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THE CURRENT STATE OF ECONOMIC POLICY REFORMS IN BANGLADESH

[The following is a further development of "comments" on a paper titled "Economic Policy Reforms in Bangladesh: Prospect and Future" written by Dr. Sadrel Reza, Director General of the Bangladesh Institute of Development Studies, both of which were presented to the first-day session of a two-day seminar on "Private Sector Growth: Creating a Conducive Environment" organized by the Dhaka Chamber of Commerce and Industry (DCCI), in collaboration with the German Federation of Small Business and Crafts (ZDH) and Technonet Asia (TA), Singapore, held on 27-28 August 1994. This is being circulated as a PIAG Note as it is closely related to the work already done or being done and projected by PIAG.]

Although the present Government has made commendable progress in economic reforms during the last three years, I would like to echo the feeling which is being expressed in several quarters, including a recent commentary by my colleague Dr. CAF Dowla published in *The Financial Express,* that the economic reform process in Bangladesh is being halted or that it is now being pursued half-heartedly with halting steps. Some indications to this effect have been publicly expressed also by the Honorable Finance Minister. The halting progress of the reform process is being blamed on the political realities of our time, especially on the adverse propaganda being faced by the ruling party from the opposition political camp. I think, if this is the actual situation, Bangladesh is fast heading toward real economic problems. The country has entered, I think, a critical phase in the economic reform process. This process needs to be vigorously, and without delay, carried forward to its logical conclusion to reap the full benefits of the reforms in terms of attaining a satisfactory sustained growth rate, and alleviating massive poverty and providing meaningful employment to the growing labor force. Let me elaborate.

I think, this year's *Budget Speech* of the Honorable Finance Minister overly exaggerates the accomplishments achieved by the reforms carried out so far. I think he painted an unduly rosy picture of the economy, which misses the dimension of what remains to be done. The Government is yet to effectively address the fundamental structural weaknesses of the economy. The macro-economic stability achieved is undoubtedly a good plus point, which together with a favorable turn in the balance of payments situation, provides an unprecedented window of opportunity. The Government should take full advantage of this opportunity to accelerate the reform process. Unfortunately the foot appears to be on the break.

The macro stability is significantly due to what may be called "a low-saving low-investment low-growth trap" in which the economy finds itself. This stability looks fragile and is unsustainable in the event of increases in government expenditure including much-needed increases in investment or development expenditures to overcome critical deficiencies in infrastructural facilities in power, telecommunications, roads, etc., as well as further increases needed in investments in social services to improve the level of human resource development, and also because government current expenditure is inevitably going to rapidly rise due to needed increases in recurrent expenditures on completed development projects and genuine need and pressures for increases in the poor salary levels of, particularly senior, government employees. Foreign investors are dissuaded to come and invest in Bangladesh for a variety of reasons including the poor infrastructure and the poor general state of human resource development. To raise the growth rate to a satisfactory figure from the present about 4 percent, the overall investment rate will have to rise to 18-20 percent from the present 13 percent. Bangladesh's investment is quite low by international standards, and even so when compared to Bangladesh's close neighbors. To a significant extent, the low overall investment is due to low public saving and investment. While private investment is also low, there are some signs that it is increasing. Public investment, on the other hand, remains stagnant near 6 percent of GDP. It has in fact declined over time. The Government needs to improve its own investment record, if it wishes to provide a further stimulus to the private sector and boost the current low growth rate.

To increase public saving and investment, the Government needs to undertake further tax reform measures to increase government revenue to a satisfactory level. Although the tax-GDP ratio has risen considerably historically, it still remains one of the lowest in the developing world. In FY 1992, this ratio was only 8.8 percent, which was only about half of the average tax-GNP ratio of 16 other low-income, lower and upper middle-income developing countries. During the same period, this ratio was 11.1 percent in India, 12.2 percent in Pakistan, 18.1 percent in Sri Lanka, 16.3 percent in Thailand and 22.0 percent in Malaysia. Most of these developing countries had even higher tax-GNP ratios even as early as 1980.[1] In Bangladesh there has been a deceleration in the tax collection level during the last two years. This is an ominous sign and signals an impending worsening budgetary situation, which is bound eventually to adversely impact on the current macro- stability.

The Government's present export promotion strategy with special incentives such as the duty drawback and bonded warehouse facilities are not leading to sufficient export diversification and expansion needed to bring about satisfactory export-led economic growth. After some export growth during the last three years, mostly due to a surge in the readymade garment sector, a visible significant deceleration in export growth has now set in. The special incentives are also being abused in some cases, which is hurting local industries. A rethinking of this strategy is required. To boost the export sector, there is no viable option left for the Government except to further liberalize imports. Our domestic manufacturers will need to gracefully accept this to increase the external competitiveness of our industries. As compensation, the manufacturers should seek protection through exchange rate adjustment. An exchange rate adjustment is a much superior method of protecting and promoting both import substitution and export industries because of (1) its non-discriminatory incentive effects on different economic activities, (2) the special encouragements it offers to substitution of domestically produced goods and services for foreign-made ones and to the development of domestic backward linkages, (3) the special incentives offered to development and growth of agricultural products, (4) the discouraging effects on smuggling across the long porous border with neighboring India, and (5) its effects of offsetting undesirable increases in industrial

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1 The sources of the information cited in this paragraph are the World Bank's *World Development Reports 1992 and 1994*.

costs due to increases in non-traded inputs such as labor, power and gas.[2] The Government appears to be much too allergic to the idea of a devaluation of the domestic currency. The exchange rate appears misaligned with the currency of our big neighbor, which is reflected in a continued massive scale of smuggling, providing undue competition to the domestic industries. Definitely the current exchange rate policy is inappropriate and hurting industrial growth. Its urgent reform is necessary.

In this regard, the best policy the Government could adopt is (1) to undertake a satisfactory dose of devaluation of the Taka to correct its existing misalignment particularly with the Indian Rupee, which occurred after the latter currency was devalued by a massive 21 percent during 1991, and (2) accelerate the ongoing process of liberalizing the currently still highly restricted foreign exchange and trade and tariff policy regime. An initial satisfactory dose of devaluation of the Taka is necessary to make business operations in Bangladesh, particularly export activities, more competitive and profitable, and instil greater confidence among the intending foreign investors that the Government is serious about maintaining the exchange rate at a realistic level, which is conducive to more profitable business operations and future foreign exchange transaction activities. After the exchange and trade policy regime has been sufficiently liberalized, the Government should free the exchange rate from its current centralized control to a fully free float and allow the exchange rate to find its own equilibrium level. In a liberalized exchange and trade policy regime, the exchange rate should depreciate as it remains overvalued under a restricted exchange and trade regime, given other factors. A greater flow of foreign capital including increased remittances by expatriate Bangladeshis will no doubt tend to appreciate the exchange rate, but so long as this greater inflow of foreign capital is matched by increased investment activity at home, which is so badly needed in the current low investment situation, there will be no adverse (i.e., appreciating) effect of foreign capital inflows on the exchange rate.

The current tax system, with its very heavy dependence on the taxes on international trade and transactions also indicates that the trade liberalization process with a reduction in the tariff levels has not yet proceeded far enough. In FY 1992/93, taxes on international trade and transactions accounted for as large as half of the total tax revenue in Bangladesh, compared to a range of 5.5 percent to 33.0 percent in India, Indonesia, South Korea, Malaysia, the Philippines, Sri Lanka, and Thailand. In the fast newly developing countries of Indonesia, Malaysia, and Thailand, this ratio ranges between 5.5 percent and 20.4 percent. South Korea has a ratio of 9.3 percent. Indonesia and South Korea are the countries which are known to have carried out comprehensive tax reforms.[3]

The financial sector is in a terrible mess even after considerable recent financial deregulation and other reforms. This sector is beset with deep-seated problems because of a large proportion of non-

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2 For some details on the critical link of the exchange rate to industrial and economic development and the importance of maintaining a competitive real exchange rate policy and the most conservative policy being followed in Bangladesh, see the author's "Current Exchange Rate Misalignment and an Agenda for its Urgent Reform", Policy Implementation and Analysis Group (PIAG), Report # 4, 23 June 1993.

3 Information in this paragraph is from the *World Development Report, 1994*, op. cit., and , *Annual Report, !992-93* (in Bengali), National Board of Revenue, Bangladesh Government.

performing loans being carried over from year to year by the nationalized commercial banks (NCBs). As Dr. Reza has pointed out, real interest rates have not come down following recent interest rate deregulation and other financial sector reforms. In fact a perplexing situation seems to be prevailing. On one hand, there appears to be a lack of demand for bank loans because of the high interest rates, which are often further compounded due to extra unofficial charges and delays the loan seekers face. On the other hand, the banks cannot effectively lower the interest rates because they have to make a provision for the bad loans. In fact, the honest bank borrowers are paying a high price for the loan defaults of many wilful loan defaulters. Even with a recapitalization of the NCBs to the extent of 17,000 million taka, which has come from our poor taxpayers, the NCBs are still saddled with a huge loss and suffer from serious capital adequacy problems. According to disclosures made by the Honorable Finance Minister and the Secretary of the Ministry of Finance in a recent interview with *The Daily Star*, because of delay in the legal process, there has been only limited success in the Government's efforts to recover outstanding bank debts, and the non-performing portion of the loan portfolio is still a big chunk, over 30 percent. Evidently further reforms of the financial sector are required, if it has to play its due role in promoting the industrialization process. The NCBs, which are dominating the financial sector, should be radically reformed or privatized. More private banks should be encouraged to increase competition. The government needs to quickly phase out its own directed credit to the jute and, if any, to other sectors. Interest rates should be fully liberalized from centralized control.

Even though we occasionally hear our honorable ministers speaking about the staggering and mounting losses of the public sector enterprises and categorically asserting that such a situation can not be allowed to persist, I share the deep concern of the private sector that the Government is really doing nothing to address this situation. The privatization process, which, along with closure or liquidation of the losing enterprises, appears to be the only viable option and one which the Government should vigorously pursue, has been in virtual limbo during recent years. The privatization process is being unduly delayed on the, not really tenable, grounds that this process is facing stiff resistance from the workers and the mainstream opposition political parties and that there are not enough buyers for the enterprises offered for sale or that the prices being offered are often too low to be acceptable. The World Bank has, in its recent comprehensive review of the privatization issues of Bangladesh, offered many useful suggestions as to how this process could be expedited. After all, in a situation where a poor country is incurring huge losses on account of public sector enterprises, which effectively reduce the public investment or development effort by a sizeable chunk of the overall government development budget, there hardly remains any justification for delaying the privatization process on any pretext! If no private buyers are found for the enterprises offered for sale, it makes good economic sense for the Government to even give them away to suitable parties, including the workers.[4] The continuing public sector losses are also adversely impacting on the efficient operation of the financial sector.

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4 See Milton Friedman's "How to Denationalize" written as early as 1976 and published in *Newsweek*, December 1976 for some such radical prescriptions for privatization in situations where buyers are lacking.

Urgent and important reforms are also needed to improve the labor market and the general legal environment for efficient private sector operation. Labor market reforms are needed to depoliticize labor, to cease centralized influence on market wages, and to upgrade labor skills and labor productivity. The National Labor Law Commission, which was established by the Government to examine the labor issues, has recently completed its Report and submitted it to the Government. We understand from knowledgeable sources that the Commission, which had tripartite representation from the Government, employers and workers, has addressed most of the pertinent labor issues. The Government should urgently consider and accept its appropriate recommendations. The Report should also be published for comments by other competent quarters.

Updating of the pending commercial legislation, the Bankruptcy Law, the Foreign Investment Protection and Promotion Act, and the Patents and Trademark Laws, and other relevant legal reforms should be expedited. At the same time, the Government should undertake further other industrial deregulation reforms, which are crucially needed to attract foreign investors as well as to promote domestic investment.[5]

[5] For more details on these and other industrial deregulations and economic reforms, the reader is referred to the author's *Regulatory Constraints to Industrial Development in Bangladesh and Recent Deregulations*, PIAG Report # 6, August 10,1994, and PIAG's *Industrial Policy Quarterly* (forthcoming in this month), where the quarterly focus covers a review of the industrial and economic deregulation process in Bangladesh.