bangladesh would imply that the donors would deduct all debt relief costs from the HIPCs' traditional aid; the US\$580 million aid reduction per year to Bangladesh would reflect the case in which the donors would deduct all debt relief costs from the non-HIPCs traditional aid. Assuming that the costs of the recent debt relief initiatives will be shared equally among HIPCs and non-HIPCs, would imply that Bangladesh's future aid would be reduced by US\$265 million a year.

Alternatively, we could assume that bilateral debt

relief will be additional and fully used for debt relief, but that multilateral debt relief will due to the “pay-as-you-go” reimbursement mechanism not be additional. This case would imply that Bangladesh's future aid would be reduced by US\$354 million a year if the costs of multilateral debt relief are financed from reductions in aid to the non-HIPCs, or US\$177 million a year if the costs are shared equally among HIPCs and non-HIPCs. To summarize, the impact of recent debt relief initiatives is likely to amount to a reduction of about 15-50 percent of Bangladesh's current aid levels.

Finally, the amount of aid effectively allocated to Bangladesh will also be influenced by the joint World Bank–IMF debt sustainability framework (DSF),¹³ which determines the degree to which IDA provides its aid in terms of loans or grants:

- countries assessed as having a low risk of debt distress will receive their assistance via loans,
- countries assessed as having a medium risk of debt distress will receive their assistance split between loans and grants, and
- countries assessed of having a high risk of debt distress will receive their assistance via grants.

Though the current aid statistics do not differentiate between aid provided via concessional loans or grants, the effective amount of aid provided depends on terms it is provided. Given that developmental loans have typically a grant element of about 50 percent, any aid provided via concessional loans is effectively only half of the aid provided via grants. Yet, IDA's modified volume approach (see IDA 2004) applies an only 20 percent upfront volume discount on grants, with the argumentation that a higher volume discount could hamper these countries' prospects of achieving the MDGs. While correct, it ignores the negative distributional implications this approach has for countries that will receive IDA's assistance in forms of loans, as is the case with Bangladesh.

Debt Issues

*Current Trends in Bangladesh's Public Debt*¹⁴

As Figure 4 shows, in 1993, Bangladesh's total public debt (TPD) amounted to 725 billion taka. Ten years later, in 2003, it had more than doubled to 1.53 trillion taka, and another 3 years later, it reached nearly 2 trillion taka. Looking at these trends seems to indicate that Bangladesh's TPD will be unsustainable in the long-run.

Table 2: Gross Benefits of HIPC, Post-HIPC Paris Club, and MDRI Debt Relief
(in US\$ millions, 2004 NPV terms, based on 30 HIPCs that reached the enhanced Decision Point by end-December 2006)

Country	Bilateral HIPC DR	Multi-lateral HIPC DR	Total HIPC DR	Post-HIPC PC DR	Total MDRI DR	Overall Total DR
Sum of 30 HIPCs	18,608	20,471	39,079	13,336	34,064	86,479
Sum of non-LDC-HIPCs	5,510	4,511	10,021	4,625	6,715	21,361
Benin	92	236	329	171	832	1,332
Bolivia	519	1,119	1,639	634	1,407	3,679
Burkina Faso	101	596	696	20	966	1,683
Burundi	119	707	826	8	110	944
Cameroon	1,047	406	1,453	2,782	1,037	5,272
Chad	40	159	199	37	900	1,137
Congo, Dem. R.	3,846	2,594	6,440	904	1,091	8,435
Congo, Rep.	971	118	1,089	1,902	89	3,079
Ethiopia	693	1,560	2,253	647	2,557	5,457
Gambia, The	21	64	85	16	314	415
Ghana	986	1,048	2,033	744	3,056	5,834
Guinea	256	409	665	380	1,185	2,230
Guinea-Bissau	253	255	507	20	185	712
Guyana	246	424	670	43	198	911
Haiti	116	20	136	81	227	444
Honduras	255	421	676	916	1,123	2,714
Madagascar	565	462	1,026	704	1,909	3,639
Malawi	286	877	1,162	118	988	2,269
Mali	200	456	655	219	1,462	2,336
Mauritania	312	452	764	141	673	1,578
Mozambique	1,526	946	2,472	102	1,617	4,190
Nicaragua	2,533	1,381	3,915	387	842	5,143
Niger	265	405	670	108	836	1,614
Rwanda	66	675	741	17	459	1,216
Sao Tome & Prin.	35	85	120	3	65	189
Senegal	253	355	609	639	1,908	3,156
Sierra Leone	293	408	701	55	323	1,079
Tanzania	1,131	1,199	2,329	707	3,060	6,097
Uganda	214	1,003	1,217	97	2,628	3,942
Zambia	1,370	1,633	3,003	735	2,015	5,752

Source: Adapted from Gunter, Rahman and Wodon (2008) Table 1.

However, expressing Bangladesh's TPD as percent of GDP (see Figure 5), provides a different picture as Bangladesh's TPD has actually decreased from 58 percent in 1993 to less than 47 percent in 2006. Furthermore, the picture improves further if looking at the trend of the ratio of nominal TPD to government revenues (see Figure 6), which has decreased from 638 percent in 1993 to 438 percent. The only worrisome part is that the share of the domestic public debt continues to increase, which is even more reflected in terms of interest payments as

percent of government revenues, see Figure 7.

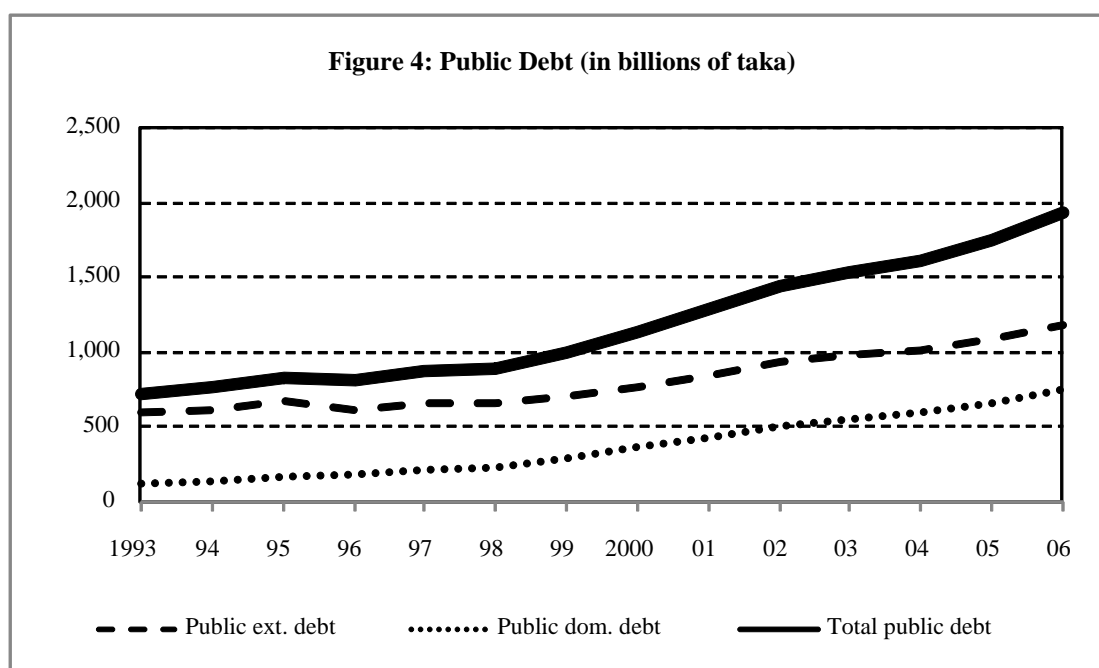
Future Debt Sustainability under Alternative Macroeconomic Scenarios

In order to assess Bangladesh's future debt sustainability, we make use of a debt projection module developed by Gunter, Lopez, Ramadas and Wodon (2002) to simulate the evolution of Bangladesh's debt from FY2006-FY2021, based on initial conditions and projections for government

Table 3: Four Benchmark Cases for the Distribution of the Costs of Debt Relief

		Question Two: Will donors make reallocations of their traditional aid budgets to HIPC's due to debt relief provided to them?	
		zero reallocation of the HIPC's traditional aid	full reallocation of the HIPC's traditional aid
Question One: Is debt relief additional to donors' traditional aid budgets?	full additionality in creditors' resources	Benchmark Case 1 HIPC's gain, while there is no impact on the non-HIPC's	Benchmark Case 2 Non-HIPC's gain, while there is no impact on the HIPC's
	zero additionality in creditors' resources	Benchmark Case 3 HIPC's gain, while the non-HIPC's lose	Benchmark Case 4 No impact on either HIPC's or non-HIPC's

Source: Adapted from Gunter, Rahman and Wodon (2008), Table 3.



expenditures, government revenues, and some other parameters. Reflecting the fact that a country's debt sustainability cannot be determined by one specific indicator, the module adopts a flexible approach to debt sustainability by providing the module's user with various options on how to define debt sustainability. We limit the analysis here to Bangladesh's fiscal sustainability;¹⁵ hence, we include all public debt (domestic and external) and exclude all private debt. Given that Bangladesh has considerable amounts of both concessional external and non-concessional domestic debts, we calculate the debt stock indicators in net present value (NPV) terms. We first analyze Bangladesh's fiscal public debt sustainability under three different

macroeconomic scenarios and then simulate the sustainability of Bangladesh's fiscal debt for two alternative financing scenarios of an ambitious government-led investment strategy to achieve the MDGs.

Alternative Macroeconomic Scenarios

The three alternative macroeconomic scenarios constitute (i) a baseline scenario based on historical values, (ii) a relatively arbitrary pessimistic scenario, and (iii) a relatively arbitrary optimistic scenario, whereby we always provide simulations for Bangladesh's NPV public debt-to-GDP ratio, the NPV public debt-to-revenue ratio, and the public debt

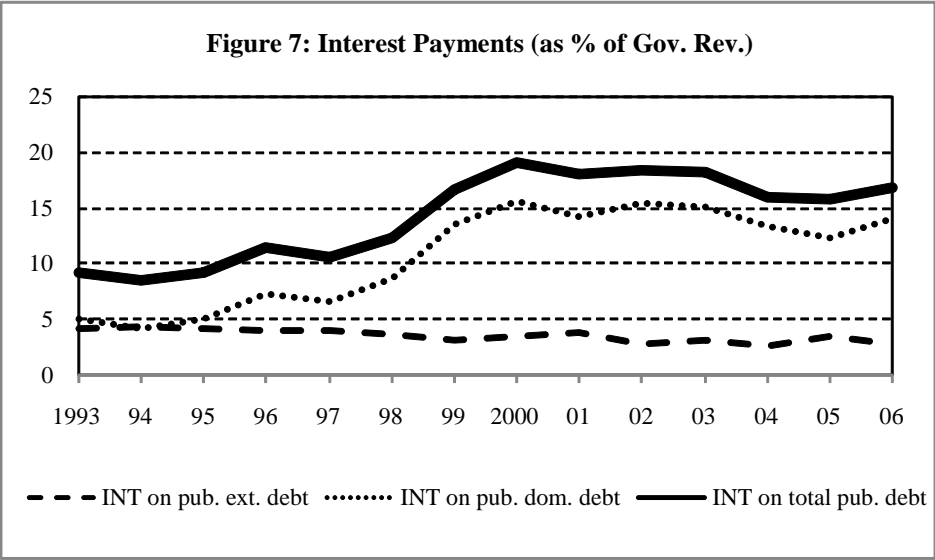
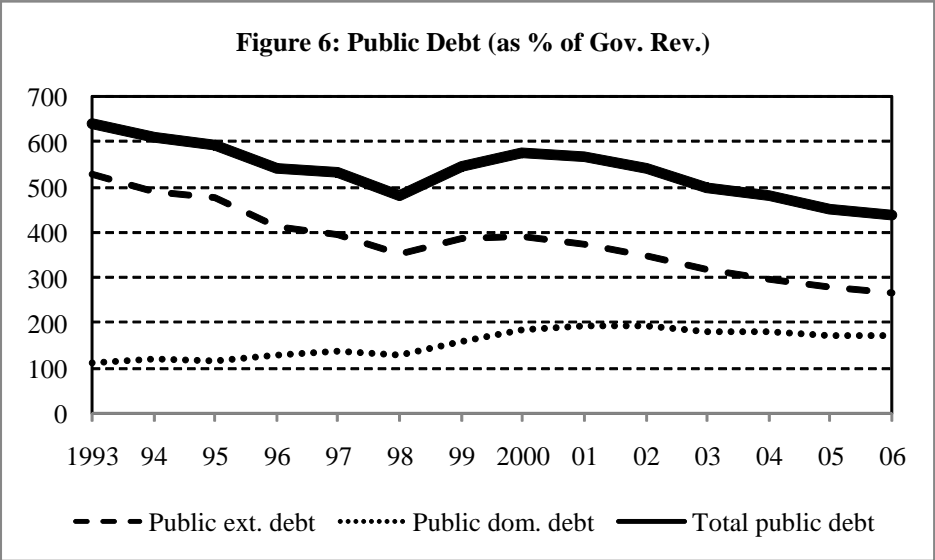
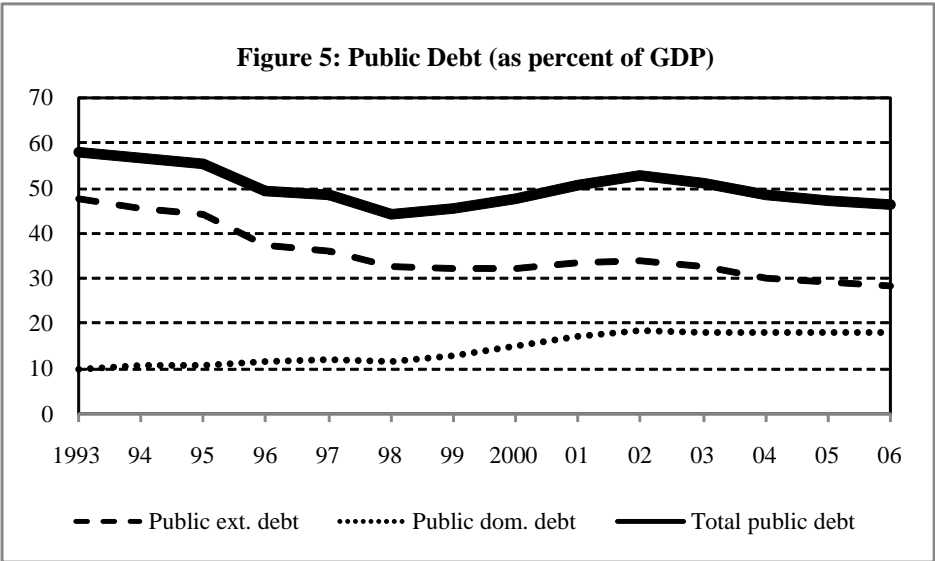


Figure 8: Initial conditions and baseline macroeconomic scenario assumptions

Initial Value	Public Ext. Debt	Nominal	Initial Value	Grants	Exports	Excha.	
	Stock	Int. Pay.		GDP	0	10,526	Rate (T/\$)
	17,701	186		61,893	0	17.7	67.2
			Growth (t0)				
				0	8.3 (h)	5.0 (h)	
			Growth (t15)				
Value (FY06)	Discount rate (%)	Interest rate (%)	Inflation rate (%)	Real GDP growth (%)	Rev. to GDP (%)	P.Spe.to GDP (%)	Average Maturity (years)
Value (FY21)	5.0	1.05	7.2	6.6	10.7	12.1	15
	5.0	1.05	5.3 (h)	5.7 (h)	15.7 (h)	17.1	15
Initial Value	Public Dom. Debt	Interest on Public Domestic Debt					
	11,265	932					
Value (FY06)	Share of Dom. Financing (%)	Interest rate (%)	Discount rate (%)	Average Maturity (years)			
Value (FY21)	64	8.27	8.27	3			
	64	8.27	8.27	3			

Source: Calculations by authors based on IMF (2007). All data is in millions of US\$ unless otherwise indicated. Please see endnote 16 for further explanations.

Table 4: Alternative Assumptions under Different Macroeconomic Scenarios

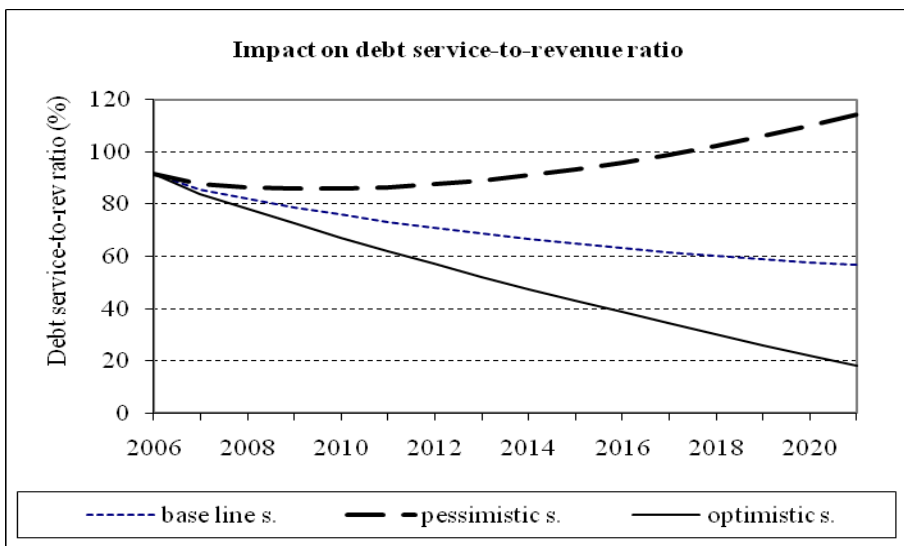
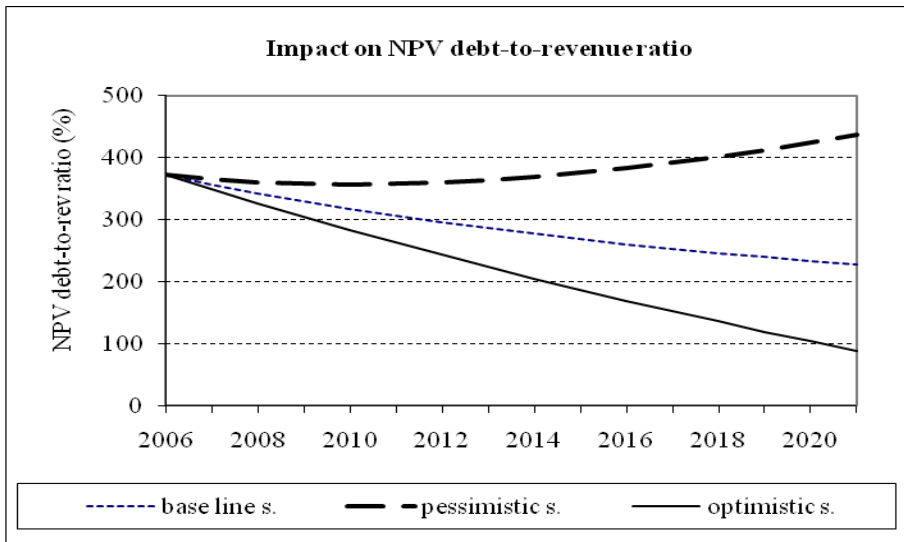
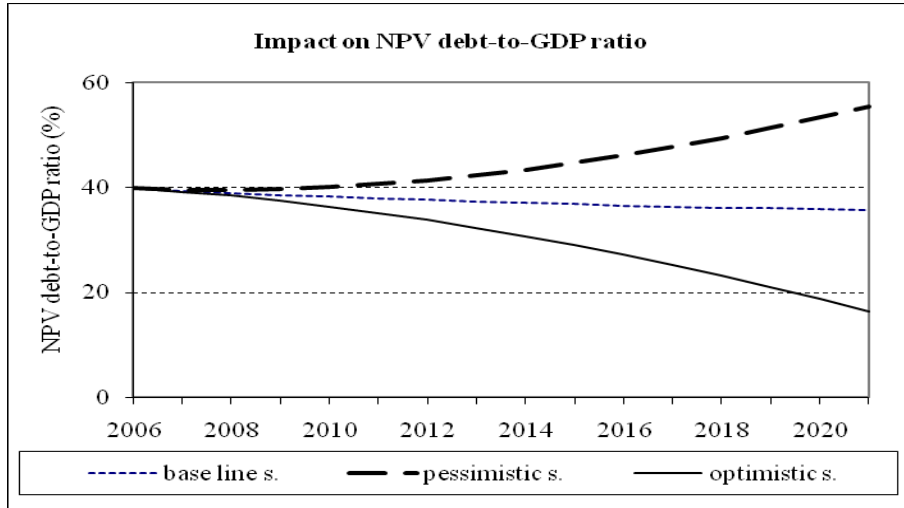
		baseline scenario	pessimistic scenario	optimistic scenario
GDP growth rate (%)	FY06	6.6	6.6	6.6
	FY21	5.7 (h)	3.7	7.7
Exports growth rate (%)	FY06	17.7	17.7	17.7
	FY21	8.3 (h)	4	12
Inflation rate (%)	FY06	7.2	7.2	7.2
	FY21	5.3 (h)	7.3	3.3
Exchange rate depreciation (%)	FY06	9.4	9.4	9.4
	FY21	5.0 (h)	6	4
Share of priority spending to GDP (%)	FY06	12.1	12.1	12.1
	FY21	17.1	17.1	17.1
Share of government revenues to GDP (%)	FY06	10.7	10.7	10.7
	FY21	15.7 (h)	12.7	18.7

service-to-revenue ratio. The actual initial conditions for FY06 and the baseline macroeconomic scenario which is mostly based on an indicator's historic averages (h) of FY02-FY06 are provided in Figure 8.¹⁶

The parameter values for the pessimistic and optimistic scenarios are arbitrarily set simply for illustrations for how sustainable Bangladesh's fiscal debt is under different macroeconomic scenarios;

they are not based on any probability, predications or value judgment. The point is to have some comparisons to the baseline scenario, though the relative changes across indicators (see Table 4) are based on basic macroeconomic theory, that is, the pessimistic scenario shows lower GDP growth combined with lower export growth, higher inflation rates, a higher exchange rate depreciations, and lower shares in government revenues to GDP; and similarly, the optimistic scenario shows higher GDP

Figure 9: Results of the baseline, pessimistic, and optimistic scenarios



growth combined with higher export growth, lower inflation rates, lower exchange rate depreciations, and higher shares of government revenues to GDP.

Results

The results for these three scenarios are graphically presented in Figure 9, showing the three different evolutions of the NPV debt-to-GDP ratios, the NPV debt-to-revenue ratios, and the debt service-to-revenue ratios for each of the three scenarios, clearly reflecting the baseline, pessimistic, and optimistic scenarios. The different results for each of the three fiscal debt sustainability indicators are due mostly to the change in the GDP growth rates and the change in the revenue to GDP ratios. The changes in inflation rates and depreciation rates influence the results only marginally. The change in export growth rates has no effect on these three indicators, though it has a major impact on external debt sustainability indicators (see Gunter 2008).

Discussion

We limit our discussion here to two important points. First, comparing the results with other low income countries, Bangladesh is actually one of the highest indebted countries in terms of both NPV debt to government revenues and public debt service to government revenues.¹⁷ Most of studies analyzing Bangladesh debt sustainability¹⁸ as well as most international comparisons focus incorrectly on either external debt (leaving out domestic debt) or on public debt-to-GDP levels. The exclusion of domestic debt and the wrong focus on public debt-to-exports or public debt-to-GDP is partly due to data constraints and partly due to a fundamental misconception. As has been explained in more details in Gunter (2003 and 2007), since the public debt will need to be paid by government revenues, the public debt-to-government revenue ratio is the most appropriate indicator to analyze a country's public debt sustainability. The only reasons why Bangladesh did not qualify for HIPC debt relief are due to a) Bangladesh's substitution of external debt with domestic debt (which started in the early 1990s), and b) the HIPC framework's focus on external public debt sustainability.

Second, as the pessimistic scenario (the bold dashed lines in Figure 9) shows, relatively small deteriorations in the macroeconomic scenario can easily threaten Bangladesh's fiscal sustainability. Keeping in mind that Bangladesh is a highly disaster prone country and that disasters are likely to increase due to climate change, the cancellation of

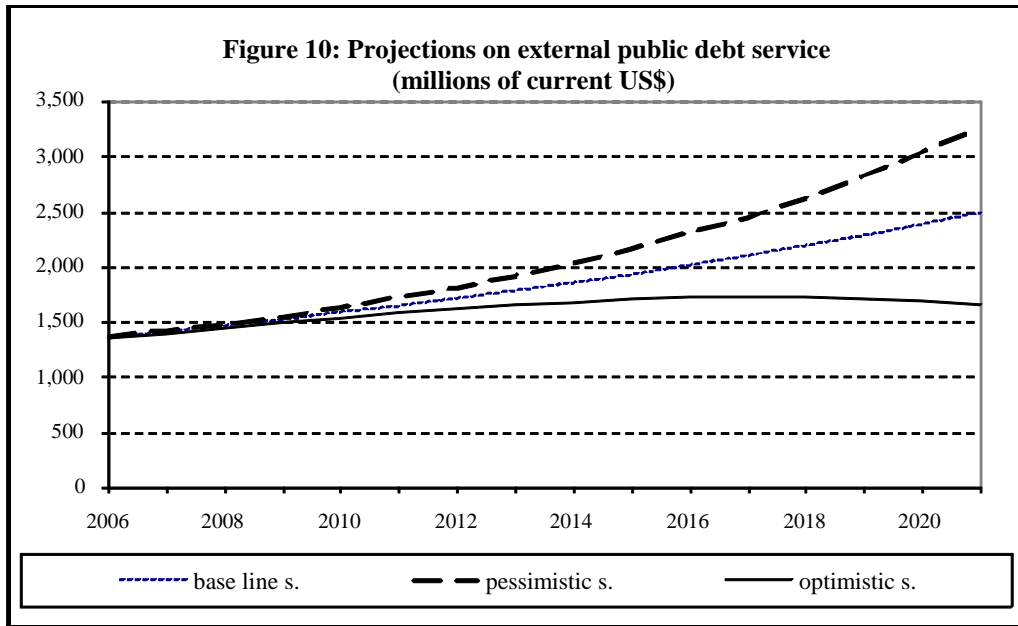
Bangladesh's external public debt would not only serve as a shock absorber but also allow Bangladesh to use its scarce resources to achieve the MDGs. While Bangladesh is unlikely to face an unsustainable debt in macroeconomic terms, if approaching debt sustainability from a human and social development perspective, Bangladesh's debt is no sustainable simply because Bangladesh has more urgent needs to reduce poverty than to make external debt service payments amounting even in the optimistic scenario to more than US\$1.5 billion every year over the next 12 years (see Figure 10).

Indeed, given that total public debt service payments amount currently to about 100 percent of government revenues, it is clear that these debt service payments can only be made as old debt is replaced by new debt, i.e. principal as well as interest payments are mostly covered by new loans. The cancellation of Bangladesh's external debt would also be justified based on equity issues as considerable amounts of debt have been canceled under recent debt relief initiatives to less poor and less indebted countries if defining poverty and indebtedness more appropriately, see Gunter (2003 and 2007).¹⁹

Debt Sustainability Versus Development

This section analyzes the implications on debt sustainability if Bangladesh would initiate an ambitious government-led investment strategy targeted at eliminating poverty, accelerating broad-based sustainable development, and preparing the country for the negative implications of climate change. We use the MDG-costing as an approximation of the costs for such a strategy, which as mentioned above, has been put at US\$8 billion per year. There obviously are many assumptions and uncertainties related to this figure, yet, we will use it for illustrative purposes and apply it over the whole 15-year projection period of the debt projection module.

In terms of government spending, the US\$8 billion annual investment strategy would imply an initial increase in the share of the primary spending to GDP of about 13 percentage points. With optimistic GDP growth rates of about 8 percent per annum and an initial GDP of about US\$62 billion, the 13 percentage points increase in primary spending to GDP would fall to a 5 percentage points increase in primary spending to GDP in 2021. Given that the share of primary spending to GDP amounts currently to 12.1 percent of GDP, the share of primary spending including the investment strategy would slowly decrease from 25.1 percent of GDP in the initial year



to 17.1 percent of GDP at the end of the projection period in 15 years.

Alternative Financing Scenarios

Given the limitations Bangladesh faces to raise revenues to finance such an investment strategy (reflected in an accelerated increase in the percentage of revenues to GDP), most of these expenditures would initially be covered by loans and grants, whereby we consider two illustrative scenarios as follows:

- i. the debt scenario assumes that the resulting financing gap in the government's budget would be covered exclusively by debt financing (keeping the shares of external and domestic financing unchanged);
- ii. the grant scenario assumes that half (US\$4 billion) of the annual costs would be covered by external grants provided by Bangladesh's development partners, while the other half would be debt-financed (keeping the shares of external and domestic financing unchanged).

While such an ambitious investment strategy would obviously affect all other macroeconomic parameters, we limit the parameter changes to GDP growth, inflation, interest rates, exchange rate depreciation, and the share of government revenues to GDP (see Table 5). These parameter changes are once again not based on any estimation, predication or value judgment, but simply chosen for illustrative purposes, though keeping some basic macroeconomic theory in

mind.

Results

The simulation results provided in Figure 11 below show that Bangladesh would obviously experience a significant increase in debt, but that—at least for the parameters chosen—the debt ratios would start to fall (i) after about 10 years under the debt scenario, and (ii) after about 7 years under the grant scenario. The three graphs of Figure 11 also show that at the end of the projection period (FY21), debt ratios would remain considerably above the initial values under the debt scenario, while they would come down to the initial levels under the grant financing strategy.

Discussion

While a much more detailed analysis would be needed to draw detailed policy conclusions, the simulations seem to indicate that some acceleration of Bangladesh's development strategy might be considered as long as the increase in debt levels is clearly limited and temporary. The problem is that there are no clear criteria of what constitutes an acceptable increase in debt levels for any given country. Recent empirical work has shown that debt distress levels are lower for countries that have better policies and institutions compared to countries that have worse policies and institutions, whereby the quality of policy and institutions has been determined by the World Bank's country policy and institutional assessment (CPIA). While there remain doubts about the appropriateness and objectivity of the World

Table 5: Alternative Financing Scenarios of a Government-led Investment Strategy to Achieve the MDGs

		baseline scenario	all debt scenario	50% grant scenario
GDP growth rate (%)	FY06	6.6	7.6	8.6
	FY21	5.7 (<i>h</i>)	5.7 (<i>h</i>)	5.7 (<i>h</i>)
Exports growth rate (%)	FY06	17.7	17.7	17.7
	FY21	8.3 (<i>h</i>)	8.3 (<i>h</i>)	8.3 (<i>h</i>)
Inflation rate (%)	FY06	7.2	9.2	8.1
	FY21	5.3 (<i>h</i>)	5.3 (<i>h</i>)	5.3 (<i>h</i>)
Exchange rate depreciation (%)	FY06	9.4	11.4	10.4
	FY21	5	5	5
Share of priority spending to GDP (%)	FY06	12.1	25.0	25.0
	FY21	17.1	17.1	17.1
Share of government revenues to GDP (%)	FY06	10.7	13.7	13.7
	FY21	15.7 (<i>h</i>)	15.7 (<i>h</i>)	15.7 (<i>h</i>)
Grants to the central government (US\$ million)	FY06 level	0	0	4,000
	FY06 growth	0	0	0
	FY21 growth	0	0	0

Bank's CPIA, there is broad agreement that better policies and better institutions lower the risk of a country to face debt distress. This broad agreement on the linkage between policies and debt distress has been operationalized in the joint World Bank-IMF debt sustainability framework (DSF) to determine country-specific debt-burden thresholds.

However, the DSF makes no adjustments in a country's borrowing constraints due to development achievements. In other words, the DSF does not contribute to reducing the tension between (a) debt-financing national development strategies to achieve the MDGs and (b) maintaining debt sustainability. Given this shortcoming, Gunter (2007) has suggested to adopt a new MDG-consistent debt sustainability concept, which would allow a country to increase its borrowing limits within certain limits as long as it makes progress with achieving the MDGs. The basic rationale behind the MDG-consistent debt sustainability is that progress made towards achieving the MDGs can be considered an asset for an economy, similar to the asset of having good policies and institutions. The econometric evidence for the appropriateness of such an MDG-consistent debt sustainability concept has been provided by Gunter, Rahman and Shi (2009).

For example, a country that has achieved universal primary education is likely more debt sustainable than a country in which only 50 percent of children go to school. Hence, instead of linking borrowing

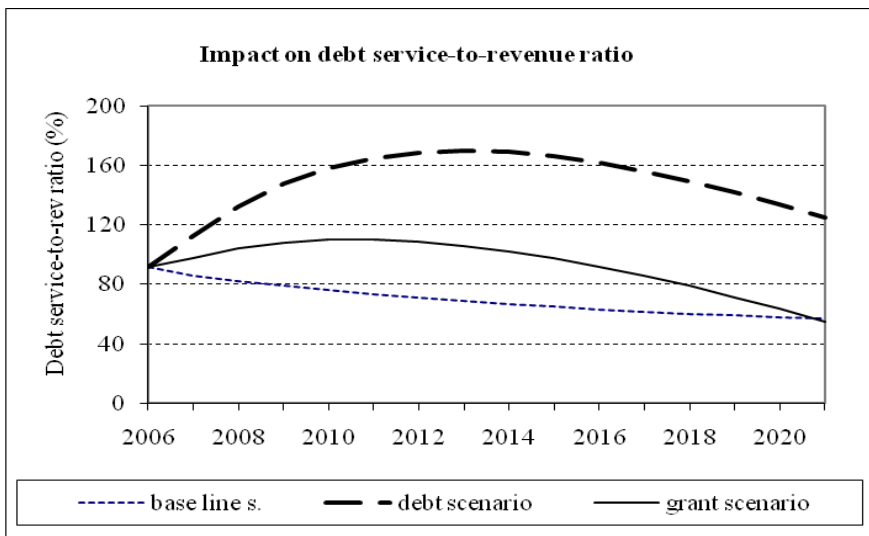
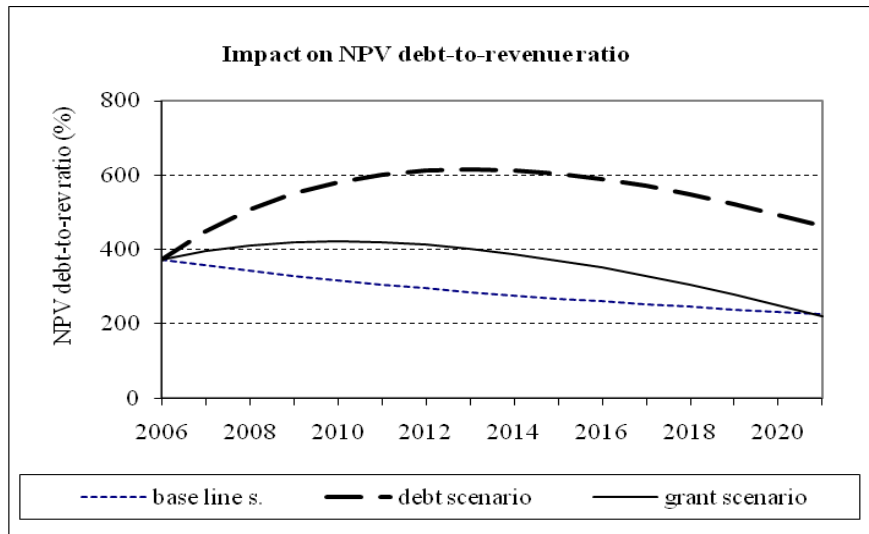
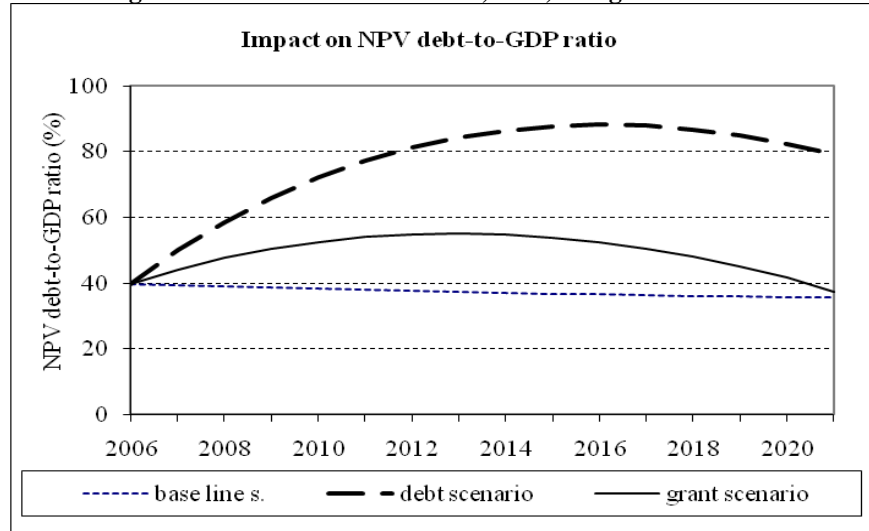
limits to possibly biased assessments of a country's policies and institutions, the linkage to MDG achievements would be more objective. Bangladesh could use the fiscal space that is provided by switching to an MDG-consistent debt sustainability concept, which would allow Bangladesh to accumulate a) new debt in the amount of US\$9.9 billion in the first year of the investment strategy, and b) additional new concessional loans in the amount of about US\$1.1 billion a year, while following the debt path of the baseline scenario, that is, reducing her MDG-consistent NPV debt to GDP ratio from 40 percent in FY06 to 35.7 percent in FY21.

Conclusions and Recommendations

First, we have shown that the share of aid allocations to Bangladesh has fallen considerably over the last 20 years, from 4.4 percent of all ODA provided to all developing countries in 1987 to 1.2 percent in 2006, and possibly even below 1 percent in 2007. Both, the reduction in aid flows as well as not having used the aid received in the most effective way imply that Bangladesh paid a high price in terms of foregone development opportunities.

Second, while the switching from external financing to domestic financing improved Bangladesh's external debt sustainability, it also implied that Bangladesh missed to qualify for any of the recent debt relief initiatives and is therefore today one of

Figure 11: Results of the baseline, debt, and grant scenarios



the highest indebted LDCs, especially if measuring indebtedness by the NPV debt to government revenues and by public debt service to government revenue ratios. Furthermore, while Bangladesh is likely to remain debt sustainable if Bangladesh continues to grow at current rates, the servicing of Bangladesh's public debt implies a high fiscal burden for decades to come. Indeed, considering debt sustainability from a human development approach, Bangladesh's debt is clearly not sustainable.

Third, as was shown with the pessimistic scenario, slightly less favorable macroeconomic circumstances than what Bangladesh is currently experiencing could seriously threaten Bangladesh's long-term debt sustainability. Furthermore, debt sustainability would also be compromised if embarking on an ambitious public-investment-led poverty elimination strategy, unless at least half of these investments would be covered by grants.

Fourth, even with a significant share of such an investment strategy covered by grants, all debt ratios would increase on a temporary basis, and unless debt sustainability is defined with an MDG-consistent debt sustainability concept, it is unlikely that there would be sufficient domestic as well as external support for an accelerated poverty reduction strategy. Hence, there is need to undertake more empirical research on MDG-consistent debt sustainability such that the concept can be applied to satisfy both a sustainable debt as well as achieving the MDGs.

Fifth, though White and Dijkstra with van Donge (2003, p. 65) have warned that "a further reduction in aid to Bangladesh would lead to lower imports, and would bring about higher inflation and higher interest rates would probably also reduce growth," aid flows to Bangladesh continued to decrease in recent years. Taking recent changes in international aid and debt frameworks into account, aid to Bangladesh may likely continue to decrease in the future. Worse, most of the aid may not be provided as grants, unless more emphasis is put on fiscal implications of Bangladesh's debt. Hence, more efforts are needed to increase as well as to improve the provision of aid to Bangladesh and to increase the share of grants.

Sixth, taking Bangladesh's record of achievement into account, Bangladesh should be "fast-tracked" for a rapid scale-up of aid, whereby the development agenda and development policies need to be designed based on a broad majority of domestic stakeholders. As Levy (2007, p. xxxii) has pointed out, "Bangladesh is perhaps the best-known example of a country with relatively weak perceived control of

corruption, but strong performance on policies and on poverty reduction." Furthermore, Levy (p. xxxv) stresses that "development partners need to take the different government trajectories into account and to engage, on a long-term basis in strengthening lagging elements of the governance system." Lessons of experience show that when reforms are imposed from abroad, even as a quid pro quo for aid, they are not sustainable. This is an important lesson that has now become well-accepted in the donor community, though it will obviously take more time until donors and recipient countries fully adhere to this lesson.

Seventh, while aid critics refer to the non-robust association between aid and growth, the UN Millennium Project Report (2005, p. 41) pointed out that there are a variety of explanations for non-robust association between aid and growth. For example, given that food aid is usually given in the midst of deep crises, "a regression of economic growth on food aid would tend to prove (erroneously) that aid causes output to decline, instead of the correct conclusion that an output decline (caused by drought, for example) causes emergency aid to raise!" Taking recent efforts of making aid more effective into account, we should be more optimistic that aid can be effective as well as work together to make it more effective, instead of continuing to be pessimistic about the impact of aid.

Eighth, while aid critics have voiced concerns about negative macroeconomic implications of a scaling up of aid, experience has shown that there is no evidence for such concerns for low-income countries. The way forward is twofold. First, minimize possible future Dutch disease effects by spending aid on productivity enhancing public investment and by central banks providing the flow of low-cost credit to stimulate private investment that usually takes care of the absorption component in the current account. Second, minimize domestic capacity constraints by removing specific supply bottlenecks, e.g., lack of infrastructure or skilled personnel. Again, public investment can play a central role in this effort.

Finally, none of the above recommendations imply that Bangladesh should emphasize aid over trade. There is no doubt that the elimination of current trade restrictions on Bangladeshi exports will benefit Bangladesh much more than any increase in aid. However, the important point is that aid and trade are not excluding each other but can instead be mutually enforcing Bangladesh's broad-based sustainable development.

Endnotes

1. Based on the Human Development Report 2007/2008, Bangladesh ranks 140th among 177 countries for the Human Development Index and 138th among 174 countries for PPP-adjusted income per capita. There are three countries (Afghanistan, Liberia, and Somalia) for which these statistics are not available, though it is clear that they are worse than for Bangladesh.
2. While the poverty rate is today higher in the nine Sahelian countries than in Bangladesh, their population is only about half of that of Bangladesh's population. See U.S. Agency for International Development Fact Sheet of August 2005:
<http://www.usaid.gov/press/factsheets/2005/fs050803.html>.
3. For example, based on Akram, Mahmud and Iftekharuzzaman (2007), a need assessment by leading ministries estimated that US\$2.2 billion will be needed to cover the damages caused by cyclone Sidr.
4. Unless otherwise noted, all data relating to net ODA, gross national income (GNI), GNI per capita, and net ODA/GNI is taken or calculated from the OECD (2007a) and Roodman (2008).
5. Based on UN Millennium Project (2005) calculations, average investments needed per person over a ten-year period (2006-2015) to meet the MDGs amount to US\$1047, of which current spending (including grants and loans) cover less than half, leaving a MDG financing gap of US\$587 over a ten year period, or about US\$59 per year and per person. Hence, additional investments needed per year to achieve the MDGs in Bangladesh would amount to about US\$8 billion, which is nearly 7 times the aid level Bangladesh currently receives (US\$1.2 billion in 2006). It should be stressed that the funds for such a nearly 7 times increase in aid levels to Bangladesh as well as for similar increases to other needy countries would be easily available if the international donor community would make good on the long-standing goal of providing 0.7 percent of GNI as aid.
6. See Faaland (1981).
7. The headlines typically ignored that Transparency International (TI) ranked only 91 countries and that TI stressed that the result for Bangladesh needs to be viewed with caution as there were only three independent survey sources available for Bangladesh, with each of it yielding very different results.
8. What began as efforts to harmonize aid and aid policies at the turn of the Millennium was then extended to also include efforts to improve the alignment of aid at the High-Level Forum in Rome in early 2003. Furthermore, a new institutional architecture, coordinated by the OECD DAC Working Party on Aid Effectiveness and Donor Practices has then emerged at the Paris High Level Forum in March 2005 to the so-called Paris Declaration on Aid Effectiveness, which centers on improving the effectiveness of aid via five key dimensions: ownership, aid alignment, aid harmonization, managing for results, and mutual accountability.
9. See Natural Resources Planners Ltd. (2008), page 7.
10. See for example McKinley (2005).
11. It is important to stress that these two cases of additionality should not be confused with the question about the additionality of DR for a DR receiving country. The question of the additionality of DR for a DR receiving country can only be addressed properly after taking possible reallocations in traditional aid into account. The cases of zero and full additionality of resources by creditors determine the total aid envelope, of which a part will be provided in terms of DR and the other part in terms of traditional aid.
12. There are two extreme answers to this question: Zero reallocation of the HIPC's traditional aid is defined as donors continuing to give the same amount (not necessarily the same share) of traditional aid to HIPC's as before providing DR, independently of whether DR is additional or not. Full reallocation of the HIPC's traditional aid is the opposite of zero reallocation. When fully reallocating the HIPC's traditional aid, donors would subtract the exact amount of DR from the HIPC's traditional aid. Hence, in this case, DR cannot be additional for the group of HIPC's; it may however be additional at the aggregate level (in terms of aid and DR to all aid recipients). As will be shown below, the case of

full reallocation of the HIPC's traditional aid does not necessarily imply that the aid provision to non-HIPCs will increase as that depends on the degree of additionality at the creditors' level.

13. See IMF and IDA (2005).
14. Unless otherwise noted, all data for this section has been taken from three IMF Country Reports and/or their corresponding Statistical Annexes for Bangladesh, see IMF (1998), IMF (2003), and IMF (2007). Fiscal data refers as reported in IMF Country Reports to central government operations, which excludes grants that are provided directly to sectoral ministries as well as some debt to public corporations. The inputs and results of this section are consistent with the excellent analysis provided by Islam and Biswas (2006) who provide further details on the sources of Bangladesh's debt but limit their debt sustainability analysis to the debt to GDP ratio.
15. A more detailed analysis of Bangladesh's debt sustainability is provided by Gunter and Rahman (2008).
16. All initial values as well as all values for t_0 are based on actual data for FY06, except the discount rates, which are set at 5% for the external debt and equal to the public debt interest rate for the domestic debt in order to avoid any distortions in the NPV calculation. The values for t_{15} are either based on historical averages of FY02-FY06 or set equal to the t_0 values in cases where historical data is not easily available, except the primary spending to GDP ratio for FY21, which is consistent to the revenue to GDP ratio for FY21 set 5 percentage points higher than the FY06 values. The increase in the revenue to GDP ratio reflects the historical trend of FY02-FY06, where the revenue to GDP ratio increased by about 1.6 percentage points, hence 5 percentage points over a 15 year time period.
17. While the full extent of Bangladesh's relative high debt-to-government revenue ratios will only become clear once the 2007 debt data (i.e., post MDRI) is available for similarly poor countries, the conclusion can already be drawn by comparing the ratios of external to domestic public debts of Bangladesh with those of the African HIPCs, see Table 10 of UNTAD (2004).
18. See International Monetary Fund and International Development Association (2008); Islam (2007); Islam and Biswas (2006); and Prasad, Velandia-Rubiano and Kanani (2008).

19. These include the HIPC Initiative, post-HIPC Paris Club debt relief, and Multilateral Debt Relief Initiative (MDRI), whereby the MDRI has been based on the human development approach to debt sustainability as it provided 100% debt relief on certain debts of MDRI eligible countries.

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