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BACKGROUND MATERIAL ON INDUSTRIAL POLICY ENVIRONMENT IN BANGLADESH:

REVIEW OF THE LIBERALIZATION PROCESS: THE GROUND COVERED SO FAR AND EXPECTED UPCOMING REFORMS

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ABBREVIATIONS AND ACRONYMS USED

ADB	Asian Development Bank
BB	Bangladesh Bank
BEPZA	Bangladesh Export Processing Zone Authority
BOI	Board of Investment
BSCIC	Bangladesh Small and Cottage Industries Corporation
DEDO	Duty Exemption and Drawback Office
DFI	Development Finance Institution
EPB	Export Promotion Bureau
EPZ	Export Processing Zone
ESAF	Enhanced Structural Adjustment Facility
FIAS	Foreign Investment Advisory Service
IDA	Industrial Development Association
IMF	International Monetary Fund
IPO	Import Policy Order
ISC-1	Industrial Sector Credit (First)
ISAC-2	Industrial Sector Adjustment Credit (Second)
NBR	National Board of Revenue
NCB	Nationalized Commercial Bank
PFP	Policy Framework Paper
PRMAC	Public Resource Management Adjustment Credit
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VAT	Value Added Tax

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I. INTRODUCTION AND BACKGROUND

The PIAG (Policy Implementation and Analysis Group) is concerned with establishing a policy environment which is conducive to organization and operation of private sector businesses and industries. Its primary focus is on removal of regulatory, procedural and other policy constraints on business formation and expansion, especially for small enterprises with limited financial and political resources. The intention is to create a deregulated/liberalized competitive market economy where the private sector business can fully thrive, which is expected to bring about maximum possible contribution to economic growth, employment creation and foreign exchange earnings. The PIAG objectives are sought to be achieved in the following three ways:

a) identification of regulatory and other policy constraints and gaps on private sector development;

b) rapid implementation of appropriate policies; and

c) promotion of informed dialogue and feedback between policy makers and private entrepreneurs, and between government ministries affecting industrial expansion.

Regulations and controls which increase investment and transaction costs of businesses/industries and thus impede growth need to be identified and removed/amended appropriately. Reformed policies and regulations need to be implemented rapidly. And transparency of the liberalized/ deregulated policies needs to be ensured to enhance private sector knowledge of and participation in the liberalization/ implementation process and to make the new regulations and processes themselves simple, trackable and the implementing agencies accountable to firms and investors.

Over the past decade, Bangladesh has made considerable progress in liberalizing policies for the private sector, starting from what was a tightly regulated and state-dominated economic framework. It has progressively transformed the economy towards a greater market orientation and reliance on the private sector as the engine of growth. These reform efforts were in more recent times and are currently being supported by various donor agency assistance programs such as the Extended Structural Adjustment Fund (ESAF) program of the IMF, first Industrial Sector Credit (ISC-1) of IDA and more recently by Public Resource Management Adjustment Credit (PRMAC) and Second Industrial Sector Adjustment Credit (ISAC-2) of IDA. PRMAC is mainly concerned with macro-economic policies. IDA's ISAC-2 program has passed the negotiation phase and is likely to become effective soon, following fulfilment by the Government of the agreed of the agreed conditions. The Government has undertaken a number of regulatory and other policy reform measures before the program's negotiations got under way and committed itself to undertaking further reform measures before the program's effectiveness and other reforms by the time the second tranche is due to be released i.e., by early FY 1994 (July 1993-June, 1994).

Significant improvements in the policy environment have been effected under the Government's New Industrial Policy (NIP) of 1982, Revised Industrial Policy (RIP) of 1986, post-RIP policies especially under ISC-1 and Policy Framework Paper (PFP)/ESAF of IMF and the Government's 1991 Industrial Policy. The latest Policy has promised to ensure a very liberal environment for the private sector.

Despite this progress in policy reform which went along with a relatively sound macro-policy environment, the industrial sector's performance has been disappointing. Industrial growth has been uneven and moderate, an average of 4%, during the eighties and private investment as a percentage of GDP was documented to have considerably fallen during this period and continues to remain sluggish to date. Industry still has a limited base comprising only some 13% of GDP and accounts for some 14% of employment. However, it makes an important contribution (over three-fourths) to exports and has an important share (over half) in import trade. The sector is not diversified and its structure has not changed very much during the last decade despite a spectacular growth performance of a segment of the textile sub-sector, export-oriented readymade garments. In FY90, only six sub-sectors accounted for more than 55% of total manufacturing value added and two of these (textiles and food products) represented about half of the total.

Despite significant privatization (denationalization and divestiture) actions of the eighties, the public sector still accounts for about 40 percent of industrial assets and close to 50% of manufacturing value added. Many of the public sector enterprises are operating with dismal financial performance.

The investment climate still does not look attractive enough for foreign investors. A very limited amount of private foreign investment has come despite an unduly generous package of fiscal incentives offered by the Government.

While some of Bangladesh's neighbors in South Asia such as Thailand and Malaysia are experiencing industrial booms, Bangladesh is lagging behind. Even a country like Vietnam, which was war-devastated and perhaps at a more background industrial stage than Bangladesh, has been able to attract a lot of foreign investment and has made some headway in export-led growth in recent years.

Some recent surveys carried out under World Bank's and others' auspices highlight private sector perception of impediments to industry, which suggest that numerous regulatory, procedural and other obstacles to private investment and business operation in Bangladesh still remain.

Evidently, Bangladesh's liberalization and promotional efforts have not still gone far enough and will need to be further considerably strengthened in the coming years to create a favourable investment climate and a vibrant private sector.

In what follows, policy liberalization reforms so far carried out are described and reviewed and a description is provided of the expected upcoming reforms under donor agency programs. In a second working paper, an attempt would be made to provide a preliminary outline of possible liberalization reforms which remain to be carried out.

II. THE GROUND COVERED SO FAR

This section provides a brief review of the evolution of liberalization policies. Liberalization has proceeded in several policy areas. We attempt to systematically document the progress of reforms in the following areas:

a) Liberalization of policies for private business investment and start-up;

b) Liberalization of the trade and foreign exchange regimes;

c) Liberalization in the area of business access to finance;

d) Privatization of state-owned enterprises; and

e) Improvements in other regulatory and promotional policies;

2.1 Early Liberalization Reforms

Here we cover the reforms carried out before the Government's 1991 Industrial Policy was announced.

After independence in 1972, Bangladesh put almost all existing industries (92% of industrial assets) in state hands. In a few years' time, the Government recognized the need for putting an increasing reliance on the private sector for industrial activity. It, however, proceeded slowly in this direction. Some noteworthy very early efforts designed to expand the role of the private sector in manufacturing activity were undertaken between 1974 and 1978, which included:

- an early dose of privatization of 116 industrial establishments (during 1975-78);

- establishment of the stock market (1976);

- establishment of the Investment Corporation of Bangladesh (1976) to provide bridge financing and underwriting services to companies floating shares;

- removal of the ceiling on the size of private industrial investments (1978);

- introduction of a Wage Earners Scheme (1974) leading to the institution of a secondary foreign exchange market which not only eased business access to foreign exchange resources but also allowed the establishment of 'free sector' firms, which required no formal government approval; and

- allowing private foreign investors to collaborate with private domestic industry.

2.1.1 Investment Deregulation and Easing of Business Start-up Problems

Early reform measures in this area were carried out during the 1980s especially under the New Economic Policy (NIP) of 1982, Revised Industrial Policy (RIP) of 1986 and some post-RIP policies. Reform measures undertaken in this area during this period, which are worthy of note are briefly recounted as follows:

* Curtailment of the list of industries to seven sub-sectors which are 'reserved' for public sector investment and opening up all other sub-sectors to private sector participation.

* Transforming the Investment Schedule formerly used on a mandatory basis into an indicative schedule.

* An expansion of the list of 'free sectors' where investors could invest without requiring any approval with their own finance and with recourse to foreign exchange at the secondary foreign exchange market.

* Delegation of investment sanctioning powers to financial institutions within certain project size limits. The limits specified under the NIP were doubled to Tk 60m for

DFIs and Tk 30m for commercial banks under the RIP and further substantially increased in the post-RIP period.

* Progressively relaxing the direct import content of raw materials of projects as a condition for allowing projects without government approval (starting with less than 20% under NIP, relaxing it to less than 50% under RIP and finally eliminating this import content rule since the RIP).

* Effective from September, 1988, delegation of approval authority to financial institutions for projects involving foreign investment with less than 49% equity and up to Tk 100 m in the case of DFIs and Tk 60m for commercial banks.

* Along with progressive increases in the delegated sanctioning powers of financial institutions, the definition of 'own resources' with which project sponsors could invest without having to obtain an approval was relaxed, first to include suppliers' credits and Pay as You Earn Scheme funds and later (effective December, 1989) to include also borrowing from privately owned financial institutions. The latter relaxation meant *de facto* elimination of project sanctioning limits for private financial institutions.

* Allowing projects with 100% foreign equity also outside the Export Processing Zone (EPZ).

However, these reforms apparently had a limited impact on the private sector investment climate, in the first place because these reforms did not mean much in terms of relaxation from government control on investment; second because progress in other areas like import and foreign exchange liberalization and financial deregulation was also limited; and third because certain restrictive measures were continued or introduced at the same time which reduced the potential beneficial impact of the reforms. A Discouraged List of industries where further capacity creation was deemed unnecessary or detrimental was introduced under the RIP and this list was expanded from 12 in the beginning to 19 in 1988, and to 25 by December, 1989. Thus the private sector was barred from investing in the Reserved List, while projects on the Discouraged List or over the sanctioning limits of financial institutions were under

Government control. Since the Government effectively and indirectly controlled the two DFIs, in fact the greater part of industrial investment was still under the direction of the Government.

Furthermore, severe restrictive measures were being applied to procurement of machinery and equipment, particularly for import of second-hand machinery. For the latter, in addition to detailed questioning by sanctioning authorities about specifications and prices, the project sponsors had to undergo additional difficulties, both at the time of LC (Letter of Credit) opening and of clearing machinery through customs. Regulations required that for importing machinery valued above Tk 2 lakh (Tk 200,000) and below Tk 35 lakh, a certificate from an internationally reputable surveyor to the effect that the machinery had an economic life of at least 10 years was required to be obtained and presented as a requirement for LC opening. The surveyor's certificate needed to be vatted by the Chamber of Commerce and Industry of the concerned country. For such machinery valued above Tk 35 lakh, the investor was also required to obtain a prior recommendation of the line ministry concerned. For new machinery, regulations required that the item be procured through an officially recognized domestic trading (indenting) firm (the intended purpose was to ensure correct invoicing). In the case of DFI-financed projects, the procurement procedures used by the DFI involved additional delays. In the case of suppliers' credits, the terms and conditions were required to be officially approved. Another restriction was with regard to the requirement for companies for public issue of shares. Domestic companies were required to become public when their paid-up capital exceeded Tk 10 million. Some relaxation was allowed in the case of foreign companies. In their case, projects with costs larger than Tk 50m were to comply with the public offering during the first three years of operation.

Thus existing restrictions with respect to the Reserved and Discouraged Lists, procurement of machinery, use of suppliers' credits, the requirement for public issue of shares and the very investment sanctioning process itself retained an inherent bias towards control and increased the investment and transaction costs of investors. Sanctioning took three to five months in normal cases and longer for DFI-financed projects, as revealed by a survey carried out in 1989, although shorter time limits were officially specified.

Though theoretically foreign investment with up to 100% ownership was allowed also outside the EPZ, there appeared to be an official preference for joint ventures with minority foreign shares. Existing policies and practices in fact discriminated against foreign investors. They were required to meet the whole cost of imported machinery and equipment with funds brought from abroad and, in the case of 100% ownership, the entire project cost. They were not allowed to invest in all industries of their liking or to choose product lines especially in the pharmaceutical industry. They were not allowed to borrow completely freely from domestic banks to expand their production capacities. The very attitude of official circles toward foreign investors was less than fully welcoming, as recent surveys of private sector's perceptions of impediments to industry in Bangladesh seem to suggest.

Nevertheless, the early attempts at easing the controls over the private sector were steps in the right direction. The introduction of 'free sectors' where investors could invest without requiring formal approval together with the lenient treatment of investors' 'own resources' including borrowing from private banks was a particularly forward-looking step. With the growth of private banks, it opened the way for financial-industrial groups to begin to emerge where industrial projects could be financed by commercial banks. Parallel progress in easing exchange control regulations and import controls (see below) also played an important part.

Some institutional changes were made to deal with other start-up problems of business. The Board of Investment (BOI) was established as a 'one stop' agency in January, 1989 with the foremost objectives of streamlining investment regulations and providing assistance to entrepreneurs for access to site services such as power and water and facilitating their access to various government-provided facilities and incentives such as importing machinery at concessional duty rates, tax holidays, etc. The purpose of its creation was to minimize the number of institutions that an investor had to deal with for obtaining access to site services and other facilities and incentives. The Board also became the highest authority to sanction projects beyond certain sizes and an agency to promote in general both domestic and foreign investment. A number of government institutions previously involved in the regulatory system were eliminated with the creation of the BOI. All firms were required to register with the BOI. Firms requiring import passbooks and government incentives like tax holidays, concessional duty rates were to get a letter of approval from the BOI.

The performance of the BOI as an institutional aid as perceived by industrial entrepreneurs has been mixed. While some may have benefited from its services, others point to its ineffectiveness as a real one-stop agency. The new organization owes its failures partly to the fact that it replaced the old control-minded Department of Industry using most of its staff and secondly because it was not strengthened enough to wield enough influence over other government offices. For example, a certificate of concession issued by BOI is not sufficient to get the concessional duties unless backed by an NOC (No Objection Certificate) from the National Board of Revenue (NBR). (See below for recent changes and further moves for change).

2.1.2 Trade Liberalization and Relaxation of Foreign Exchange Controls

The traditional approach in this area has been to maintain a tight control on imports and the use of foreign exchange, which owes to the popularly held view that foreign exchange must be conserved almost at any cost. The import trade has come to be controlled by direct bans and other quantitative restrictions as well as by high tariffs. There was little perception among government officials that such an approach discriminated against export production and that it also inhibited efficient import substitution. To date, that approach has largely changed, but not much ground has yet been covered in actual implementation of a trade liberalization programme.

The progress of liberalization of the trade and exchange regime consisted in a slow and gradual reduction in reliance on direct controls over trade and moderation and rationalization of tariffs as well as in simultaneous simplification of complex import procedures in an attempt to ensure an unhindered access to imported industrial inputs and some gradual relaxation of exchange control regulations. A phased program of reform was adopted which can be attributed to existing strong resistance to such reform in official circles and recognition of possible negative effects on government revenue and avoidance of possible unsettling effects on domestic market-oriented production and balance of payments. Trade policy reform was significantly begun under the World Bank's two-year ISC-1 program launched in 1986 based on a number of effective protection studies of a Trade and Industrial Policy Reform Program (TIP) supported by the Bank. There was simultaneously an effort to increase export competitiveness by assuring a free-trade status to such production by introducing and gradually strengthening a duty-drawback system and other measures and by adopting a flexible exchange rate management policy and a move towards unifying foreign exchange markets.

An early reform (in 1974), in response to a foreign exchange crisis, was the establishment of a Wage Earners Scheme (WES) which allowed nationals earning foreign exchange abroad to import goods more or less freely or to sell foreign exchange in a secondary market at a premium. This scheme was subsequently expanded to allow selected exporters to sell their foreign exchange earnings into this secondary market. The emergence of this secondary exchange rate led to the gradual expansion of imports through this market, which was accompanied by a simplification of import procedures. It also allowed the expansion of 'free sectors' which financed all of their equipment and material imports' foreign exchange requirements from this market. Growth of such 'free sectors' as readymade garments, textiles and food processing has been particularly striking.

Other early reforms carried out included (i) the replacement of a positive import list of items that were permitted to be imported by a Negative List and a Restricted List with the implication that any item not on the Negative List could be imported, either freely or by fulfilling specified restrictions and (ii) simplification of the licensing procedure for importing industrial imports requiring only a passbook specifying broad categories of eligible raw materials and spare parts. In 1988, the Government adopted the Harmonized System of notation as the basis for classification of trade restrictions including tariffs, which provided a common basis for trade flows, tariffs and direct controls and removed some of the ambiguities that plagued the previous system and facilitated customs administration.

The reform under the ISC-1 program included: (1) compression of tariff variations by reducing the number of rates as well as the tariff level; (2) a partial removal of quantitative restrictions (QRs); and (3) streamlining of import procedures. The number of tariff rates was reduced from 24 to 11 covering 7000 products. The top duties which extended up to 300 percent were reduced to a maximum of 150% in July, 1987, except for a few products. This maximum rate was further reduced to 100% in October 1990 for most products. There was also downward adjustment of lower tariff rates falling especially on industrial raw materials and intermediate inputs. However, these reforms were carried out in a haphazard manner without paying enough attention to the resulting effective rates of protection (ERPs). In many cases, unduly high ERPs to domestic products were still being retained because of lower tariff rates on industrial inputs and still high levels of tariffs on outputs.

With respect to the QRs, the government agreed on a 20% annual reduction of the Negative List of imports beginning with FY88 and phasing out of all restrictions by FY90. However, this agreement was only partially implemented and QRs are still widely in place in Bangladesh. In 1990, 36% of tariff headings were still subject to QRs. The value of imports controlled under QRs is estimated to have been 52% in 1990.[1] Because of continuation of wide use of QRs, the problems of importers', especially export firms', access to imported inputs in the banned and restricted lists persisted. The problems were largely resolved only in a few industry cases like readymade garments and some textile products where imports were allowed under special bonded warehouses and against back-to-back LCs.

An early attempt to liberalize tariff restrictions on trade for export competitiveness was the introduction of a system of refunding actual duties. This was subsequently supplemented by the use of duty drawback at pre-determined flat rates for a limited number of products. In FY78, the system of importing materials duty - free under a special bonded warehouse arrangement was introduced for readymade garments to start with. It was later extended to certain textile and a

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[1] World Bank, The Manufacturing Sector in Bangladesh: Selected Issues: Vol. II, Bangladesh: Private Sector Perception of Impediments to Industry, Draft, February 27, 1992, p. 4.

few other products. However, the duty drawback system in general and especially the drawback at actual rates has not worked well because of poor administration. The use of both the special bonded warehouse system and the flat-rate duty-drawback system has remained limited in product coverage even to-day.

Another reform was the adoption of a flexible exchange rate management system. Available estimates of movements in real effective exchange rates suggest, however, that nominal exchange rate adjustment to maintain or improve real effective exchange rates for exports had been fairly satisfactory only in the late seventies and early eighties. This adjustment became infrequent and inadequate afterwards.[2]

In the early period, not much was accomplished in the area of liberalization of foreign exchange regulations. A major innovation was the XPL/IEC (Export Performance Licensing and Import Entitlement Certificate) system which enabled freer access to foreign exchange in the secondary exchange market. The XPL was provided at specified rates to non-traditional exporters as an incentive measure. It was later simplified into an XPB (Export Performance Benefit) system. (With the unification of the dual exchange rate system in January, 1992, the XPB system got abolished automatically). There were also some minor relaxations of foreign exchange restrictions, carried out during this early period, for business travels and other purposes.

2.1.3 Financial Sector Reforms

Early efforts under the NIP and RIP to ease problems of smooth and prompt access to both term and working capital finance took the forms of introduction of standardized and administered interest rate structures and other terms and specification of time limit directives with regard to loan

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[2] See A. Rab, Exchange Rate Policy, Export Development, Inflation and Trade and Industrial Policy Reform in Bangladesh, TIP, Planning Commission, Government of Bangladesh, 31 January, 1990.

Also see World Bank, Bangladesh Selected Issues in External Competitiveness and Economic Efficiency, Report No. 10265-BD, March 16, 1992, pp 42-45.

sanction and disbursement and of other directives with regard to collateral requirements. To ensure greater availability of credits, the Government stipulated that financial institutions and commercial banks should not ask for any collateral from entrepreneurs when granting term loans for industrial projects. To speed up the process for term lendings, the banks were required to take action on the application within two months. Preferential (subsidized) interest rates were maintained for priority sectors like exports, small industries, jute, sugar, etc., with refinance facilities from Bangladesh Bank.

Limited access to finance remains, however, a major problem, perhaps the single most important constraint facing entrepreneurs as suggested by some recent surveys. It appears to be more the procedural complexities that are involved than the nominal cost of credit itself. Effective cost of credit is higher than nominal cost due to delays and bribes. Lack of working capital is also reported to be a very serious problem which has affected capacity utilization. Readymade garment industry has remained largely insulated from the credit crunch because of its reliance on back-to-back LCs as well as alternative modes of financing (e.g., joint ventures, equity).

Limited access to formal financial sector credit has been especially acute for small businesses. Such businesses have come to depend heavily on an informal sector of creditors, who supply materials or buy outputs on credit arrangements at interest rates which are considerably higher than those maintained in the formal sector.[3]

Government efforts to ease problems of access to finance from the formal banking system at administered terms did not liberalize bank lendings and deposits to be decided by free market forces which made priority lendings and mobilization of term deposits commercially unattractive. Furthermore, lack of financial discipline such as absence of enforcement of loan recoveries, especially by government-owned DFIs and nationalized commercial banks and heavy government-directed loan operations to public enterprises many of which were losing money and not able to service debt undermined the very

[3] See World Bank, Studies of Small Firms Informally Financed, Draft, July 1, 1992.

viability of these financing institutions to sustain credit delivery on a long-term basis. The mounting debt recovery arrears of the two DFIs led the multilateral donor agencies, the World Bank and the Asian Development Bank, to suspend replenishing of their funds. The Government was unable to provide foreign exchange funds to these institutions from its own resources and expected the donors to supply the needed funds. This led to a severe credit crunch for the industry sector, which accounted for a fall in private investment levels in the eighties.

Against this background, certain monetary sector reforms of limited scope were carried out under an adjustment program of the World Bank and the Government is also currently undergoing another monetary sector reform exercise with IDA and USAID support.

The reforms accomplished included introduction of a more market oriented-approach to interest rate determination, discontinuation of subsidized refinancing facilities from Bangladesh Bank, imposition of new regulations with respect to accounting policies for provisioning of bad debt and suspension of interest, and adoption of an action program to improve debt recovery.

The transition to greater market orientation was initiated in November 1989, by establishing a system of new interest rate determination, under which banks were free to adjust their lending and deposit rates within certain bands; while interest rate subsidies have been made transparent and reimbursable. Bangladesh Bank, with technical assistance from USAID, has developed a methodology to calculate shadow market rates for lending to major sectors, taking into account the cost of funds, operating costs and risks. The new structure was a significant improvement over the previous fixed interest rate regime, though the imposition of bands limited the effect of changing market conditions on interest rates and credit decisions. Reforms also included abolition of credit ceilings and replacement of existing refinancing programs by a general rediscount facility at the bank rate for commercial banks.[4] Lastly, to strengthen financial institutions and industrial

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[4] See World Bank, <u>Bangladesh: Managing the Adjustment Process - An Appraisal,</u> Report No. 8344-BD, March 16, 1990, P.34.

credit delivery the Government instituted credit recovery measures, together with recapitalization of the DFIs. However, the pace of this recovery effort slackened after the initial start. Other measures taken included imposition of new regulations with respect to scheduled bank accounting policies for provisioning of bad debt and suspension of interest and institution of financial courts designed to improve debt recovery.

2.1.4. Privatization of State-owned Enterprises

Privatization action focused mainly on the manufacturing industries. After liberation in 1972, the socialistic-minded government took in state hands all properties abandoned by Pakistanis and nationalized all large industries and financial sectors. Soon after, however, some recognition of private sector role was expressed by the Government. In the early seventies, the privatization process was begun by denationalization of some 120 small businesses which were plagued by problems of mismanagement. An official privatization policy was adopted only after a new government came to power in 1975, but it was still at a conservative pace. During 1975-81, 255 state enterprises mostly small unprofitable ones, were privatized.

Major privatization came under the 1982 NIP, which involved a substantial number of large-scale industries in jute, textiles, chemicals, food and steel and engineering. By the end of FY83, about 70 major units in the manufacturing sector (including 28 jute mills and 26 cotton textile mills) were returned to private ownership. The divested jute and cotton mills were returned to their former private owners, while the other units were either returned to their former owners or sold to the highest bidders. Under the NIP, in all 33 jute and 27 textile mills were privatized. In the case of textiles, this meant returning to private hands mills possessing about 45% of the sub-sector's production capacity. An additional four mills were privatized within the next few years. In the case of jute mills also, the ratio of privatized to public-sector-retained assets was substantial.

However, one significant aspect of the privatization of jute and textile mills was that few former owners bought more than 51% of the equity (their previous stake possession before nationalization was 30%) as the offer did not look attractive enough. The retention of government equity up to 49% in these privatized mills meant in practice that these mills did not fully rid themselves from government control and intervention or from the pernicious spill-over effects of the mismanagement of the retained nationalized mills.

The substantial government retention of equity in these privatized mills along with retention of a substantial proportion of the mills meant that even after the major privatization move, the Government retained about 78% of the aggregate equity in the textile sub-sector. This percentage lessened gradually as new private start-ups were greater than the new capacity the Government continued to add. (In the jute sector, however, existing demand situation did not warrant any new capacity creation either in the public or private sector).

Nevertheless, the bold move to privatize 33 jute and 27 textile mills in the country's two leading manufacturing industries dispelled the doubt that the Government could ever begin to reverse its liberalization policies or even renationalize privatized entities and had a significant effect on private sector activity and investment in other parts of the economy. This incidental effect may have been the Government's main contribution to improving the economy, transcending the actual divestiture of the mills which mostly were already in bad shape.[5]

The fully or partially privatized enterprises under the NIP, constituted 38% of industrial capacity in jute, 70% of fixed assets in textiles, 12% in the sugar and food industries, 10% in the chemical industries, and 4% in steel and engineering. Over 650 industrial units were transferred to the private sector, leaving only 160 in public hands; and the public sector's share of fixed industrial assets declined to 40% in FY86.

The privatization effort slackened afterwards. Starting with FY87, a partial divestiture program was taken in hand with privatization of 49% of the equity with retention of majority

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[5] See World Bank, Bangladesh: Report on the Textile Industries Restructuring Study - Phase 1, Revised Draft, Washington, D.C., May 9, 1992, PP. 8-10.

control by the Government. In this program, 16 public enterprises were initially listed for divestiture, of which three were successfully marketed in FY87. The process was inevitably slow because of the fledgling nature of the stock market and the need to promote public confidence in the divestiture process by selling off only the profitable enterprises.

Privatization was extended to other sectors as well. Majority shares (51%) of two nationalized banks were returned to private ownership under the NIP. Six private banks were also permitted to come into operation during this period. This was followed by the establishment of a number of investment finance corporations in partnership with foreign partners. The nationalized banks (two DFIs and four commercial banks), however, still dominate the financial sector activities.

No privatization program touched such sectors as transport and communications, oil, gas and power. In the agricultural sector, certain privatization actions involved sale and distribution of fertilizer and irrigation equipment, which proved to be immensely successful in improving agriculture's growth performance.

2.1.5 Improvements in Other Regulatory and Promotional Policies

Along with measures to progressively liberalize the investment sanctioning process, some other early steps taken to improve the investment climate for the private sector especially for foreign investment included (i) the signing of the Foreign Private Investment (Promotion and Protection) Act of 1980; (ii) permitting establishment of several foreign banks and joint venture banks, and (iii) application of additional promotional measures. The Foreign Investment Act protects foreign investors from possibility of nationalization or expropriation of their investments, guarantees repatriation of profits from such investments and provides full indemnification in the event of financial losses due to civil unrest. Full repatriation of investments and fair and equitable treatment are also assured under this act. Further bilateral investment protection agreements have been signed by the Government with many countries including the USA, the UK, Germany, France, South Korea, etc. Bilateral agreements have also been concluded with many countries for the avoidance of double taxation.

Foreign banks and joint venture banks established include the Islamic Bank of Bangladesh Limited (a joint venture with 70% foreign equity), the Saudi-Bangladesh Industrial and Agricultural Company, and the Industrial Promotion and Development Company of Bangladesh (IPDC). The last agency, a joint venture with 30% GOB equity and remaining participation by four international development finance institutions, has been set up to identify and promote viable investment opportunities and to attract foreign capital to such investments.

Existing stated policies such as labor policy, tax and tariff policies, import and export policies make no discrimination between local and foreign investors. At the same time, a number of fiscal incentives have been put in place: duty concessions on imported machinery, a tax break ranging between 5 and 12 years and allowing repatriation of capital and capital gains with approval from Bangladesh Bank and allowing remittances of dividends of non-resident shareholders, foreign nationals' savings, retirement benefits and personal assets, and approved royalties and technical fees up to certain limits. There were also institutional improvements to attract greater foreign investment.

These initiatives, however, had limited success in attracting foreign investment. This was precisely due to many regulatory or procedural complexities still remaining, which deterred foreign investment (See below).

Some (post-RIP) policy improvements also included removal of existing discriminations between public and private sector industries regarding financing or provision of infrastructure. Furthermore, special duty rebates extended to public sector units were removed. The NIP and RIP strengthened institutional support for the private sector by creating agencies to monitor the implementation of policies, and to provide support services (e.g., market information) for investors.

2.2 Recent Reforms

With the announcement in FY92 of a new industrial policy, Industrial Policy-1991 (IP-91), a new phase of liberalization reforms began. The new policy makes a clear break with the past policies in the following ways:

* It puts more emphasis on the need for a rapid industrialization process and to this end:

* It assigns a greater role to the private sector and to enable the private sector to play its assigned role, it envisages the government role to be supportive rather than regulatory.

* It promises a smooth and speedy transition to a competitive market economy through removing all sorts of regulatory constraints on private sector development, increasing efficiency in resource allocation based on competitive prices and interest rates, liberalizing and harmonizing tariffs and taxes, and maintaining competitive and efficient banking and financial schemes.

* It lays special emphasis on export development as the key to rapid industrialization in Bangladesh.

* It adopts a stance toward more vigorous attraction of foreign investment and promises removal of all barriers to such investment.

* It also emphasizes the promotion of small and rural industries.

Despite this admirable focus of the new policy, progress in actual implementation of the reform process has been rather slow. The policy does not explicitly spell out what it undertakes to do in concrete terms to move to a competitive market economy, to make the industry more efficient and internationally competitive or to progressively reduce the current still bulky size of what is largely an inefficient public sector. There were also certain inconsistencies contained in the Policy. For example, it retained the prerogative for regulating industries on grounds including market saturation, retained regulatory functions of a number of patronizing authorities and other offices and assigned unrealistic roles to certain authorities like BOI and BSCIC. Admittedly, the original Policy needed a further refinement, which the Government under ISAC-2 has recently brought about & the Policy as revised upto December 1992 has been published recently.

An additional refinement already given effect recently and incorporated in the revised Policy is the dropping of electricity (generation and distribution) and telecommunications sectors from the Reserved List and opening up these areas for private investment.

Some of the immediate changes brought about to liberalize investment controls under IP-91 have been:

* abolition of (Indicative) Investment Schedules and the Discouraged List of industries;

* further enhancement of delegated investment sanctioning limits to Tk 300m for DFIs and nationalized commercial banks;

* setting of time limits for DFI/NCB/BOI/BSCIC/ BEPZA approvals of projects: 2 months for BOI/BSCIC/BEPZA and 3 months for DFI/NCB after receiving applications. The applicant is to be informed within 15 days if the application is incomplete; and

* waiving of the obligation of companies involving foreign investment to sell shares through public issue regardless of the size of their paid-up capital.

The third of these measures is directed toward encouraging foreign investment. Some more early IP-91 measures taken to encourage foreign investment were:

* withdrawal of restrictions on access to working capital faced by foreign firms based on their equity holdings; and

* announcement of tax exemption facility for interest

on foreign loans as well as on royalties and technical assistance fees.

Recently, the government has also announced tax exemption facility for capital gains earned by foreign shareholders on transfer of their shares.

Some new measures announced to promote export production include:

* redefinition of an export-oriented industry as one which exports 70% or more of its total products or services in monetary value, directly or if indirectly helps exports through supply of local materials;

* allowing imports of machinery and spare parts at a concessionary duty rate of 10%; and

* more recently, exemption of income tax at half of the existing tax rate, i.e., at the same rate allowed for BEPZA industries.

Another reform measure undertaken recently is the waiving of the obligation of also domestic firms to become public limited companies when their capital exceeded Tk 10m.

More recent reforms which have been supported by IDA's ISAC-2 are outlined as follows:

A. Relaxation of Investment Controls and Improvement of the Investment Climate

a) A major reform brought about is the removal altogether of the requirement for government approval of industrial projects other than for industries in the reserved/regulated sectors.

b) Foreign investors are no longer required to obtain prior approval of Bangladesh Bank (BB) to repatriate profits and dividends to purchase shares to set up industries or to invest in shares and securities through the Dhaka Stock Exchange.

c) Residents who bring in their earnings abroad through the normal banking channel and invest in new industries, stocks, shares or government bonds or use such funds for purchasing state enterprises offered for sale have been exempted from income tax on such invested income.

d) Previous regulations over the terms of suppliers' credits have been simplified. Commercial banks are now exempted from obtaining prior BB clearance to open LCs against suppliers' credits and other foreign borrowing contracted in the private sector in accordance with the prescribed criteria of the BOI, provided the maximum effective rate of interest is LIBOR + 4% and the repayment period is not less than seven years. The interest rate condition has been considerably relaxed from the previous LIBOR + 2%. The requirement of prior BB permission for repayment of such credits and payment of interest on such credits has also been withdrawn.

e) The requirement of prior BB approval for remittances of royalties and technical fees has also been lifted, when such remittances are in accord with the BOI guidelines.

f) Commercial banks have been empowered to extend term loans on normal banking considerations to foreign firms operating in Bangladesh without requiring any prior clearance from Bangladesh Bank.

g) Commercial banks have been empowered without prior BB approval also to remit savings of expatriate personnel returning from Bangladesh so long as the salary benefits are clearly stated in the BOI-approved employment contract.

h) Prior BB approval is not required also for remittances of dividends and capital gains of foreign investors on shares and securities purchased through the Dhaka Stock Exchange after withholding tax if any. Note that the tax payable on capital gains on shares now stands exempted.

B. Relaxation of Exchange Control Regulations

Foreign exchange regulations have been relaxed especially for exporters and Bangladeshis working abroad. The changes made are as follows:

a) Exporters are now allowed to retain 5% to 10% of their earned foreign exchange in a foreign currency account in US dollar or pound sterling to meet their genuine business purposes such as business visits abroad, participation in export fairs and seminars, importation of raw materials, machinery or spare parts, etc., 5% in the case of exports of petroleum oil and lubricant products including naphtha, furnace oil and bitumen, readymade garments and electronic goods where import content is relatively high and 10% in other cases. The retention margin has been substantially raised from the previous 2% - 2.5%.

b) Exporters have been allowed also to open interest-bearing renewable term deposit accounts with such retained foreign exchange.

c) They have been exempted from obtaining prior BB permission to open back-to-back LCs against export orders so long as such exports conform to existing guidelines with respect to value addition.

d) The amount of foreign exchange which Bangladeshis can bring from abroad without declaration to the customs authorities has been relaxed to $ 2,500 in the case of resident Bangladeshis and $ 5000 in the case of nonresident Bangladeshis. They are allowed to take back the unspent amount while going back abroad. They are allowed to open a bank account including an interest bearing fixed-term account with any amount of foreign exchange brought in after declaration. Non-resident Bangladeshis maintaining their foreign currency accounts in Bangladesh are now allowed to retain such accounts up to five years after they come back home.

C. Other Recent Reforms under ISAC-2

These reforms in various areas could be outlined as follows:

C.1. Relaxation of Investment Controls

In this area, the Government has introduced a few further reforms which include:

a) elimination of the requirement for sponsoring agencies' approval of appointment and remuneration of foreign officials, experts and staff within defined automatic approval limits; and

b) elimination of BOI/BSCIC/BEPZA oversight of DFI/NCB-funded projects and of all approvals, allocations, etc., other than for the purpose of delivering incentives/services through BOI/BSCIC/BEPZA.

C.2. Import Liberalization

Phased reduction in dependence on QRs on the import trade continued in FY92 and left 193 HS 4-digit codes on the Control List (CL) plus about 130 groups of other IPO restrictions in the IPO text in June, 1992. (The CL HS 4-digit codes numbered 250 items in FY91 IPO and 320 in FY90 IPO). The Government has made commitment to abolish most CL items except those which could be retained for non-trade reasons of religion, health or public safety.

Progress on tariff reforms has been very slow in terms of changes in the rate structure. The introduction of trade-neutral Value Added Tax (VAT) in FY92 was a significant structural reform measure which facilitated further reform in the tariff structure by both promising substantial additional revenue and by creating the scope for eliminating other protective levies on imports. The customs duty (CD) rate structure simplification into seven non-zero and non-luxury rates (7.5, 15, 30, 45, 60, 75 and perhaps 100%) has been attained with a longer list of exceptions than had been previously envisaged under

ISC-1. Under ISAC-2, the Government has undertaken to further continue the process of tariff rationalization by lowering the high tariff rates, using only CD rates as a protective instrument, eliminating all CD rate discriminations between users and industries, using LCA/permit fee as a temporary revenue measure in FY93 and applying advance income tax to all tax paying importers. The last has been already implemented. Further tariff rationalizations envisaged are:

a) apart from 4 luxury product groups, all tariffs above 100% to be reduced to 75% or less (most) or 100% (some);

b) about half (by CY91 import value) of now at 100% to be reduced to 75% or less;

c) about one quarter (by CY91 import value) of now above 50% to be reduced to below 50% including significant inputs to a) and b);

d) all now below 7.5% to be raised to 7.5% or 15% with some exceptions at zero rate on non-trade reasons; and

e) consolidation to eliminate distinctions between users (all) and between similar products within HS-4 headings (most).

Partial trade-neutrality of non-CD taxes on textiles was partially achieved in FY93 by imposition of a 2.5% excise duty on domestic yarn and textiles as against the 15% VAT on their imports. However, in the face of objections from the industry and in view of its ailing state, the Government reverted to the use of specific excise duties at rates prevailing before FY 92 when the VAT was introduced.

Preparation is under way along with cabinet approval of a draft legislation to reorganize the existing Tariff Commission into an autonomous, better staffed National Tariff Commission to conduct industrial protection analysis.

Progress in the streamlining of import and customs clearance procedures has been limited. To simplify customs clearance procedures, pre-shipment inspection/assessment was introduced on a trial basis in FY93. To ease problems of tariff assessment, the Government has prepared an operative tariff schedule for FY92 and a draft one for FY93, the latter to be finalized with some revisions. A program has been developed to computerize customs entry.

Some import procedural simplication measures introduced just recently and put into effect from February 1993 (and incorporated in the revised 1991-93 IPO) are:

- cessation of the requirement of use of (industrial importer) passbooks for import items other than those in the Controlled List;

- cessation of the issue of import permits for imports effected by direct payments abroad by non-resident Bangladeshis;

- permitting imports on the basis of pro-forma invoices of foreign suppliers and abolition of the mandatory requirement of use of local indentors' indents;

- waiver of the mandatory requirement to ship goods on Bangladesh flag vessels for export industries.

C.3. Liberalization for Export Promotion

For liberalizing access to world-priced inputs for export industries, the following further steps have been taken:

a) The duty drawback system has been improved by strengthening the Duty Exemption and Drawback Office (DEDO), by introducing flat DD rates for 335 products and by reducing drawback processing time to 5 days for flat and 4 weeks for actual rate applications.

b) Special bonded warehouse (SBW) facilities have been extended to 2 non-garment firms on trial basis. The Government has approved and publicly announced arrangements for SBW improvement/expansion to any industry allowing:

i) non-back-to-back LC credit arrangements;

ii) advance import of one-third of the greater of last or next annual requirements,

iii) duty suspension on machinery and spare parts (100% exporters) without involvement of 'sponsoring' agencies, and

iv) relaxation of 30% value added requirement for high-value items.

c) The Government has returned to flexible management of the exchange rate in 1991 which was aimed at maintaining the real effective exchange rate (REER) at its November, 1988 level. The Government is committed to maintaining flexible management of the exchange rate to promote export production as well as to allow it to help, in part, protect domestic production during tariff rationalization.

C.4. Improvements in Other Regulatory and Promotional Policies under ISAC-2

These could be noted as follows:

a) The government has recently announced a long-term comprehensive export development strategy for a period spanning eight years upto 2000 prepared with World Bank support, which has provisions for a package of policy incentives as well as extensive procedural and institutional reforms aimed at making export trade smoother and vibrant.

To enlist prompt government attention and support, a high-powered National Committee on Export is envisaged under this structure to be formed soon, which will be headed by the Prime Minister, with several other Ministers as members. Other features of the strategy briefly include, among others:

* all manufacturers-exporters are to receive SBW facility;

* flat rate duty drawback to be extended to at least 500 product items in medium term and eventually to all export product items;

* cash compensation system to be reintroduced for smaller companies unable to enjoy SBW or DD facilities;

* an Export Promotion Scheme with donor support to be launched for such purposes as providing technical and financial assistance to individual firms for undertaking product development, market research and promotional campaign; and

* institutional development to be undertaken of public organisations such as EPB, NBR and commercial banks handling exports to enhance their capabilities to serve the export-oriented drive.

(b) The Government (MOI) has with FIAS support undertaken a study for

i) identification of legal, regulatory and procedural obstacles to industry; and

ii) review of efficiency of existing fiscal and financial incentives for both foreign and domestic investors.

A report of the study has been already completed recently (November, 1992).

c) The Government has undertaken review plans for BOI's reorganization. This organization has already been relocated in Prime Minister's office with upgraded Executive Chairman.

d) A Public/Private Task Force with a broad scope to form proposals on investment promotion has been established (chaired by Executive Chairman of BOI). The task force has already prepared its report which is currently under review of the Government.

III. EXPECTED UPCOMING LIBERALIZATION REFORMS

The Government has made its option clear in favor of private sector-led industrial development. Some robust performance of the agricultural sector during the past several years was due in large part to policies which significantly expanded the role of the private sector in the distribution of agricultural inputs. In contrast, the industrial sector performed poorly throughout the 1980s in terms of production, investment and job creation. Despite substantial ground covered so far in improving the incentive structure for private investment and regulatory framework for industry, the investment climate has still not become propitious enough for a vigorous private sector response. The Government recognizes the need for pushing ahead with further liberalization reforms for achieving rapid industrial growth. In line with its 1991 Industrial Policy, the Government has spelled out its development strategy in favor of export-oriented activities and efficient import substitution. Progress to promote this strategy has been limited since the existing trade and exchange regime still strongly discriminate against export production and arbitrarily among import-substitution activities. Moreover, there remain other regulatory and administrative controls and policy anomalies which constrain smooth and efficient private sector performance.

The Government is already in the process of undertaking more liberalization reforms during remaining years of FY93 and FY94, especially supported by ISAC-2 which seeks to address issues in the areas of trade liberalization and various aspects of private sector development. These are documented below.

3.1 Investment Liberalization

Considerable progress has been made in reducing controls on private foreign and domestic investment. In addition to earlier measures (such as elimination of indicative investment and discouraged lists; of mandatory public listing of companies when capital exceeded Tk 10 million; of the need for approval of publicly listed companies' chief executive salary rates; and of public oversight of investments funded by entrepreneurs or private banks), other more recent further liberalization measures include decision to phase out BOI approval function of large investments financed by DFIs and NCBs, and elimination of distinctions between the treatment of domestic and foreign investments. Formerly DFI and NCB-sanctioned investments upto their sanctioned limits were subject to BOI approval if they involved foreign investment.

The Government has now decided to eliminate oversight of private investment altogether. Government intervention would henceforth be limited to normal business registration, appropriate social regulation (relating to environment, public safety, etc.) and the administration of incentives and provision of services by or through the BOI, BEPZA and BSCIC. With these exceptions, the 'sponsoring' or 'patronizing' functions of government agencies have been abolished. Among the approvals, allocations and entitlements eliminated are those relating to private foreign firms' production capacity changes.

The Government has also recently curtailed the reserved list to allow private investment in the power and telecommunications sectors. The Government is to consider opening to private investment other industries such as air transport and perhaps railways and export oriented defence industries. Appropriate regulation would replace reservation of such industries in the public sector. The government is to launch a study to review the scope and implementation of industrial regulations relating to environment, factory safety, depletable resource management, natural monopolies, etc., with a view to bringing them into line with best international practices and introducing automaticity and transparency in enforcement.

3.2 Trade and Exchange Liberalization

As stated in this year's budget speech of the Finance Minister, the Government policy aim in this area is to remove the anti-export bias of the trade regime over a period of five years bringing down effective protection to low levels prevailing in internationally competitive developing countries. This would require phasing out all quantitative restrictions (QRs) on imports but a few which would be retained for non-trade reasons of religion, public health, security, etc., simplification of import procedures and tariff reform.

Removal of QRs. Further reform in this area would comprise completing the process of phasing out QRs on imports and otherwise streamlining import procedures, which was initiated in the mid-eighties under the first Industrial Sector Credit.[6] Direct controls on imports are exercised by the Import Policy Order (IPO) which specifies two types of controls: a Control List (CL) of items codified according to the Harmonized System (HS) and various restrictions contained in the IPO text. Phased reduction of QRs in the past left in June, 1992 (in the 1991/93 IPO) 193 headings on the CL at HS four digit level and 130 groups of other restrictions in the IPO text. Among the latter group are provisions relating to the use of local agents, import permits and opening LCs, foreign-invested firms' production capacity, importation of second-hand machinery and other goods and job-lots, imports on proforma invoice, imports for re-export, etc.

The envisaged liberalization for FY93 consists in reduction of the existing CL items to 93 and removal of many of the non-CL restrictions and codification of the remaining non-CL restrictions. The QR reduction is to be completed in FY94 when only pre-shipment, quarantine and radiation certification requirements and other restrictions for reasons of public health and safety, religion and social considerations and a small number of highly sensitive items will remain in place. For FY94, it involves reduction of the remaining CL restrictions to 54 CL items. The retention of sensitive items is to be followed by investigation carried out and recommendations made by the National Tariff Commission (NTC), which is yet to take shape. (The remaining number of CL items in FY94 includes any transfers from the IPO text for trade reasons, and that number may subsequently increase to a higher figure when all the control items relating to non-trade reasons are property codified and listed). The non-CL restrictions further envisaged to be removed in the reform process are detailed below under simplification of import procedures.

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[6] This credit's objectives were similar to those under ISAC-2: to effect reforms in import control and tariff regime, export policy administration, and investment controls.

<u>Simplification of Import Procedures.</u> The further envisaged reforms to this effect are listed as follows:

a) Cessation of the issue of <u>import permits</u> other than for controlled imports.

b) Removal of requirements for <u>import entitlements</u> and all related bureaucratic procedures, other than for controlled imports. This would include removal of the involvement of 'sponsoring' ministries in the import process with consequent restructuring of the functions of the offices of Chief Controller of Imports and Exports (CCIE), Board of Investment (BOI) and other agencies and abolition of the import permit/LCA fee.

c) Removal of the requirement for imports to be transacted by LC to allow direct payment transactions by any importer, not restricted to special groups importers such as scientists, expatriate citizens or to imports effected under the PAYE scheme.

d) Removal of all restrictions on imports of second-hand machinery other than reasonable requirements for pre-shipment inspection.

e) Removal of restrictions on imports of other second-hand goods and job-lots, subject to review by the NTC.

f) Improvement of the special bonded warehousing scheme, including its expansion to any activity by allowing

- non-back-to-back LC credit arrangements;

- advance import of one-third of the greater of last or next annual requirements;

- duty suspension for machinery and spare parts for 100% exporters in FY93; (Applicable concessional duties have been recently reduced, not altogether suspended.)

- removal of any involvement of 'sponsoring' agencies in machinery imports; and

- relaxation of the 30% value-added requirement for high-value items.

As noted above, the IPO has been revised recently to incorporate several of these and other relevant changes. Other envisaged import simplification measures include publication of the full operative schedules of tariff and taxes for FY93 and FY94 for making the import taxes transparent to the importers, satisfactory operation of pre-shipment inspection services, and contracting of international agents for offshore duty assessment. These measures are aimed at reducing the difficulties now often experienced in establishing import values and duties during customs clearance and reducing corruption and improving efficiency of customs administration.

Tariff Reform: This reform encompasses several dimensions: (a) moderation of high tariffs; (b) tariff compression to a few rates; (c) upward revision of the too low tariff rates; (d) making the other levies trade-neutral, or eliminating them and making the tariff alone serve as a protective tax (exception advance income tax); and (e) finally removing all concessions and distinctions between users and between similar goods (at HS 4-digit level).

In FY91 and FY92, some reform effected under ISC-1 included a) reduction of the non-luxury tariff rates above 100% to that level and some to 75%, b) abolition of the regulatory duty on imports and replacement of the development surcharge on imports by adjusted customs duty rates not above 100%, and c) replacement of import sales tax and domestic excise duties by trade-neutral VAT on most non-textile products and supplementary excise duties on some final goods. Under ISAC-2, proposed reform in FY93 and FY94 includes a) proceeding toward establishing 50 percent as the ceiling on nominal protection by FY94 with few and temporary exceptions, and b) reducing the rate dispersal which would involve removing both the user-defined concessions that yield extraordinary effective protection levels and other fine distinctions in the tariff schedule. This is not a complete reform but would mean significant improvement of the current structure, and is expected to be a precursor to further reform in, say, next two/three years, which would contain effective protection within a moderate range in the medium term (by FY96/97).

The envisaged tariff structure modification by FY94 includes downward adjustment of rates above 50% to 50% for most products and 75% for some NTC-approved time-bound cases; other CD adjustments including raising of the too-low or zero rates, elimination of all user-defined CD rates and other concessions to make effective protection moderate for most activities; elimination of the import permit/LC fee; imposition of trade - neutral supplementary excise duties (SEDs) on a few (luxury) products to accommodate reduction of the CD structure ranging from 75 to 100% or more to 45, 60 and 75%. Zero tariff rates are to be retained for a few specified products for non-trade reasons. Other envisaged non-zero rates include 7.5% for specified primary inputs and 15/30/45% for most raw/semi/final goods. The lower end of the envisaged tariff compression has commenced in FY93 when relatively few products will attract rates of 7.5 or zero percent, with less discrimination among importers than previously. Exceptional use of nominal rates of 60% or 75% (or perhaps even 100% would need to be supported by NTC recommendations for industry assistance. Under the credit, the NTC is planned to be fully operational by the second tranche of the credit, i.e., by early FY94. Its establishment has been delayed; the draft Ordinance/Bill has been approved in principle but is yet to receive final approval either as an Ordinance or as an Act passed by parliament.

Export Liberalization: In addition to recent measures taken to expand the scope and effectiveness of operation of duty drawback (DD) and special bonded warehouse (SBW) systems, other specific measures stipulated under ISAC-2 include: a) continued expansion and satisfactory operation of DD schemes including extension of flat rate coverage by 50 a month or other satisfactory number; b) continued expansion and satisfactory operation of the SBW scheme including its extension to any activity by allowing effective provisions for advance imports and including other simplified import procedures (see above) and including pro-rating machinery/spare parts duty suspension for non-100 per cent export oriented industries. Duty suspension for 100% export oriented activities was stipulated to be realized before ISAC-2's effectiveness; however, as noted above, existing duties to be paid in the first place have been reduced recently rather than fully suspended. Other stipulated measures include satisfactory concrete steps to relax the regulatory environment, possibly including lifting of bans on re-export and sales on consignment (or sale-or-return) basis in addition to LC basis (subject to review). Implementation of other parts of the recently announced export development strategy including institutional aspects such as a) establishment of a Cabinet Committee, an Export Council, an Export Assistance Fund and b) strengthening of the Export Promotion Bureau (EPB) is also envisaged.

Exchange Regime Liberalization: A number of measures have been taken at the beginning of FY93 to liberalize the exchange control regime. In addition to measures relating specifically to exporters including allowing them to retain 10% of export earnings for most activities and 5% for low value - added garments and other products for facilitating their business activities, more transparent Bangladesh Bank or BOI guidelines have been issued for several types of control, allowing some individual transactions to occur without prior approval. These transactions are a) suppliers' credits and other foreign borrowings, and payments of interest and principal there on; b) royalty and other fees for technology transfer; c) expatriate employees' savings; d) back-to-back LCs against export LCs; and e) term borrowings by foreign invested firms from domestic banks.

More planned specific actions for further relaxation of exchange controls include satisfactory implementation of a) the recently announced relaxation and streamlining of exchange controls; b) automatic access to foreign exchange for domestic firms' foreign training and consultancy expenses under satisfactory guidelines; and c) continued satisfactory operation of flexible exchange rate management.

3.3 Financial Sector Reforms

Liberalization issues in this area relate to such issues as freeing the financial sector from undue government intervention, allowing its operations to be determined by market competition, promoting mobilization and optimal allocation of financial resources and ensuring long-term viability of the financial institutions to service their essential financing functions. These and other related issues are being addressed separately in an ongoing study program, supported by IDA/USAID. The specific content of the immediately implementable reform package that is likely to emerge from this program is yet to take shape.

The aim is to pursue the reform process that was initiated in FY90 (November/December, 1989). At that time a more market-oriented system of interest rate determination was introduced, interest rate subsidies were made transparent and reimbursable from Bangladesh Bank by a general rediscount facility, a new system of accounting and provisioning for bad debts was introduced and work initiated for reclassification of bank loans. One financial institution, Bangladesh Shilpa Bank was recapitalized and work initiated for recapitalization of the Nationalized Commercial Banks (NCBs). More recently, the Government has taken some more financial reform measures. More progress was made toward market oriented interest rates with the removal of ceilings and floors on lending rates, except those for agriculture, export and cottage industries retained for social and developmental reasons. Ceilings on deposit rates were also removed, and the minimum deposit rates on both savings and fixed deposits were reduced by half a percentage point.

More concrete steps including floatation of bonds worth over Tk 17,000 million were taken to recapitalize the NCBs to augment their capital and to enable them to make provisions for bad and doubtful debts. With this floatation, the recapitalization of the four NCBs has been completed. Other recent measures undertaken include institution of financial loan courts to improve loan recovery and initiation of privatization of one DFI.

Further envisaged financial reforms include further interest rate liberalization and measures to foster financial market development on a sound footing. These would include measures to compensate the banks for half of the written-off loan losses not met by bank provisioning (e.g., forgiven agricultural loans) and measures to correct existing loopholes in the legal procedures for recovering outstanding debt defaults.

3.4 Privatization

Although the stated intention under the 1991 Industrial Policy is to gradually privatize all public enterprises with perhaps certain exceptions which would remain subject to review, the Government is going slowly on the privatization plan. Out of 40 industries identified in October 1991 for privatization, sale of 6 units was completed by mid 1992 through sale of shares to a wholly state-owned insurance company, and privatization of only 4 other units has since been completed. Efforts have been initiated to disinvest 17 enterprises approved by the Committee on Privatization. Privatization of these enterprises is to be completed and actions taken to identify additional entities for disinvestment under the PFP/ESAF program. Under a jute sector restructuring program to be launched soon, the Government would be expected to divest government shares in the private jute mills and undertake privatization of the public mills except the unviable ones. The ADB's Industrial Sector Program Loan requires that 10 textile mills and 6 other industrial units be offered for sale by December 1992, and an equal number by December 1993. The Ministry of Industries has met the December 1992 requirement by offering 13 units for sale, but the Textile Ministry has so far offered 9. The numbers here refer only to offers for sale, not to how many sales were consummated. In general there appears to be considerable delays on the part of the Government about the privatization program. In the agricultural sector, existing tubewells maintained on a rental basis by public bodies are to be privatized.

Labour opposition to privatization schemes supported by opposition political parties has apparently become a strong political consideration making the government move hesitantly in its privatization plans. This is evident as the Finance Minister recently made a public statement to the effect that successful implementation of a privatization policy would require a consensus from the mainstream opposition political forces. The current depressed state of private sector activities is perhaps also partly to blame for the lack of enthusiasm on the part of the Government to privatize at least failing public enterprises (except the genuinely unviable ones which should rather be closed down or liquidated with assets sold out.)

3.5 Other Regulatory and Promotional Policies

Recently the Government has carried out some studies, with support from FIAS, to identify legal, regulatory and procedural obstacles to industry, to review fiscal and financial incentives to industry and review plans for BOI reorganization. Under ISAC-2, the Government is to formulate and announce action programs on the basis of these studies for further reforms in FY93 and FY94. The study on regulatory environment has revealed need for urgent attention to laws and legal procedures and institutions affecting business. The study on fiscal incentives points to need for rationalization of the corporate tax regime to promote foreign and domestic investment in productive activities, including reform of tax holidays, tax allowances and deductions as well as some tax administration issues.

The Government has initiated the design of further organisational changes in the BOI to enable it to effectively play its promotional role toward private sector development. This office has recently been brought under Prime Minister's Office and its Executive Chairman has been upgraded. Further actions to follow are filling of the vacant Board Member posts and a substantial increase of the staff strength. The Government has requested further FIAS assistance to implement further reforms in a three-year program funded by the UNDP under a project document signed in May, 1992. Helped by the first phase of this support, the reformed BOI would be expected (under ISAC-2) to be operating satisfactorily to promote and facilitate foreign and domestic investment in all sectors of the economy (before the second tranche is released).

During the period of the ISAC-2 program, the Government would be expected to maintain and implement the macroeconomic framework agreed as part of the Policy Framework Paper (PFP) process and monitored through IMF's ESAF and IDA's PRMAC programs. Actions of particular importance are flexible exchange rate management to maintain external competitiveness, in part, to support import liberalization and promote efficient import substitution and effective implementation of the trade-neutral VAT and supplementary excise duties to replace tariffs for revenue purposes.

Some institutional reforms to be implemented under ISAC-2 relate to a) strengthening the process of Customs assessment and clearance; b) ensuring transparency of import taxes in force; and c) developing a full system of industry assistance (protection) analysis. With respect to the first of these reforms, the Government is to ensure satisfactory procedures and operation of the Pre-shipment Inspection (PSI) scheme and contract and engage the services of international agents for offshore duty assessment in association with PSI. The aim would be to use the agents' valuation for obviating the need for using NBR-fixed tariff values which often distort the pattern of intended protection provided by tariffs.

For assuring transparency of import taxes to the importing public, the NBR is to systematically compile all operative tariffs and other import taxes. The Operative Tariff Schedule (OTS) for FY93 is due for publication before effectiveness of ISAC-2. Publication of FY94 OTS would be due for publication before release of the second tranche. The Government is also to regularly monitor and analyze customs revenue data on the same format as the OTS, to enable the work of tariff rationalization to proceed on a sound analytical base. Ex post processing started with July, 1990 imports. More recently, daily processing at main Customs Houses has begun. The next step is to organise and implement a method of comprehensive reconciliation, before ISAC-2's effectiveness. The Government is to examine the option of entrusting this component of the scheme on a contract basis to an experienced firm, with NBR staff to take it over pending the implementation of the UN's Automated System for Customs Data (ASYCUDA) management.

For tariff and protection analysis, the Government is to transform the existing Tariff Commission into a much strengthened National Tariff Commission and make it satisfactorily operational before the second tranche of ISAC-2 is released.

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