

# Macroeconomic Management From Stabilisation to Growth?

*This paper examines Bangladesh's macroeconomic performance in the light of market-oriented liberalising policy reforms. By looking at the trends in fiscal, external and investment-savings balances, it analyses how, despite falling inflows of foreign aid, Bangladesh achieved macroeconomic stabilisation and an acceleration of economic growth in the 1990s. The paper concludes that for consolidating the transition from stabilisation to growth, improvements are needed in many areas such as revenue mobilisation, the efficiency of the financial system and the overall investment environment.*

**WAHIDUDDIN MAHMUD**

## I

### Background

The macroeconomic scene in Bangladesh, since the early 1970s, has undergone successive shifts in terms of policy environment, often linked with change in the ruling political regime. In the early years following the War of Liberation in 1971, macroeconomic management was primarily aimed at reviving a war-ravaged economy in an overall framework of extensive state control and with an avowed ideology of socialism.

The state became the de facto owner of a large number of enterprises that had been abandoned by their Pakistani owners. After the killing of Sheikh Mujib and the change of government, there was a policy shift towards privatisation and promotion of the public sector. The denationalisation of abandoned enterprises continued with varying speed into the 1980s when a second wave of divestment was initiated under the military government of general Ershad.

From the late 1970s to the beginning of the 1980s, there was a short-lived episode of investment boom, with investment in both public and private sectors growing at nearly 15 per cent annually in real terms [Mahmud 1995]. This was made possible by relying on an increasing flow of foreign aid and adopting a privatisation strategy based on lavish dispensation of cheap credit and provision of other incentives such as highly protected markets for domestic industries. To a large extent, latter-day problems regarding so-called 'sick' industries and the large-scale default of bank loans originated from this experiment with aid-dependent state-sponsored private capitalism.<sup>1</sup> There was no mobilisation of domestic savings and the investment boom ended abruptly when the external aid climate severely deteriorated in the early 1980s.

A major change of direction occurred in the early 1980s with the adoption of market-oriented liberalising policy reforms undertaken along the guidelines of the World Bank and IMF and implemented under fairly rigid aid conditionality. These reforms were initiated against the backdrop of serious macroeconomic imbalances, which had been caused in part by a decline in foreign aid and, in part, by a preceding episode of severe deterioration in the country's terms of trade. The beginning of the 1990s saw the launching of a more comprehensive programme of macroeconomic reforms, which coincided with a transition to parliamentary democracy from a semi-autocratic rule. While the macroeconomic restructuring has had considerable success in

stabilising the economy, the long-awaited transition from stabilisation to growth has yet to gather pace, although some beginnings appear to have been made during the 1990s.

## II

### Trends in Macroeconomic Indicators

The reforms initiated in the 1980s were aimed at reducing fiscal and external deficits to a sustainable level, consistent with the reduced level of aid availability.<sup>2</sup> The trends in various macroeconomic indicators over the last two decades are shown in Table 1. During the 1980s, the fiscal deficit came down from 6.6 per cent of GDP in the first half of the decade to 5.4 per cent in the second half, while the external current account deficit was reduced from 6.7 per cent to 4.7. But this success was achieved at some cost. The macroeconomic balances were improved not so much by raising revenue or exports, but by squeezing expenditure on the fiscal front and imports on the external front. Thus, between the two halves of the decade, the tax-GDP ratio barely increased, while development expenditure as a percentage of GDP declined from 6.6 per cent to 5.4 per cent. Similarly, export revenue as a percentage of GDP barely increased, while the import-GDP ratio declined from 14.3 per cent to 12.8 per cent. Thus, as in the case of most other early experiments in structural adjustment, the attempt to achieve macroeconomic stabilisation in Bangladesh in the 1980s was made along the contractionary route.<sup>3</sup>

The policy reforms in the 1980s included mainly the withdrawal of food and agricultural subsidies, privatisation of state-owned enterprises, financial liberalisation, and withdrawal of quantitative import restrictions. The reforms of the early 1990s were particularly aimed at moving towards an open economy - such as making the currency convertible on the current account, reducing import duties generally to much lower levels, and removing virtually all controls on the movements of foreign private capital. Besides, fiscal reforms were undertaken including the introduction of the value added tax.

The launching of wide-ranging policy reforms in the beginning of the 1990s was followed by some positive developments in the macroeconomic scene. There was a marked improvement in the government's budgetary position, particularly in terms of increased revenue mobilisation in the early 1990s. While the net inflow of foreign capital further declined to around 2 per cent

of GDP, both investment and saving rates steadily improved, thus paving the way for superior growth performance. The ratio of investment to GDP, which had stagnated at less than 17 per cent in the 1980s, increased to about 23 per cent towards the end of the 1990s. This increase was almost entirely due to the dynamism in private investment, which has risen from less than 10 per cent of GDP to about 16 per cent since the late 1980s, with the investment rate in the public sector remaining almost unchanged at around 6 to 7 per cent of GDP.

The growth of GDP, which averaged 3.7 per cent annually during the 1980s, increased to 4.4 per cent in the first half of the 1990s, and further to 5.2 per cent in the second half. Meanwhile, due to robust and sustained growth in export earnings, the export-GDP ratio increased from less than 6 per cent in the later half of the 1980s to the current level of above 15 per cent. With the accompanying increase in imports, the trade openness of the economy (that is, the combined ratio of imports and exports to GDP) neatly doubled during the same period.

All this was achieved along with remarkable success in keeping inflation under control. In the first half of the 1980s, the average annual rate of inflation as measured by the consumer price index was ominously high at 13 per cent. It is only the contractionary effect of structural adjustment of that period that brought inflation down - to around 8 per cent in the second half of the decade. During the 1990s, there was further decline in the inflation rate - down to 5.6 per cent in the first half of the decade and 5.8 per cent in the second, and this time the reduction was achieved despite the relative buoyancy of the economy, as compared to the preceding decade. The 1990s thus saw positive developments on several fronts: transition to parliamentary democracy, strengthening of economic growth performance, and consolidation of

economic stabilisation in the face of declining foreign capital inflow. This said, there were some periodic lapses in macroeconomic discipline – particularly related to the timing of approaching national elections - thus producing the symptoms of the so-called 'political business cycle'.<sup>4</sup>

Despite the overall soundness of these macroeconomic trends, there were some disconcerting features. While the increase in the investment rate was entirely led by private investment, there were some symptoms of a feeble investment response to policy reforms. In the early 1990s, for example, the marked increase in the domestic savings rate found no commensurate response from private investment, producing a situation of aggregate demand deficiency. This was evident from a sharp fall in the inflation rate to near zero, along with a fall in private sector credit expansion and an unprecedented build-up of international reserves [Mahmud 2001]. It is difficult to ascertain whether the rapid reduction in industrial protection achieved through import Liberalisation at that time played a role in this. The uncertainty created by these reforms, which had no pre-announced targets or timetable, could have been a contributing factor as well.

There were other episodes of stagnation or decline in investment in manufacturing.<sup>5</sup> Thus, apart from the resource constraint on investment growth, the 'desire to invest' factors may have become important in the post-reform era, particularly because of the withdrawal of public investment from directly productive sectors. This problem may have much less to do with the structure of industrial incentives than with the overall investment climate. The factors that discourage investment in Bangladesh are well documented, including poor infrastructure, a weak financial system, corrupt and inefficient bureaucracy, collection of illegal protection money, and an inadequate legal system. These factors

**Table 1: Macroeconomic Balances, 1980-81 to 2001-02**

(In percentages of GDP at current market prices)

	5 - Year Averages				Annual		
	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-2000	1999-2000	2000-01	2001-02
<i>External sector</i>							
Exports of goods and services	5.4	5.6	8.6	12.7	14.0	15.4	16.9
Imports of goods and services	14.3	12.8	12.6	17.3	19.2	21.5	22.8
Trade deficit	8.9	7.2	5.4	6.2	5.2	6.1	5.9
Workers' remittances <sup>1</sup>	2.7	2.9	2.9	3.6	4.7	4.5	5.8
Current accounts deficit <sup>2</sup>	6.7	4.7	2.1	1.9	1.1	2.3	-0.4
<i>Investment and Savings</i>							
Gross Investment	16.9	16.6	17.9	21.5	23.0	23.1	23.1
Public	4.8	6.1	6.7	6.8	7.4	7.2	6.4
Private	12.1	10.4	11.3	14.7	15.6	15.8	16.8
Gross domestic savings <sup>3</sup>	8.00	9.4	12.5	15.3	17.9	17.0	17.2
Gross national savings <sup>4</sup>	10.7	12.3	15.5	18.9	22.3	20.8	23.
<i>Government Budget</i>							
Total revenue	6.3	6.7	8.6	9.0	8.4	9.0	10.2
Tax revenue	5.2	5.4	6.9	7.2	6.7	7.6	7.7
Current expenditure	4.6	6.0	6.5	7.2	7.5	7.7	8.0
Development expenditure <sup>5</sup>	6.6	5.4	5.6	5.7	5.4	6.5	5.6
Total expenditure <sup>6</sup>	12.9	12.2	13.4	13.4	13.2	14.8	14.3
Budget deficit	6.6	5.6	4.8	4.4	5.1	5.1	4.7
Domestic borrowing <sup>7</sup>	1.0	0.5	0.8	1.9	2.7	3.1	2.5
Foreign financing <sup>8</sup>	5.6	5.0	4.0	2.5	2.4	2.0	2.1

**Notes:**

<sup>1</sup> Remittances from Bangladeshi, workers abroad.

<sup>2</sup> Equals trade deficit minus net factor income from abroad; the latter includes private transfers (mainly remittances), interest payments on external public debt and other investment incomes. It differs from official estimates because it does not include official transfers (foreign aid as grants); a negative value implies surplus.

<sup>3</sup> Equals gross investment minus trade deficit; also equals gross national savings minus net factor income from abroad.

<sup>4</sup> Equals gross investment minus current account deficit.

<sup>5</sup> Expenditure under Annual Development Plan (ADP).

<sup>6</sup> Includes food account balance and certain capital expenditures and net lending not included in the development budget.

<sup>7</sup> Includes net borrowing from the banking system and net sale proceeds of savings certificates.

<sup>8</sup> Includes grants and concessional loans net of amortisation.

Budgetary figures are the realised actual and may differ from official ones because of the data reconciliation done by the World Bank and IMF.

Sources: Various publications of the World Bank, IMF, Bangladesh Bank and Bangladesh Bureau of Statistics.

Also inhibit the inflow of foreign private investment, which remains insignificant despite Bangladesh's liberal policies.<sup>6</sup>

It is noteworthy that in some years, the inflation in price indices of domestically produced industrial goods was near zero (Table 2). While low inflation is a measure of successful stabilisation, it may also be in part a symptom of aggregate demand deficiency. In the latter case, production contraction can happen in some parts of the economy if prices are not flexible downward, which may be the case not only for industrial production but also for many subsistence type activities where the price (of the service or the product) may be determined somewhat inflexibly like the so-called subsistence wage. The problem of pushing inflation too low is that it can result in a hit or miss situation if the aim is not to adversely effect capacity utilisation envisaged in the presence of downward inflexible prices, particularly at a time when trade liberalisation policies are aiming at bringing about large relative price changes.

The experience of macroeconomic management in the 1990s also shows the fragility of the country's balance of payments, notwithstanding impressive export growth. Periods of marked dynamism in investment and industrial activity turned out to be short-lived, limited by the balance of payments constraint and resulting in the depletion of foreign exchange reserves. This was true of the two episodes of mini-boom that took place around 1994-95 and 2000-01. In both cases, there was an upturn in large-scale manufacturing production associated with a rapid expansion of private sector credit and high growth in the import of capital goods and industrial inputs (Table 2). In both cases, external deficits increased and foreign reserves sharply diminished, until stabilisation measures stifled the growth of investment and manufacturing.

The above phenomenon is reminiscent of a dominant 'trade gap' in the erstwhile popular two-gap model of foreign aid.<sup>7</sup> It reflects the highly import-intensive nature of investment and manufacturing activities in Bangladesh, where most capital goods

are imported, domestic manufacturing depends heavily on imported raw materials, and intermediate goods and finished consumer goods account for less than 10 per cent of all imports. There seems to be thus little room for adjusting to lower import growth without subduing investment demand or creating capacity underutilisation in the economy.

There were also other adverse factors limiting the prospects of an economic upturn. Political unrest and natural disasters like floods severely disrupted the economy from timetotime [Mahmud 2002]. The effectiveness of public development spending was compromised by widespread corruption and inefficiency in project implementation. Again, because of the inefficient banking system, there was apprehension that a large part of any increased flow might turn into bad loans. The surge in credit disbursements had therefore to be restrained, not only to keep monetary expansion within safe limits, but also to prevent a further deterioration in banking discipline.

While domestic savings show healthy trends since the early 1990s, it is not easy to explain these trends. The determinants of domestic saving mobilisation are poorly understood in Bangladesh. One visible source of the increase in the savings rate in the early 1990s was the significant improvement in the government's budgetary position resulting in a likely increase in public savings. The surplus of revenue earnings over current expenditures clearly increased in that period (Table 1).<sup>8</sup> But this cannot explain the continued increase in domestic savings since. In fact, one may be tempted to conclude from the experience of recent years that if investment demand were to rise, matching savings would be forthcoming. However, there are uncertainties about these saving estimates. These are derived indirectly from the investment estimates (Table 1), which themselves suffer from many methodological and data deficiencies. Also, in the years, the official estimate of export earnings is suspected to have had an increasingly upward bias, thus resulting in a possible underestimation of the external current account deficit. This would

**Table 2: Annual Percentage Change in Select Macroeconomic Indicators, 1990-91 to 2002-03**

	1090-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
<i>Real GDP (at market prices)</i>	3.34	5.04	4.57	4.08	4.93	4.62	5.39	5.23	4.87	5.94	6.04	4.4	5.3
<i>Crop agriculture</i>	0.84	1.11	0.97	-1.66	-3.42	1.74	6.44	1.07	3.11	8.10	4.10	-2.5	3.0
<i>Manufacturing</i>	6.38	7.38	8.62	8.15	10.48	6.41	5.05	8.54	3.19	4.76	9.10	5.5	6.8
Large scale	6.02	7.34	9.00	8.25	11.44	5.67	3.97	9.28	4.19	4.35	9.75	4.6	6.6
Small scale	7.28	7.48	7.70	7.88	8.10	8.28	7.75	6.77	0.75	5.80	7.46	7.7	7.2
<i>Inflation index:</i>													
National CPI <sup>1</sup>	8.3	4.6	2.7	3.3	8.9	6.7	2.5	7.0	8.9	3.4	1.6	2.4	5.1
Food	8.1	4.2	1.9	2.9	9.3	7.0	1.4	7.1	11.8	4.1	0.9	1.2	4.9
Non food	8.7	5.3	4.3	3.9	8.2	5.8	4.8	6.7	4.0	3.4	2.8	4.5	5.5
Domestically produced													
industrial goods <sup>2</sup>	12.7	7.0	1.3	0.6	na	na	5.2	8.9	1.5	1.1	2.1	n.a.	n.a.
Money supply (M2)	12.1	14.1	10.6	15.4	16.11	8.26	10.8	10.2	12.8	18.6	16.6	13.1	15.6
Private sector credit (net) <sup>3</sup>	11.4	7.3	11.3	8.5	23.6	22.6	12.2	13.0	13.8	10.8	16.9	14.4	14.9
Merchandise exports (US\$)	12.7	16.0	19.6	6.3	37.1	11.8	14.0	16.8	3.0	8.3	12.4	-7.4	9.4
Merchandise imports (US\$)	-7.4	0.5	15.5	2.9	39.2	17.0	3.1	5.1	6.6	10.5	11.4	-9.3	13.0
Of which: capital goods	-5.0	4.7	4.4	-3.4	29.9	6.0	-1.6	7.0	-5.0	8.3	18.0	4.1	4.5
Exchange rate (nominal) <sup>4</sup>	8.3	7.0	2.6	2.2	0.5	1.7	5.7	6.4	6.9	4.7	7.3	6.4	0.8
<i>Memorandum items</i> <sup>5</sup>													
Real exchange rate <sup>6</sup>	98.8	92.2	91.8	91.2	92.4	92.1	96.6	104.8	103.3	102.2	101.0	98.7	Na
Foreign exchange reserve: <sup>6</sup>													
in billion US dollar	0.88	1.61	2.12	2.77	3.07	2.04	1.72	1.74	1.52	1.60	1.31	1.58	2.47
in months' equivalent of import <sup>7</sup>	3.0	5.5	6.3	7.9	6.3	3.6	2.9	2.8	2.3	2.3	1.7	2.3	3.2

Notes: 1 Official general consumer price index of BBS (base: 1985-86=100).

2 Price index of domestically produced industrial goods (general) of BBS (base: 1988-89=100).

3 Growth of year-end netoutstanding bank credit to private sector; figures for 1991-92 and 1992-93are adjusted forthe loan write-offs made inthoseyears.

4 A positive change indicates depreciation of taka.

5 Index of real effective exchange rate of taka as estimated by IMF (base: 1990=100); a negative change indicates depreciation of taka.

6 Gross official reserves.

7 Import includes net non-factor service payments.

Source: Various publications of the World Bank, IMF, Bangladesh Bank and Bangladesh Bureau of Statistics.

the later years.<sup>9</sup>

### III Fiscal Policy and Public Expenditure

#### Budgetary Trends

The budgetary trends, as shown in Table 1, have some notable features. First, fiscal operations of the government had to be defined in the context of the steadily declining availability of foreign aid. The decline has been particularly rapid in the 1990s. Net foreign financing came down from 5 per cent of GDP in the second half of the 1980s to only 2.6 per cent in the second half of the 1990s. The overall budget deficit also shows a declining trend all along, although there was some recourse to increased domestic borrowing, especially in the late 1990s, in response to declining foreign financing.

Second, the revenue-GDP ratio increased significantly in the first half of the 1990s, by about 2 percentage points of GDP. Thus the challenge of reduced aid availability in the 1990s was met not by reducing expenditure but by improved revenue effort, and to a lesser extent by increased domestic borrowing. In fact, there was a slight increase in total government expenditure as a proportion of GDP - a reversal of the trend of the earlier decade.

Third, of the two broad components of government expenditure - current and development - it is current expenditure that has risen over the last two decades - from 4.6 per cent to 7.3 per cent of GDP. The increase was particularly sharp in the second half of the 1980s; since then the rise has been much more restrained. The transition to a democratic regime thus seems to have resulted in increased accountability, in respect of restraining the government's current expenditures. As regards the development budget, its size as a proportion of GDP slightly increased in the 1990s, but it never fully recovered to the level of the early 1980s.

Overall, fiscal policy in the 1990s played a useful role in averting a potential contraction in demand in the face of declining foreign aid availability. Along with higher revenue mobilisation and some increase in domestic borrowing, the budget deficit was brought down a little and inflation was kept under control. The result was a reasonably stable macroeconomic environment, which allowed the real side of the economy to attain modest growth acceleration.

This said, fiscal management seems to have often played only a passive role as a tool of aggregate demand management. The government's development spending, being the flexible part of the budgetary expenditures, can potentially play a counter-cyclical role. In practice, this is hardly the case because of weak implementation and monitoring of the Annual Development Plan (ADP). Actual development spending usually falls short of the budgeted amount - in some year by very large margins - and about half of all development spending is usually incurred in the last quarter of the financial year. In the early 1990s, for example, when the economy seemed to be suffering from an aggregate demand deficiency, the government was unable to increase the size of the ADP [Mahmud 1995].

#### Public Spending Patterns

Public spending patterns have undergone significant changes in the last two decades, reflecting the changing developmental role of the government under the economic reforms. These changes

development spending, which is the flexible part of budgetary expenditure.<sup>10</sup> As can be seen from Table 3, allocations have fallen appreciably for a number of sectors - most notably, manufacturing industry, water resources, energy, and agriculture.

Allocations to manufacturing industries have been reduced to almost an insignificant proportion, showing that the government has virtually withdrawn from investment in setting up new industries. The sharp fall in allocations to agriculture in the latter half of the 1980s reflects the reduction or elimination of agricultural subsidies in that period. With the rapid expansion of tube well irrigation in the private sector, the proportion of allocations to water resource development has also declined. Also, the decline in investment in energy reflects increased reliance on private companies for the generation of electricity and for exploration activities. The reverse of this structural change in development spending is the increased proportional allocations to transport and communication, rural development and to social sectors, especially education.

Broadly speaking, one finds a close concordance between the accepted development strategy and the patterns and trends in public development expenditures. The government has gradually withdrawn from the directly productive sectors, while concentrating more on providing public goods in the form of education and health, physical infrastructure, and rural development. Two points, however, may be made at this stage regarding the above restructuring of development spending. First, the a priori rationale and the actual effectiveness of increased allocations to social sectors are two separate aspects, so that much will depend on whether the budget deficit was actually brought down a little and inflation was kept under control. Second, the structural shift in the budget, towards higher social spending, has come about from a redefinition of the role of the government and is, therefore, of a permanent nature. In future, higher allocations to social sectors will require more difficult reforms, for example, prevent ing tax evasion or downsizing the government.

It is worth taking a closer look at public expenditure on health and education by combining both current and development expenditure.<sup>11</sup> Table 4 shows the trends of public expenditure in education and health (including family planning), as shares of total budget expenditure and as percentages of GDP. It can be seen that the proportional allocation of education and health has continuously increased throughout the reform period, beginning from the early 1980s. Their combined share of total budgetary expenditure has gone up from 14 per cent to 23 per cent during this period. The increase has been particularly rapid for

Table 3: Sectoral Shares in Development Expenditure  
(In Percentages)

	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-2000
Agriculture	13.09	5.48	5.93	4.72
Rural development	3.51	2.59	5.40	9.14
Water resources	13.99	12.63	8.76	7.16
Industry	9.57	11.60	1.59	1.24
Energy	21.87	23.33	17.74	17.08
Transport and communication	15.34	10.71	118.82	21.96
Physical planning and housing	5.32	3.77	5.48	5.50
Education	3.97	4.40	8.14	13.08
Health and family planning	5.18	4.71	7.73	8.04
Others	7.47	17.45	21.60	12.10
Total	100.00	100.00	100.00	100.00

Source: Based on the revised budget figures as reported in various World Bank publications and Bangladesh Economic Survey, Ministry of Finance, various issues.

education, whose share has nearly doubled. This restructuring of public expenditure has also resulted in a rising proportion of GDP being allocated to these two sectors. It is remarkable that these proportions were not allowed to fall even when total budgetary expenditure declined as a proportion of GDP, as in the second half of the 1980s.

The analysis of benefit incidence shows that the distribution of benefit from public spending on both health and education among households is weakly pro-poor, that is, the distribution is more equal than the overall income distribution in the economy, although it favours the relatively rich. Only expenditure on mother and child health and on primary education is strongly pro-poor, so that the poor gets more absolute benefit than the rich [World Bank 2003]. There are also many inefficiencies and wastages in the delivery of public services in these social sectors [Mahmud 2002a]. Clearly, ensuring adequate access of the poor to education and health services of sufficient quantity and quality requires much more than allocating more budgetary resources to these sectors. Nevertheless, it must be acknowledged that the public expenditure policy of Bangladesh deserves credit for raising the share of these sectors in the total budget, and also for implementing at least a weakly pro-poor stance in the distribution of benefits.

There is, however, a major concern, and it has to do with the absolute size of resources devoted to health and education. As can be seen from Table 5, per capita public expenditure on health and education in Bangladesh is much lower even by south Asian standards. Sri Lanka is of course an exceptional country in this regard, but even India devotes a much larger absolute amount in this regard. This is a reminder of the fact that the scarcity of resources, arising from the low levels of per capita income and of public spending generally, is a major limiting factor in improving the education and health of the poor in Bangladesh.

### Revenue Mobilisation

In spite of an appreciable improvement in revenue collection in the 1990s, the revenue-to-GDP ratio in Bangladesh remains very low by international standards. Even within the sub-continent, the revenue-to-GDP ratios of Pakistan (15 per cent), India (17 per cent) and Sri Lanka (19 per cent) exceed that of Bangladesh (10 per cent) by a wide margin. Particularly appalling is the state of direct taxation, which accounts for only about 15 per cent of total revenue and 1 per cent of GDP (Table 6).

The low tax-GDP ratio results from huge tax evasion and from the fact that agriculture and other informal sectors are virtually excluded from the tax net due to weak tax administration. In the past, the tax ratio could be increased, or prevented from falling, mostly by enhancing the rate structure and/or expanding the tax base, suggesting that the tax system is income-inelastic [Mahmud 2001]. In fact, most of the revenue gains during the early 1990s were due to the introduction of the value-added tax (VAT), with its higher coverage and rates compared to the taxes it replaced, that is, excise duties on domestic production and sales tax on imports. However, those gains turned out to be mostly of a final nature.

One important concern regarding trade liberalisation, through the reduction of import duties, is its likely adverse impact on the government's revenue. Trade policy reforms in Bangladesh, as will be discussed later, involved substantial reductions in customs duties, especially in the early 1990s. Although the share of these taxes in total tax revenue has declined to some extent

reported in *Bangladesh*

their revenue contribution as a proportion of GDP has not (Table 6). This has been made possible by the rapid increase in the import-GDP ratio, which has more than compensated for the reductions in the duty rates. The adverse revenue effect of import liberalisation was thus avoided by increased trade openness.

The introduction of VAT in 1992 also helped in raising revenue from imports while rates of protective duties (customs duties) were being reduced. Being applied uniformly on imported and domestically produced goods, VAT on import has no protective effect and is not therefore in conflict with the policy of reducing protective tariffs. Although essentially a tax on consumption, it is imposed on most types of imports including raw materials and intermediate goods because of the ease of collection at the import stage. While the VAT paid on imported inputs is adjusted for in assessing the VAT on domestic production, such import taxes are also a means of taxing production in the informal sector lying outside the tax net.

Another potential tax instrument for sustaining revenue efforts while reducing protective tariffs is provided by the so-called supplementary duty which was introduced alongside the VAT. Like the VAT, it is meant to be a tax on consumption to be imposed equally on import and domestic production; and it can also be

**Table 4: Government Expenditure on Health and Education**  
(In per cent)

	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-2000
<i>Of Total Budget Expenditure</i>				
Education	8.16	11.24	13.62	15.51
Health and Population Planning	5.40	5.88	6.77	7.13
<i>Of GDP at Market Prices</i>				
Education	1.00	1.33	1.81	2.11
Health and Population Planning	0.66	0.70	0.90	0.97

Source: Based on the revised budget figures as reported in various World Bank publications and *Bangladesh Economic Survey*, Ministry of Finance, various issues.

**Table 5: Per capita Spending on Education and Health in South Asia**  
(US dollars)

	1997	1998	1999	2000
India	15	16	15	19
Pakistan	15	14	13	12
Sri Lanka	32	34	33	35
Bangladesh	11	11	11	12

Source: World Bank (2003).

**Table 6: Structure of Taxes in Bangladesh 1986-87 to 1999-2000**  
(In per cent)

	1986-87 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-2000
Direct taxes	16.78 (0.92)	17.99 (1.22)	15.54 (1.15)
Income tax	14.98	16.84	14.17
Landtax	1.80	1.14	1.39
Indirect taxes	83.22 (4.58)	82.01 (5.58)	84.46 (6.26)
Sales tax/VAT	11.63 (0.64)	31.27 (2.20)	46.38 (3.44)
Customs duties	37.98 (2.09)	33.68 (2.28)	29.67 (2.20)
Excise duties	27.05	10.27	1.41
Others	6.73	6.79	6.99
Total tax revenue	100.00 (5.50)	100.00 (6.81)	100.00 (7.41)

Notes: Figures in parentheses are percentages of GDP at market prices

Source: Based on estimated actual revenue collection as

*Economic Survey*, Ministry of Finance (various years).

selectively imposed on relatively inessential items of consumption. In practice, however, the potential role of this tax does not seem to have been fully appreciated. It has been often used as a protective import duty, and at times it has also been imposed on domestically produced intermediate products like natural gas, thus implying a departure from the principle of incentive neutrality.

As a result of these tax reforms, the share of import taxes in total tax revenue thus remains high following trade liberalisation. In 2000-01, for example, this share was more than half, with 26 per cent of tax revenue coming from customs duties, 20 per cent from VAT on imports and another 7 per cent from supplementary duties on imports. The continuing import dependence of tax revenue involves some risks. A slowdown in import growth may adversely affect tax revenue, particularly in the event of further reduction of protective import duties. This is currently a relevant issue since Bangladesh seems to have embarked on a new phase of import liberalisation according to the national budget for 2003-04. At the same time, Bangladesh's main export item, readymade garments, faces some uncertainty as the Multifibre Agreement (MFA) is phased out at the end of 2004. This casts some doubt about whether Bangladesh's trade openness can continue to increase as in the recent past. Among other things, it points to the need for improved revenue collection from domestic taxes, including direct taxes.

## IV

### External Sector Policies

#### Impact of Import Liberalisation

By international standards, Bangladesh has had one of the most rapid episodes of import liberalisation, from the withdrawal of quota restrictions in the late 1980s to the reductions in tariffs in the first half of the 1990s. But since then, the pace of further import liberalisation has slowed down. Table 7 shows the trends in the average rate of protective import duties since the early 1990s (as well as the average rate of all import duties based on actual collection). Besides customs duties, protection for domestic production is also provided by the so-called incentive-neutral taxes like VAT and the supplementary duty, when these are levied asymmetrically only on imports but not on domestic production or when higher rates are applied on imports than on domestically produced substitutes. Taking into account the protective effect of all these taxes, the average nominal protection rate can be seen to have fallen from 73.6 per cent in 1991-92 to 32 per cent in 1995-96 and further to 26.5 per cent in 2003-04. The slower decline in the later eight-year period is partly because cuts in customs duties were offset by other protective duties and para-tariffs.

As a result of these reforms, Bangladesh still has a relatively closed economy. Although the initial phase of import liberalisation in Bangladesh was more rapid than in many developing countries including India, it has now the most protected economy even

in south Asia (in respect of the unweighted average rate of protective import tariffs as on early 2004).<sup>12</sup> This remains true in spite of the substantial cuts in import duties announced in the

budget for 2004-05 (Table 7). As noted earlier, these duty cuts may represent a new phase of import liberalisation relating to the multi-year loan programme of the World Bank and the IMF beginning in 2003-04.

A feature of the above tariff reforms is the end-use based discrimination in protective duty rates. Capital goods and primary commodities are subject to much lower rates of tariffs compared

to intermediate goods, while the highest rates apply to finished consumer goods.<sup>13</sup> This has also helped to retain relatively high rates of protection for the latter goods, even with much lower average import tariffs; at the same time, the anti-export bias of the tax system is reduced because of lower taxes on imported inputs. Such a system of tariff escalation has suited the interests of the protectionist lobbies, since the domestic import-substituting industries mainly produce finished consumer goods. The protection rate can be particularly high for manufacturing activities with low value addition dependent on imported inputs (that are subject to lower duty rates). The system of incentives thus created makes the domestic industries even more import dependent. Another fallout of the above system of tariffs is to create very low, even negative, protection for the domestic engineering and capital goods industry, thus stifling its growth.<sup>14</sup> This adverse effect has been discounted because of the rather small size of this industry and because the removal of duties on machinery imports has been a means of providing incentives for other industries. This ignores the potential role of a domestic capital goods industry in technological adaptation, which is especially important for upgrading traditional technology in the informal sector. Large-scale industries in Bangladesh, on the other hand, rely almost entirely on imported machinery.

In spite of the reduction in import tariffs, a considerable anti-export bias still remains [World Bank 2004a]. This problem is addressed to some extent by the existing schemes of duty

drawback, bonded warehouses, and selective cash incentives for exports, which are essentially means for providing exporters duty free access to imported inputs (or for compensating for the payment of such duties). There may also be a pure 'subsidy' element in the cash incentives, which are currently provided to a number of export items including fresh fruits and vegetables, light engineering products, jute products and fabrics used for exported garments. However, the scope and effectiveness of such schemes are limited both by revenue considerations and administrative feasibility constraints.

While external liberalisation in Bangladesh has been accompanied by acceleration in overall industrial growth, this is mostly attributable to the success in garment exports. A substantial contraction has taken place in many import-substituting industries; indeed, the official index of Bangladesh's large and medium-scale

**Table 7: Average Rates of Customs Duties and All Protective Import Duties<sup>1</sup>**

	(In per cent)			
	1991-92	1995-96	2003-04	2004-05 <sup>2</sup>
Unweighted average customs duty	70.6	28.7	18.8	16.3
Unweighted total protection rate <sup>3</sup>	73.6	32.0	29.1	26.5
Average collection rate <sup>4</sup>	28.7	23.7	18.0	na
	(37.4)	(31.8)	(25.5)	

Notes: 1 The average rates reported here are based on 8-digit 6877 tariff lines; they do not include tariff exemptions or concessions, nor do they reflect 'preferential' tariffs.

2 According to the budget for the financial year 2004-05.

3 'Total protection' incorporates, in addition to customs duty, protection provided by the infrastructure development surcharge, license fee (LF), regulatory duty (RD), as well as protection resulting from asymmetric implementation of the supplementary duty and VAT. Asymmetric implementation results when the so-called protection neutral taxes are levied only on imports but not on domestic production and/or when higher rates are applied on imports than on domestically produced substitutes.

4 The collection rate reflects tax exemptions as well as tax evasion: includes duties on all lines of import items, but not the advance income tax on imports.

source: Estimated from World Bank (2004) and World Bank (2004a).

manufacturing industries shows that almost half of the country's 4-digit industries contracted during the first half of the 1990s - the period of rapid tariff reductions. And though some gains were made in the overall production efficiency of import-substituting industries, they occurred more because of the exit of the relatively inefficient (mostly state-owned) industrial units rather than technological improvements made at the firm level [World Bank 1999, 2004a]. Clearly, domestic industries need to improve production efficiency in order to be able to withstand a further reduction in protection. One exception is the pharmaceutical industry, which grew rapidly as an import-substituting industry, trebling its output in the 1990s, and is now well positioned to enter the export market.<sup>15</sup>

It is noteworthy that, in the post-liberalisation period, small-scale manufacturing activities (excluding handlooms and cottage industries) fared better than large-scale manufacturing, growing at an average rate of more than 9 percent annually in the 1990s.<sup>16</sup> Import liberalisation is likely to have played a role here, by allowing better access to imported inputs and technology. Small industries seem to have benefited from the liberalisation of the imports of capital machinery and raw materials, while their products - being mostly remote substitutes for imported items - had an advantage over those of their large-scale counterparts, which faced stiffer competition from imports.<sup>17</sup>

The extent and speed of further import liberalisation remain a contentious issue in the country's economic reform agenda. In the absence of any pre-announced target and timetable, tariff reform in Bangladesh would seem to be a 'learning-by-doing' process (even if not consciously recognised to be so). The credibility of such an approach depends on the government's willingness and capability to conduct trade policy reforms in an analytical way. Besides assessing the effects of tariff reforms, it will be important to relate this impact with policy reforms in other areas, such as tax administration, provision of infrastructure and the functioning of financial and labour markets. The impact of protection afforded through tariff escalation and the selective interventions for export promotion is bound to be discriminatory in nature. While the room for such discrimination may be gradually reduced with further reforms, there is clearly a role for an active industrial policy, at least in the transitional reform period. If there is no well-devised industrial policy, there will be one by default.

### Export Growth

Until hit by the global recession in 2001, Bangladesh had achieved robust and sustained growth of export earnings, averaging about 15 per cent a year in nominal US dollar terms in the 1990s. As a result, the ratio of export earnings to GDP doubled from 7 to nearly 14 per cent. But in 2001-02, export earnings declined in dollar terms for the first time since 1985-86. There was a recovery the following year and, in 2003-04, export growth hit a six year high of 16 per cent. While this shows the resilience of export growth in Bangladesh, it will not be easy in the medium term to sustain the export momentum of the 1990s. A positive aspect of the external sector, however, has been the continued growth in the inflow of migrant workers' remittances - from about 2.5 per cent of GDP in the beginning of the 1990s to more than 5 per cent in 2001-02, amounting to about US\$ 2.5 billion annually.

Bangladesh increased its garment exports rapidly by taking advantage of export quotas and preferential access in the major markets (US and European Union) along with its abundance of

low-cost female labour. There is now a great apprehension about how readily Bangladesh's garment industry will be able to cope with competition from other exporters, once the export quotas in the US market are removed with the expiry of the Multi-Fibre Agreement (MFA). The dependence on imported fabrics and yarns puts Bangladeshi garment exporters at a disadvantage, by increasing the lead-time needed to meet orders from foreign buyers.<sup>18</sup> Among garment exporters, Bangladesh has the advantage of the lowest wage rate (it is followed closely by China), but it loses out in the marketing value chain because of its dependence on marketing intermediaries. In the post-MFA period, relatively larger firms with better marketing ability have a better chance of surviving the competition and even gaining in the process [Nadvi 2003].

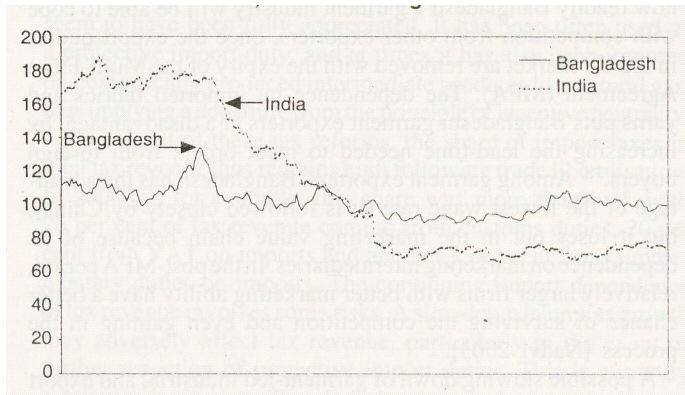
A possible slowing down of garment-led industrial and export growth threatens to curtail Bangladesh's prospects for accelerated economic growth. Given the high import-intensity of its manufacturing and investment activities, adjusting to slower import growth will not be easy. Also, in the event of a slowdown in the growth of the garment industry, the desirability of further import liberalisation may be put into question on the grounds that it may hurt overall industrial growth - thus hindering the progress towards establishing a more efficient, competitive industrial base. The policy imperatives are thus clear: to make every effort to compete effectively in garment exports post-MFA; and to move towards export diversification, by at least preparing the ground for it in the next few years.

Bangladesh has potential comparative advantage in a number of export items such as horticultural products (fresh and processed), leather goods, light engineering products, and certain chemical products. It should also be able to take advantage of the provisions of the EU, Canada, Australia, and other industrialised countries that may allow duty-free access of exports from least developed countries. To take advantage of these opportunities, it will need to give attention to a number of export-facilitating factors: better infrastructure, including efficient port facilities; standardisation of product quality; technological improvements, leading to higher productivity; and an improvement in the overall domestic investment climate. Foreign direct investment can also be an important factor in promoting exports, not only by bringing in investment funds per se but also by providing product quality assurance (for example through brand names) for buyers in import markets.

It may be noted that the heavy dependence of domestic industries on imported raw materials and intermediate goods makes it difficult for Bangladesh to satisfy so-called 'rules of origin' to obtain preferential access for its exports in the markets of developed countries. Thus, most of Bangladesh's garment exports are not eligible for the generalised system of preferences (GSP) in the European Union market, since they are made largely from imported fabrics. Within the textile category, a relaxation in the rules of origin for knitted garments since 1999 has led to a surge of exports of knitwear from Bangladesh to the EU market. More recently, a similar relaxation in the Canadian market has led to another surge in garment export from Bangladesh to that market.

### Trends in Real Exchange Rate

A remarkable aspect of Bangladesh's reform experience has been the relative stability of its real exchange rate (Table 2 and Figure). Though substantial trade liberalisation took place at a time of marked and steady decline in external deficits, there was



Note: Monthly data, January 1980 to April 2002; Base: 1990=100. A negative change indicates depreciation of the domestic currency.

Source: IMF

hardly any real devaluation of the taka (with only mild devaluation up to about 1997, followed by modest appreciation). The strength of the taka was due to the rapid growth in export earnings, along with increasing flows of workers' remittances, which together more than offset the decline in aid inflows.

During this time, the currencies of many developing countries, including India and Pakistan, underwent massive real devaluation.<sup>19</sup> This put Bangladesh at a disadvantage in export competition and in marketing its exports within these countries, especially neighbouring India. The real value of the Bangladesh taka appreciated by an estimated 25 per cent or more against the Indian rupee between the late 1980s and the mid-1990s. This, combined with the fact that Bangladesh opted for much faster import liberalisation than India did at that time, resulted in a dramatic increase in Bangladesh's trade deficit with India. By the late 1990s, Bangladesh's exports to India could pay only for a meagre 4 per cent of its imports from that country, compared to more than 15 per cent a decade or so earlier. From the poverty perspective, however, these movements in the bilateral real exchange rate produced a benefit; with the liberalisation of rice imports, commercial rice imports from India can now help to smooth consumer prices when rice harvests in Bangladesh are poor [Dorosh and Shahabuddin 1999].

While the success in garment exports may have at times raised the spectre of the 'Dutch disease', the prospect of a large real devaluation caused by an export debacle is a more serious concern for Bangladesh. Most parts of the Bangladeshi economy in effect represent semi- or non-tradables; these include not only services, whose value accounts for nearly half of GDP, but also small-scale manufacturing that produce poor substitutes for imports. This is also true of many agricultural products, including rice, in which Bangladesh has no commercial foreign trade in most years.<sup>20</sup> Devaluation would depress production incentives in these activities, by increasing the price of imported inputs and turning the domestic terms of trade against these activities vis-à-vis tradable activities - not an encouraging prospect for achieving accelerated GDP growth, let alone pro-poor growth.

The dangers of a large devaluation underline the importance of international support to tide over the adverse balance of payments effect of an export slow down. They also highlight the importance of promoting export growth and diversification through various non-price incentives and measures, as mentioned above, rather than relying on an aggressive exchange rate policy, as is often advocated. An added implication is that - in an economy

**Rates, India and Bangladesh**  
tradable-based growth - the use of the exchange rate as a tool

export promotion needs to be approached with caution

[Harberger 2001:559].

for

## Financial Policies

Bangladesh's financial reforms started in the early 1980s by

allowing the set up of commercial banks in the private sector, the number of which has gradually increased. About 30 private

sector banks (PCBs), including several foreign banks, now operate side by side with four large nationalised commercial banks (NCBs). The PCBs now account for nearly half of total deposits. The second aspect of the reform was to gradually liberalise interest rates from the early 1990s. In the initial phase, floors were introduced for deposit rates and banks were allowed to fix the lending rates freely, but within the given bands for certain priority sectors (agriculture, export and cottage industries). Banks were compensated for lending at a lower rate to priority sectors by the amount of the difference between the subsidised rate and the market rate. Later on, the floor on deposit rates and the subsidies on priority lending were withdrawn; but certain ceilings on lending to priority sectors still remain.

The earlier regime was based on the belief that credit can be best allocated by the government's dictates. However, the NCBs, along with certain specialised development banks, performed poorly in terms of loan recovery and costs of financial intermediation. The new liberalised system is based on the hypothesis that depositors can get a fair return and credit can be allocated more efficiently through the liberalisation of financial markets. The actual results of financial liberalisation were, however, different from those envisaged. One main reason for this was that Bangladesh adopted financial liberalisation without providing for adequate regulation and supervision.

Private banks also became infected with the widespread culture of loan defaults plaguing the public sector banks, although the reason for the malaise in the two cases was not the same. The NCBs were burdened with politically-brokered loans and loans given to loss-making state enterprises, while private banks suffered from 'insider lending' to the sponsor directors of banks, some of whom simply plundered away depositors' money. It is only after the central bank could enforce some measure of regulation on the behaviour of the sponsor directors that the loan default rate in some of the private banks (and in PCBs as a whole) started to improve compared to the NCBs.

The widespread culture of loan default has resulted in high costs of financial mediation, as reflected in the large spread between the deposit and lending rates of interest (as high as 6 to 7 per cent). As a result of liberalisation, the interest spread actually increased, at least initially, rather than decreasing because of market competition. As a result, the relatively efficient private banks, including foreign ones, can reap excess profits. The resulting high cost of borrowing not only tends to depress private investment, it also puts strains on the government budget by increasing the cost of servicing public borrowing from commercial banks. The erosion of the capital base of the NCBs also creates a large contingent liability for the government budget. The NCBs were recapitalised on a huge scale in the early 1990s; since then their capital bases have again gone into the red.<sup>21</sup> A notable example of unregulated liberalisation is provided by the upheaval in the country's stock market, which happened

in the later part of 1996. Just when foreign portfolio funds were beginning to flow into Bangladesh without any restriction, boosting the country's nascent stock market, the market went through an episode of phenomenal boom and bust that virtually destroyed any prospects of its further growth, at least in the near future.<sup>22</sup> This episode was mainly created by the machinations of some unscrupulous share-traders who took advantage of laxity in regulation. The main losers were unsuspecting middle and low-middle income families many of whom put their lifelong saving in stocks.

Table 8 shows how the structure of bank interest rates has been affected by reforms. The mechanisms of interest rate determination, following the market-oriented reforms, are yet poorly understood. It has been observed by some authors [Hassan 1966] that interest rates, particularly lending rates, are somewhat rigidly determined and their variations in real terms are primarily wrought by changes in the inflation rate. The interest rates are also found to be rather unresponsive to the central bank's market-oriented instruments of intervention, including those affecting banks' liquidity position. The central bank has thus only limited influence on credit and monetary expansion, so that the outcome is more by default than by design. This is a major shortcoming of the overall macro-financial management and is a reason why 'prudent' monetary policies as stabilisation measures sometimes result in overkill.

How have the reforms affected the allocation of loans by the commercial banking system? The estimates in Table 9 show trends in the amount of loans advanced by commercial banks to certain sectors, as a proportion of the share of these sectors in the country's GDP, in the respective periods. The proportionate share of annual bank advances going to agriculture and small and cottage industries can be seen to have significantly declined, while large-scale manufacturing has been able to more than hold its ground. The previously designated priority sectors have thus lost out in the competition. One can of course argue that the proportionate shares of bank advances received by different sectors, or their trends over time, can hardly be indicators of the efficiency of credit allocation. It is, however, well known that farmers and small entrepreneurs are largely deprived of access to formal sources of credit and, as a result, resort to borrowing from informal sources at much higher interest rates. The returns from activities for which they seek loans are therefore likely to

be higher than those in organised sectors having access to formal sources of credit. Any diversion of credit away from these sectors can hardly be taken as an efficient reallocation of credit, let alone

contributing to pro-poor growth.

This does not mean that the previous system of directed or subsidised credit allocations were efficient (say, in terms of loan repayment) or effective in the sense that the benefit of subsidised credit was reaped by those for whom it was intended (given the prevalence of high transaction costs). What it means is that the reforms towards financial liberalisation have had little to do with the problem of providing access to credit to those sectors or activities that are most starved of it.

Nor has liberalisation done much to help the so-called 'missing middle' - the small-scale enterprises that are mostly bypassed both by the formal banking sector that tends to concentrate on the big clients, and by the microcredit programmes, which cater

to the very small. A number of innovative programmes have been initiated in recent years for extending microcredit to small enterprises; still the problem of missing middle is likely to remain. There is clearly a need for new kinds of institutional innovations,

particularly when the ongoing banking reforms are aimed at reducing the number of rural branches of the NCBs, or at eventually privatising the NCBs. Could these rural branches be reorganised into local/regional banks mobilising rural deposits and providing credit to local small-scale enterprises? Could bank-NGO collaboration be helpful? Could some NGOs now engaged in microcredit programmes be turned into rural banks under an appropriate legal framework? These are some of the unresolved questions whose answers must be found if financial markets have to play their role in supporting broad-based pro-poor growth in Bangladesh [Mahmud 2003].

## VI Conclusion

Bangladesh has made some beginnings in converting the gains of macroeconomic stabilisation into sustained and accelerated growth. To consolidate this process, and to meet the risks of slippage, improvements are needed on several fronts. The currently low tax-GDP ratio has to be increased to support higher public social spending and to increase the contribution of the government's fiscal operations to domestic savings. At the same time, serious concerns regarding the quality of public development spending need to be addressed. Financial sector reforms must be strengthened in order to reduce the cost of financial intermediation and to reduce resource wastage, such as through large-scale loan default. More generally, institutional reforms must address the whole range of factors adversely affecting investment incentives and production efficiency. The need for this is all the more urgent as Bangladesh faces the risk of a slow down in export growth because of post-MFA competition in the global readymade garment market. For more than one reason, Bangladesh's economic growth prospects crucially depend on sustaining high export growth - through the

**Table 8: Trends in the Structure of Interest Rates**

	<i>(In per cent)</i>									
	1986-87	1988-89	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2003 Dec	
<b>Bank at, Lending interest rate</b>	10.75	10.75	9.75	6.5	5.5	7.5	7	6	5	
<b>Deposit interest rate</b>	14.7	14.7	15.0	14.4	12.2	13.7	14.2	13.8	12.4	
<b>Interest spread</b>	8.6	8.9	9.1	6.5	4.9	6.7	7.1	7.0	6.3	
<b>Inflation</b>	13.9	8.4	8.3	2.7	8.9	2.5	8.9	1.6	5.1	
<b>Real lending rate</b>	0.8	6.3	6.7	11.7	3.3	11.2	5.3	12.2	7.3	
<b>Real deposit rate</b>	-5.3	0.5	0.8	3.8	-4.0	4.2	-1.8	5.4	1.2	

Source: The deposit and lending interest rates are weighted averages as reported in Bangladesh Bank publications (estimates for the last two years are from unpublished data). Inflation rate is based on the official Consumer Price Index (general).

**Table 9: Ratio of Commercial Banks' Loan Advances as Proportion of Sectoral GDP, 1986-87 to 1997-98**

Sector	1986-87 to 1988-89	1991-92 to 1993-94	1995-96 to 1997-98
<b>Agriculture (crops and animal farming)</b>		0.96	0.90
<b>Large and medium-scale industry</b>	2.85	3.17	327
<b>Small-scale and cottage industry</b>	1.05	0.60	0*51

Note: Three year averages.

Source: Unpublished data of Bangladesh Bank and official national income estimates.

continued growth of garment exports, and through export diversification as well.

*Address for Correspondence:*  
wmahmud@bangla.net

## Notes

[The author is indebted to S R Osmani with whom he has undertaken collaborative work on this and related topics.]

1 The subsequent decline of development financing institutions (DFIs) was also closely linked to the shortcomings of that round of privatisation in Bangladesh.

2 For a discussion on these reforms and macroeconomic developments in the 1980s, see Task Forces (1991).

3 One redeeming feature of macroeconomic developments in the 1980s, as shown in Table 1, is the increase in public investment. This increase, however, barely compensated for the decline in private investment, resulting in a slight decline in the overall investment rate. However, the

actual investment scenario of the decade was probably much worse. The figures in Table I are based on the revised national income series, which

was initially estimated from 1990-91 onward, but was subsequently extended backward to cover the period of the 1980s. In spite of the improved estimation methodology used in the revised series, the investment estimates suffer from many weaknesses, which are likely to have been made worse through backward extrapolation. In fact, the old series show a substantial decline in the investment-GDP ratio during the 1980s, which is also home out by a decline in the import of capital goods; see Task Forces (1991). It is also highly improbable that public investment was increasing at a time when public development expenditure was being curtailed, although the two are not exactly the same.

4 In 1995-96 and 2000-01, both pre-election years, the government's domestic borrowing and the rate of credit expansion in the private sector

were unusually high, while trade deficits increased substantially and foreign exchange reserves fell; see Mahmud (2002), Chapter 19 and *Bangladesh Economic Survey*, ministry of finance (various issues).

5 This can be seen from the growth of machinery imports, which is a good proxy for industrial investment; see Table 2 and Mahmud (1997).

6 Foreign direct investment peaked at about US\$ 250 million in 1997-98, accounting for about 0.5 per cent of GDP in that year; by 2001-02, it had fallen to US\$ 65 million annually.

7 In other words, the persistent problem seems to be one of the external balance rather than of the aggregate resource balance, that is, the savings-investment balance. This is more evident from the later episode of upturn in 2000-01; the domestic inflation rate in fact declined to less than 2 per cent in that year, but foreign exchange reserves came down to a critically low level, equivalent to less than two months' import payments; see Table 2.

8 Public savings are not however identical with the government budget's revenue surplus, since the budget's current expenditure does not fully reflect public consumption.

9 The official estimate of export earnings is from the data of the Export Promotion Bureau; as a result, Bangladesh Bank's balance of payments estimates are reconciled by including an 'errors and omissions' figure.

10 In comparison, the sectoral allocation pattern of current expenditures has remained relatively stable; see Mahmud (2002a).

11 Among the few notable changes in the current expenditure pattern was increased allocations to education, specially towards the late 1980s; see Osmani et al (2003).

12 Among 139 developing countries considered, Bangladesh is ranked the 7th most protectionist country, India 12th, Pakistan 23rd and Sri Lanka 61st, see World Bank (2004), Chapter 3.

13 Between 1992 and 1996, the import-weighted average customs duty rate on capital goods declined from 19 per cent to 10 per cent, and for final consumer goods, from 47 per cent to 21 percent; see World Bank (1999), p 39.

14 A striking example is provided by the decline of the domestic textile machinery industry (power looms); this industry has been virtually eliminated during the past seven to eight years.

15 Incidentally, Bangladesh stands to gain from the WTO agreement regarding the waiver of patent rights for the domestic production of drugs in LDCs until 2016, and for the production and trade in certain life-saving drugs among developing countries generally.

16 *Statistical Yearbook of Bangladesh 2000*, p 452.

17 Small industries are likely to have grown also at the cost of cottage

industries, whose value added grew at only 2.8 per cent annually during the same period.

18 In recent years, there has been some growth in backward-linkage domestic production of fabrics, but only under high cash incentives (subsidies) that are now being phased out. Keeping stock of grey cloth and establishing domestic capacity for dyeing and finishing may be another way out.

19 According to IMF estimates, Pakistan, India and China have all maintained a lower real effective exchange rate (REER) of their respective currencies as compared to Bangladesh, with 1990 as the base year; only Sri Lanka and Vietnam had higher real effective exchange rates.

20 The non-tradable nature of these agricultural products arises from the large spread between export and import parity prices caused by poor marketing infrastructure and limited access to export markets [Mahmud et al 2000].

21 The ongoing reform programme for NCBs, supported by the World Bank and IMF, is designed to overhaul their management structure, restrict their further growth and prepare them (except one) for eventual privatisation.

22 The average stock price index increased more than threefold in a matter of two-three months during late 1996; since then the price index has precipitously dropped far below the pre-boom level.

## References

- Dorosh, P and Q Shahabuddin (1999): 'Price Stabilisation and Public Foodgrain Distribution: Policy Options to Enhance National Food Security', Working Paper No 12, Food Management and Research Support Project, Ministry of Food and International Food Policy Research Institute, Dhaka.
- Harberger, A C (2001): 'The View from the Trenches: Development Processes and Policies as Seen by a Working Professional' in G M Meier and J E Stiglitz (eds), *Frontiers of Development Economics: The Future in Perspective*, World Bank and Oxford University Press, Washington, DC, New York.
- Hassan, M K (1996): 'A Review of Financial Sector Reform in Bangladesh' in *Growth or Stagnation: A Review of Bangladesh's Development 1996*, University Press, Dhaka.
- Mahmud, W (1995): 'Recent Macroeconomic Developments', *Experiences with Economic Reform: A Review of Bangladesh's Development 1995*, Centre for Policy Dialogue, University Press, Dhaka.
- (1997): 'Macroeconomic Update', *Growth or Stagnation: A Review of Bangladesh's Development 1996*, Centre for Policy Dialogue, University Press, Dhaka.
- (2001): 'Bangladesh: Structural Adjustment and Beyond' in W Mahmud (ed), *Adjustment and Beyond: The Reform Experience in South Asia*, Palgrave-Macmillan/St Martin's Press in association with International Economic Association, Basingstoke, UK, and New York.
- (2002): *Popular Economics: Unpopular Essays*, University Press, Dhaka.
- (2002a): 'National Budgets, Social Spending and Public Goods: The Case of Bangladesh', IDS Working Paper 162. Institute of Development Studies, University of Sussex, Brighton, UK.
- (2003): 'Strategy for Pro-Poor Growth in Bangladesh', paper presented at seminar on Accelerating Growth and Poverty Reduction in Bangladesh, World Bank and Bureau of Economic Research, University of Dhaka, Dhaka, June 26-27.
- Mahmud, W, S H Rahman, and S Zohir (2000): 'Agricultural Diversification: a Strategic Factor for Growth' in R Ahmed, S Haggblade and T Chowdhury (eds), *Out of the Shadow of Famine: Evolving Food Markets and Food Policy in Bangladesh*, Johns Hopkins University Press, Baltimore.
- Nadvi, Khalid (2003): 'Globalisation and the Challenges to Bangladesh's Garment Industry', mimeo, Institute of Development Studies, University of Sussex.
- Osmani, S R, W Mahmud, B Sen, H Dagdeviren and A Seth (2003): *The Macroeconomics of Poverty Reduction: The Case of Bangladesh*, UNDP Asia-Pacific Regional Programme of Macroeconomics of Poverty Reduction, Dhaka and Kathmandu.
- Task Forces (1991): 'Macroeconomic Policies' in *Report of the Task Forces on the Bangladesh Development Strategies for the 1990s*, University Press, Dhaka.
- World Bank (1999): *Bangladesh Trade Liberalisation: Its Pace and Impacts*. Report No 19591 BD. World Bank (South Asia Region), Washington, DC.
- (2003): *Bangladesh: Public Expenditure Review*, World Bank and Asian Development Bank, Washington, DC, Manila.
- (2004): *Trade Policies in South Asia: An Overview*, World Bank, Washington, DC.
- (2004a): *Bangladesh: Growth and Export Competitiveness*, Draft, World Bank (South Asia Region), Washington, DC.