

OVERVIEW

BANGLADESH: STRATEGY FOR SUSTAINED GROWTH¹

I. Introduction

1. This is a report on the growth performance and potential of Bangladesh. The report argues that the 1st phase of Bangladesh's development – rising from the post-independence desolation and establishing a positive development record – has been a success. The country has clearly come a long way since independence in 1971 and its future is anchored in far stronger fundamentals than the pervasively bleak conditions then. Good economic and social policies and pioneering social entrepreneurship, partnered under innovative institutional arrangements, have contributed immensely to the successes attained. These have also enabled the country to cope with some critical (and widely reported) weaknesses in governance.

2. The primary objective of the report, however, is to draw attention to the 2nd and current phase of Bangladesh's economic development – ensuring a speedy transformation to middle-income country (MIC) status. For that, the much-improved economic fundamentals and successful implementation of an array of first generation reforms augur well, as do a young, rapidly growing labor force and an established culture of entrepreneurship. But the challenges ahead are also major. To sustain and improve her good growth record, needed to achieve the poverty reduction objectives set forth by the government's Poverty Reduction Strategy (PRS),² Bangladesh must not only pursue actively a range of second generation policy reforms (i.e., deepen the first generation reforms), but also rebalance the policy focus toward key structural areas where progress has been lagging. As the report shows, this is needed to stimulate the productivity performance of the economy (the efficiency with which capital and labor are used to produce output), and thereby ensure long-term sustainability of growth.

3. In tracing Bangladesh's path to MIC status, it is useful to first envision a middle-income Bangladesh and work backward from there. Three complementary features seem inextricable from that vision. Namely, an economy with (i) much higher degree of industrialization; (ii) deeper and better-managed global integration, and; (iii) rapid urbanization, with Dhaka continuing to be an important engine of growth and emergence of a more diverse set of dynamic urban centers as viable alternatives to Dhaka.

4. What is needed then is a deepened understanding and careful management of the mutually reinforcing transitions within each of these areas. Policymakers would also need to nurture an enabling environment to support the key long-term transitions. In particular, by strengthening economic governance, ensuring continued macroeconomic stability, addressing the burgeoning infrastructure constraints (especially those related to the power sector, ports, and transportation), deepening and making more efficient the financial sector, and addressing acute skills shortages.

5. The government's PRS document appropriately places economic growth at the center of its strategic and policy focus – growth is the first of the three elements (human development and better governance are the other two) that constitute the policy triangle on which the PRS's vision and strategic agenda for poverty reduction are built. It also rightly stresses the importance of outward-oriented, private sector-led growth, thriving on macroeconomic stability, improved governance, promotion of technology, a stronger small and medium enterprise (SME) sector, and agricultural diversification. However, as the

¹ This report was prepared prior to the emergence of the political turmoil in October 2006. Nonetheless, given its particular focus on the longer-term development agenda facing Bangladesh, the relevance and validity of the report's analyses and conclusions should not be affected by the recent political events.

² *Unlocking the Potential: National Strategy for Accelerated Poverty Reduction*, Government of People's Republic of Bangladesh, 2005.

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Joint Staff Advisory Note (JSAN)³ observes, a well thought-out process of growth acceleration is missing in the PRS. The systematic piecing of a strategy for sustained economic growth in this report is an effort to narrow some of that analytical gap.

³ Joint IDA-IMF Staff Advisory Note on the Poverty Reduction Strategy Paper, December 2005.

II. The Record of Growth and Development

II.1. A Synopsis of the Development Record

6. *Starting out as desperately poor, with much of the institutional and physical capital obliterated by the 1971 war for liberation, Bangladesh was written off by many international observers.* Henry Kissinger famously prophesied Bangladesh's economic future as "an international basket case." Extremely weak initial conditions and various vulnerabilities offered plenty to worry about. Summing up the conditions then, a World Bank report in 1972 noted:⁴

Even under the best of circumstances, Bangladesh constitutes a critical and complex development problem. The population is poor (per-capita income of \$50 to \$70 – a figure which has not risen over the past 20 years), overcrowded (population density is nearly 1400 per square mile) and becoming more so (population is growing at 3 percent per annum), short-lived (life expectancy at birth is well under 50 years), in many cases unemployed (perhaps 25-30 percent), and largely illiterate (under 20 percent literacy rate).

Furthermore, most of the population (90 percent rural) lived below subsistence, with the poverty rate estimated at over 70 percent, child mortality was extremely high at about 240 deaths for every 1,000 children, and gender discrimination was prevalent: there were only 958 females for every 1,000 males in 1970, which then was lower than in India, Pakistan, Nepal, and Sri Lanka in the region.

7. *Bangladesh's development record has been a remarkably positive one, especially when viewed through the prism of the weak initial conditions and surrounding pessimism.* Thirty some years later, life expectancy has risen to 64 years (comparable to neighboring India's), population growth has dropped to 1.5 percent (resulting from a reduction in the fertility rate from 7 children in 1972 to 3), literacy has more than doubled, child mortality has been cut by 70 percent, unemployment is down to 4 percent, poverty incidence has fallen to 40 percent, and about a quarter of the population lives in urban areas. Bangladesh is on track in meeting its Millennium Development Goal (MDG) on gender parity, having already achieved the goal in primary and secondary schooling. There were an estimated 978 females for every 1,000 males in 2005 – more than in India and Pakistan.

Figure 1.a : Per-Capita GDP: Bangladesh Vs. Median LIC

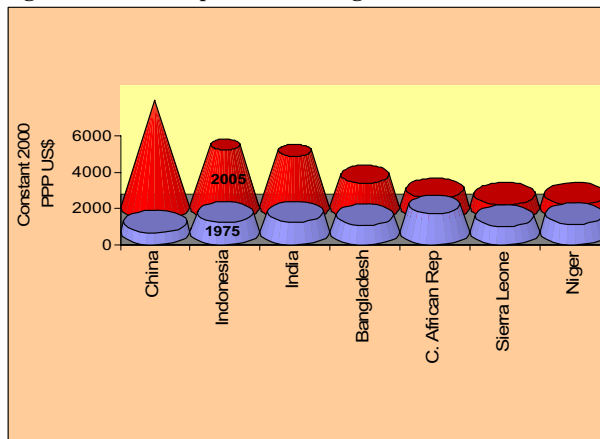
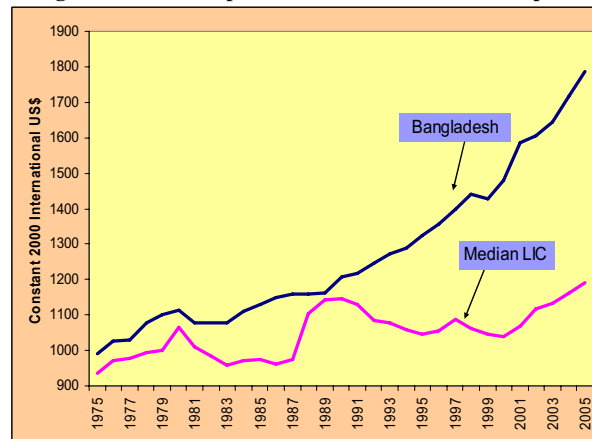


Figure 1.b: Per-Capita GDP: International Comparisons



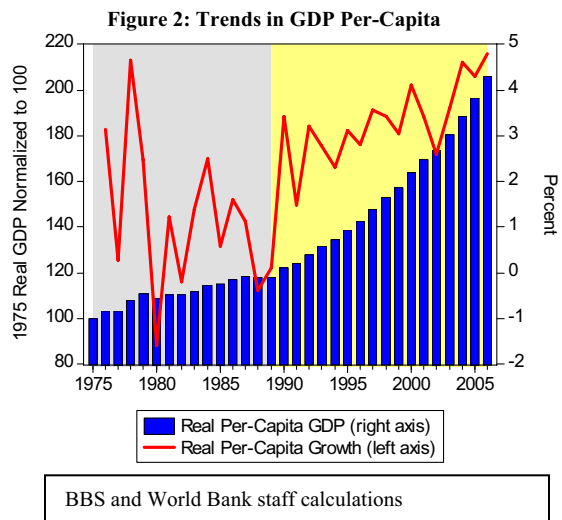
Note: Included LICs are the 21 countries whose per-capita GNI in 1975 was at or below US\$265, the cut-off for LICs eligibility used by IDA in 1975. Source: World Development Indicators, BBS, and World Bank staff calculations.

⁴ *Bangladesh: Reconstructing the Economy*, Report No. SA35, the World Bank, 1972.

8. ***Income growth has been crucial in raising living standards and reducing poverty.*** Since 1975, Bangladesh’s per-capita gross domestic product (GDP) has more than doubled in real Taka value and increased by close to 90 percent in constant PPP US\$ terms, outpacing most other low-income countries (LICs). In 1975, Bangladesh’s per-capita GDP was just 6 percent higher than that of the median LIC,

9. Rwanda (**Figure 1.a**).⁵ By 2005, the margin relative to the median country in the same group had increased to 50 percent. Six out of the 21 countries that classified as LICs in 1975 saw a decline in their per-capita GDP and another 8 saw a smaller increase than did Bangladesh. Of course, some other LICs did much better: since 1975, China’s per-capita GDP has increased almost ten-fold, Indonesia’s over three-fold and India’s over two-and-a-half fold (**Figure 1.b**).

10. ***Strong economic growth has been mostly a post-1989 phenomenon.*** Abstracting from the post independence turmoil, since 1976, the growth process exhibits two distinct phases (**Figure 2**). The first phase spans the years 1976-1989 and was a period of positive but mediocre 1.2 percent average per-capita growth, benefiting from sporadic reform episodes – mostly related to domestic market deregulation (including for agricultural inputs and outputs) and divestment of state control from some state enterprises. In comparison, the median country growth across the globe was 1.7 percent, while the per-capita GDP of even the median LIC (among the 21 who classified as LICs in 1975) caught up slightly with Bangladesh (**Figure 1.a**). The second phase begins in 1990, deriving from deepening of the earlier reforms plus a new wave of reforms in the areas of macro stabilization, trade liberalization, and financial deregulation. The latter phase also coincided with political democratization in the early 1990s. Per-capita GDP growth almost tripled, to 3.3 percent, in the latter period, more than double that of the median country across the globe and three times that of the median LIC. In fact, growth has been on an increasing trend in the second phase, averaging 3 percent in the 1990s and close to 4 percent in the 2000s.



11. ***Growth has both underpinned and benefited from substantial progress on human development.*** Growth acceleration since 1990 has been accompanied by faster progress on poverty reduction and some human development measures. After a virtual stagnation in the 1980s, the poverty rate fell from 58 percent in 1992 to 49 percent in 2000 and further to 40 percent by 2005;⁶ one of the fastest rates of poverty reduction in the region. In other areas, secondary school enrollment remained stalled at about 20 percent between 1975-90, but has since increased to 43 percent; access to sanitation facilities has doubled since 1990, and; child malnutrition rates (by weight), have been reduced considerably after showing little progress in the 1980s, although Bangladesh still has a lot of distance to cover on this one.

12. ***Much of the social sector progress started in the first two decades after independence, well before the growth acceleration, a feature that is somewhat unique to Bangladesh.*** This owes to good social policies and innovative social programs pioneered by world famous nongovernmental organizations (NGOs) and community-based organizations, such as Grameen Bank (winner of the 2006 Nobel Peace prize along with its founder, Prof. Mohammad Yunus) and the Bangladesh Rural Advance

⁵ Among the 21 countries that fell under IDA’s LIC classification in 1975 were Bangladesh, China, Haiti, India, Indonesia, Nepal, Pakistan and 14 Sub-Saharan African countries.

⁶ The poverty statistics are from various rounds of Household Income and Expenditure Survey (HIES).

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Commission (BRAC), partnered with government agencies and international donors. As a result, progress on most human development indicators (see **Table 1**) has been even more impressive than income growth on many counts and also stands out in comparison with most LICs.⁷

Table 1: Progress on Key Social Indicators

	Then	Now
School enrollment, secondary (% net)	19 (1990)	43 (2005)
School enrollment, primary (% net)	71 (1990)	93 (2004)
Fertility Rate	6.1 (1972)	3.0 (2005)
Immunization, DPT (% of children ages 12-23 months)	1 (1980)	88 (2005)
Immunization, measles (% of children ages 12-23 months)	1 (1982)	81 (2005)
Improved sanitation facilities (% of population with access)	20 (1990)	39 (2004)
Life expectancy at birth, total (years)	45 (1972)	64 (2005)
Malnutrition prevalence, weight for age (% of children under 5)	68 (1983)	48 (2004)
Mortality rate, under-5 (per 1,000)	239 (1970)	73 (2005)
Mortality rate, infant (per 1,000 live births)	145 (1970)	54 (2005)

Source: *World Development Indicators, World Bank*

13. **Despite the good development record, the remaining challenges are daunting.** In 2005, Bangladesh's per-capita GDP in current PPP terms was only US\$1,997 (or US\$420 at market exchange rates), compared with India's US\$3,486, China's US\$6,572, and Malaysia's US\$10,843.⁸ Its population of over 140 million is compactly packed in a land area of 147,570 sq. km., one of the highest population densities in the world; over 2 million people are added to this each year. Almost half of the country's population lives near sea level and 40 percent of its land area is flooded for three months each year, exposing large parts of the population and land to the threat of global climate change and resulting rise in sea levels. In fact, few other countries are as imperiled by climate change.⁹ Close to 60 million people still live in deprivation, two-thirds of them caught in extreme poverty. The level of human development remains low despite the tremendous progress since independence. Adult illiteracy is persistent at about 50 percent and falling slowly, particularly among women. Child malnutrition rates are among the highest in the world and maternal mortality rates, albeit lower than in India, Pakistan, and Nepal in the region, are among the highest in the world outside of Sub-Saharan Africa.

II.2. Main Characteristics of the Growth Process

14. The long-term growth process in Bangladesh displays at least five key characteristics: (i) remarkable stable growth; (ii) broad-based growth, spread over a number of major economic activities; (iii) striking uniformity in regional GDP growth in the 1980s and 1990s, although regional expenditure growth has varied quite a bit and substantial differences remain in income and expenditure levels; (iv) significant urban-rural differences, with the largest urban centers (especially Dhaka) driving the growth process, and; (v) a relatively good record on accompanying employment creation. A brief description of each follows.

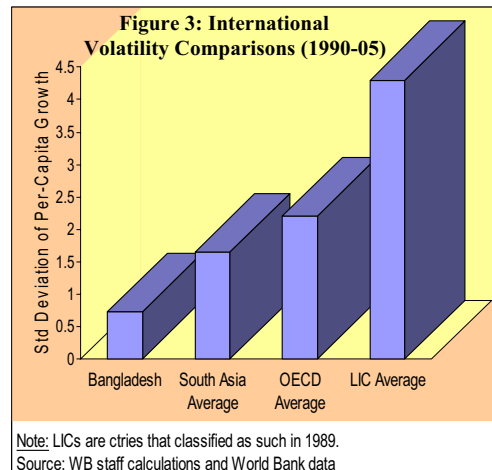
⁷ For elaboration of this, see *Bangladesh Development Policy Review: Impressive Achievements But Continuing Challenges*, World Bank, 2003.

⁸ World Development Indicators.

⁹ *The Financial Times*, 2007, "Bangladesh Plight Serves As Warning to World," February 1.

Remarkably Low Volatility of Growth

15. *An impressive feature of the growth process has been its remarkable and improving stability.* The standard deviation of per-capita GDP growth fell from 1.6 over 1976-1989 phase to 0.7 over 1990-2005. *In fact, the standard deviation in the latter period was the lowest in the world (Figure 3).* It is quite likely that low volatility has had a positive impact on long-term GDP growth, and even on income distribution.¹⁰ Furthermore, Bangladesh is among the handful of countries that have avoided even a single year of negative per-capita growth since 1990. The achievement of low volatility is all the more creditable given Bangladesh's exposure to natural calamities. An impressive record on strengthening disaster management and macroeconomic stability are the likely factors in achieving the low growth volatility. Progress on disaster management is brought out by comparing the two major floods in 1998 and 1988: even though the former lasted longer, was more far reaching, and inflicted more physical damage, the human and economic loss from it was much lower.¹¹ The good record on macroeconomic stability is discussed later.



Broad-Based Nature of Growth

16. *Growth has also been broad-based, although the sectoral composition is shifting away from agriculture, as is common for developing economies during periods of sustained high growth. Manufacturing sector growth has improved to about 7 percent since 1991, compared with 5 percent in the 1980s (Table 2),* benefiting from better performance by both small-scale and large- and medium-scale enterprises. Manufacturing exports, especially of ready-made garments (RMGs), have played a crucial and catalytic role: RMG exports increased from an insignificant amount in early 1980s to \$2.5 billion (6 percent of GDP) in FY96 and \$7.9 billion (13 percent of GDP) in FY06. The impact of the RMG sector boom has been much more far-reaching. For one, the sector has catalyzed the emergence and growth of a number of ancillary industries. It has also contributed to rural growth – and female empowerment – through its recruitment of a large number of female workers from poor rural backgrounds. A number of other products, such as ceramics, pharmaceuticals, and food products have also experienced strong export growth over the last decade, although from a much smaller base than garments. As a result, the merchandise exports to GDP ratio increased from 7 percent in 1991 to 18 percent in 2006 and the share of manufacturing in merchandise exports from 67 percent in 1981 to over 90 percent.

17. *Construction, too, has been booming since the mid-1990s,* fueled by the strong manufacturing sector growth and the large amounts of remittance inflows, coming primarily from the Gulf countries. *Remittances through formal channels have more than doubled since 2001, from US\$1.9 billion to almost \$5 billion in FY06* (remittances through informal channels are estimated to be at least half of that), which is about 8 percent of GDP and half of merchandise exports. These increases are linked to stricter enforcement of money laundering activities (within Bangladesh and internationally) and higher global fuel prices which have benefited the Gulf region where majority of Bangladeshi emigrants are based.

¹⁰ Ramey and Ramey (1995) and Hnatkovska and Loayza (2005) confirm the negative impact of volatility on GDP growth. Laursen and Mahajan (2005) show a negative impact of volatility on income inequality.

¹¹ *The 1998 Floods in Bangladesh: Disaster Impacts, Household Coping Strategies, and Response*, International Food Policy Research Institute, 2001.

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Table 2: Growth Rates of Output Components

	1981-85	1986-90	1991-95	1996-2000	2001-2006	1981-2006
Growth Rates (%)						
GDP Growth	3.7	3.7	4.4	5.2	5.6	4.6
Agriculture Sector Growth	2.7	2.4	1.6	4.9	2.8	2.9
Industrial Sector Growth	5.7	5.9	7.5	6.4	7.8	6.7
Manufacturing	4.7	5.3	8.2	5.6	7.4	6.3
- large & medium scale	4.4	5.4	8.4	5.5	7.3	6.3
- small scale	5.4	4.9	7.7	5.9	7.7	6.4
Construction	6.4	5.6	6.3	8.8	8.4	7.1
Services Sector Growth	3.7	3.8	4.6	4.8	5.8	4.6
Wholesale and Retail Trade	4.6	4.4	5.4	6.0	6.7	5.5
Transport, Storage, & Communications	5.6	3.7	3.5	5.7	7.3	5.2
Shares of GDP at Producer Price (%)						
Agriculture Sector	31.7	31.2	27.6	25.7	21.5	27.6
Industrial Sector	21.3	21.2	23.4	25.3	26.8	23.6
Manufacturing	14.1	13.3	14.6	15.6	16.0	14.7
Construction	5.8	5.8	6.3	7.2	8.0	6.6
Services Sector	47.0	47.6	49.0	49.0	51.7	48.9
Wholesale and Retail Trade	13.0	12.5	12.5	12.8	13.6	12.9
Transport, Storage, & Communications	10.8	9.9	9.6	8.8	10.2	9.8

Source: Bangladesh Bureau of Statistics. 2006 data are provisional.

18. **Agriculture sector growth has been more sporadic.** The sector recorded relatively good growth of about 5 percent in the second half of the 1990s, recovering from weak performance in the first half. Growth in the 2000s has fallen to its long-term trend of just under 3 percent. Agriculture's share in GDP, in the meanwhile, has fallen from 30 percent in FY90 to under 20 percent. **Growth in the services sector – which is half of GDP – has mostly mirrored GDP growth.** Not only have GDP and services grown at an identical average rate of 4.6 percent since 1980 (considerably lower than service sector growth of over 7 percent in India), year-on-year movements in the two series have been highly correlated. Growth in services is also marked by extremely low volatility: the standard deviation of services sector growth over 1981-2006 was 1.0, compared with 1.8 for the industrial sector and 2.4 for agriculture.

Sub-National Variations

19. **Per-capita GDP growth in the 1980s and 1990s was strikingly similar across the 6 Divisions (Table 3)** – Dhaka, Chittagong, Khulna, Barisal, Sylhet, and Rajshahi. Annual *Divisional* growth obtained from Bangladesh Bureau of Statistic's (BBS) *Old Districts* data varied in a narrow 1.8-2.8 percent range across *Divisions* over FY83-99. Similarly, *Divisional* growth aggregated from BBS's district-level data, varied between 2.7 and 3.1 percent in the second half of the 1990s.¹² Furthermore, the growth acceleration at the national level since 1990 was experienced in varying degrees by each of the 6 *Divisions*. It was most pronounced in the Sylhet Division, where per-capita growth accelerated by over 3 percentage points over FY90-99 compared with the FY83-89 period. Dhaka and Chittagong Divisions experienced with 2 and 1.3 percentage point acceleration, respectively. **Nonetheless, a fair amount of dispersion is seen among the Divisions' per-capita GDP levels.** In FY00, per-capita GDP of the most well-off *Division* (Dhaka) was about 50 percent higher than that of the least well-off *Division* (Sylhet).

¹² It must be noted that data at the *Old District* level are fairly unreliable. For one, these are based on the 1968 SNA, whereas the 1993 SNA is currently being used. The *District* level data address some of these quality concerns.

Table 3: GDP Levels and Growth by Division

Division	Aggregated From District Level Data			Aggregated From "Old District" Data		
	GDP per-capita (Tk, current prices)	GDP Share in Total (%)	GDP per-capita growth	GDP per-capita growth		
	FY00	FY00	FY96-00	FY83-89	FY90-99	FY83-99
Dhaka	22,303	37.7	2.9	1.3	3.3	2.4
Chittagong	18,128	19.3	2.8	1.7	3.0	2.5
Khulna	17,875	11.6	3.1	2.6	3.0	2.8
Barisal	15,383	5.8	3.0	2.1	2.2	2.2
Sylhet	14,886	5.2	2.7	0.0	3.1	1.8
Rajshahi	15,174	20.4	3.4	1.8	2.6	2.3
National	18,511	100	2.3	1.6	2.9	2.4

Source: BBS, and Staff calculations

20. GDP data for the next administrative level, the *District*, are available only for the FY96-00 period, although additional insights is provided by District-level expenditure data from the Household Income and Expenditure Surveys (HIES), since they cover a longer period, FY92-05.¹³ *As in the case of the Divisions, per-capita GDP growth was also relatively uniform across the Districts.* Almost 90 percent of the *Districts* experienced average growth in the 3-5 percent range over FY96-00, none experienced negative growth and only two experienced growth of over 5 percent. *The per-capita expenditure growth rates, on the other hand, varied widely, between -4.8 to 6.2 percent, over FY92-05. There is also considerable dispersion in both GDP and expenditure levels of the Districts.* In FY00, the average per-capita GDP and the average per-capita expenditure of the top five *Districts* were about two-and-a-half times those of the bottom five. Per-capita GDP of Dhaka, the most well-off *District*, was three-and-a-half times that of the least well-off *District* (Gaibandha) in FY00.

21. *Analytical work in Chapter 6 identifies some correlates of cross-District differences in expenditure growth over FY92-05.* The chapter finds expenditure growth at the *District* level to be negatively correlated with the initial expenditure inequality, gender disparity, and large landholdings, and positively correlated with the degree of urbanization and access to electricity. Also, *Districts* with lower per-capita expenditure, on average, experienced faster expenditure growth, implying mild regional convergence in per-capita expenditure, although the speed of convergence suggested by the results is quite slow: the estimated time to full convergence is about 90 years after accounting for the mentioned correlates of growth, and about 150 years without considering the correlates.¹⁴

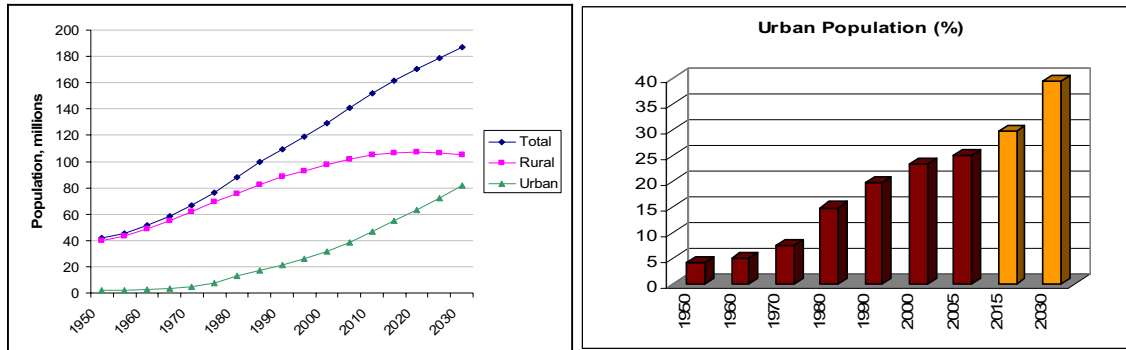
Growth Process Led by Major Urban Centers: Growing Primacy of Dhaka

22. *Although still predominantly rural, Bangladesh is undergoing a rapid transformation toward urbanization (Figure 4). Growth in the country has been led by its urban centers, especially the largest ones* (see Chapter 5 for details). Urban population has grown at an annual rate of about 6 percent since independence; compared with 2.2 percent population growth at the national level. About 35 million people, or a quarter of the population, currently live in urban areas, compared to only 8 percent at independence: the number is projected to cross 80 million by 2030. Over the same period, the share of urban activities in GDP is estimated to have increased from a quarter to almost one-half.

¹³ Although expenditure data are not representative at the *District* level, these are tightly correlated with GDP data across districts. Still, the *District* level aggregations for expenditure are to be interpreted with caution.

¹⁴ At the *Divisional* level, expenditure growth over FY00.-05 was significantly faster in the top 3 Divisions (in terms of their per-capita expenditure level in FY00) than the bottom three, leading to increased divergence in living standards between the two groups and slower progress on poverty reduction in the latter.

Figure 4: Urbanization in Bangladesh



Source: UN World Urbanization Prospects and World Bank staff calculations

23. **Urbanization has been more concentrated in the largest cities.** The four largest cities – Dhaka, Chittagong, Khulna, and Rajshahi – account for over 60 percent of the urban population, up from 48 percent in 1970 (see **Table 4**). Dhaka, the national capital, has seen an eight-fold increase in its population since 1970. The city accounts for a third of the urban population with its 12 million residents, and its “urban primacy” level (share of total urban population) exceeds that of most global comparators.¹⁵ Furthermore, as per UN estimates, it is the fastest growing mega city in the world (along with Lagos, Nigeria), a pace at which its population would be close to 22 million by the year 2015, making it the 6th largest city in the world (it is currently the 11th largest) and the 3rd largest in Asia by 2015.¹⁶ Chittagong, Khulna, and Rajshahi have each experienced a more-than-five-fold increase in population since 1970.

Table 4: Population dynamics of the largest agglomerations (population figures in thousands)

	City Population Rank (2000)	Population (2000)	Population (1990)	Population (1980)	Population (1970)	Annual Growth (1970-2000)
Dhaka	1	12300	6619	3248	1474	7.1%
Chittagong	2	3581	2265	1333	693	5.5%
Khulna	3	1426	972	622	310	5.1%
Rajshahi	4	1016	517	238	105	7.6%

Data Source: Global Cities Database <http://www.econ.brown.edu/faculty/henderson/worldcities.html>

24. **The population trends, not surprisingly, mirror the concentration of economic opportunities in these cities.** Most major industrial activities and auxiliary businesses services are concentrated in the largest cities. Dhaka alone accounts for 80 percent of the RMG output and half of manufacturing sector employment¹⁷ and a tenth of its labor force is engaged in RMG industry – over seven times the national average. If this is linked to availability of complementary businesses services, then the data bear that out as well – the representation of business services, particularly finance and real estate, in employment is also considerably higher in Dhaka and the other large metropolitans relative to the rest of the country.

A Positive Record on Employment Creation, Skill Levels Remain Low

25. **An overall positive record on employment creation has accompanied GDP growth (Chapter 3).** According to the 2002-03 Labor Force Survey (LFS), the economy created 5.3 (9.5) million new jobs between 2000-2003 (1996-2003), accommodating most of the 5.6 (10.2) million entrants into the labor force. In common with other developing countries, open unemployment is quite low at about 4 percent.¹⁸

¹⁵ For example, primacy levels of the largest cities in India, Pakistan, and Korea are 6%, 22% and 23%, respectively.

¹⁶ Ahmed et al. Mimeo, World Bank 2006.

¹⁷ Dhaka Urban Poverty: Land and Housing Issues, Draft paper, World Bank, 2005.

¹⁸ The labor force data are to be interpreted with caution given the considerable quality issues.

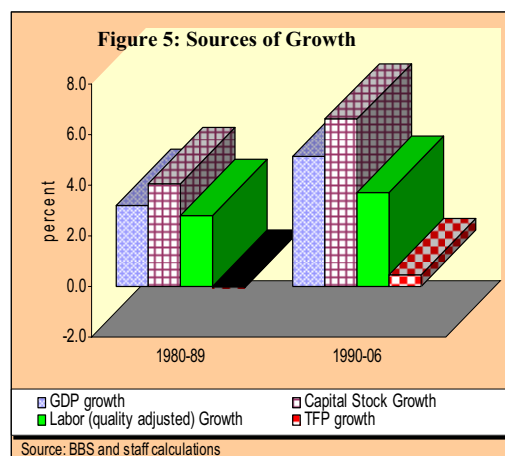
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Female labor force participation is on the rise, increasing from 16 percent in 1996 to 26 percent in 2003. Real wages increased across all major economic sectors between 2000-2004, rising by close to 30 percent in manufacturing, indicating some tightening of the labor market despite rapid growth in labor supply.

26. *Nonetheless, some important aspects of the labor market deserve more careful attention.* The unemployment rate is 8 percent for the 20-24 year olds and even higher for those with higher secondary or degree education. The income of the self-employed workers (almost half the work force) appears to have declined over the 2000-03 period. Furthermore, the formal sector comprises only about a fifth of the labor force (although this ratio is higher than in India) and shows no signs of picking up – in fact, data for the 2000-03 period show a decline in the formal sector’s share. The share of “unpaid family workers” in the workforce increased over the 2000-03 period at the expense of all other job statuses except “employers”. Above all, skill levels remain critically low, owing to low literacy rates and generally poor quality of education and worker training, that are also not particularly relevant to market needs.¹⁹

II.3. Factors Underlying GDP Growth

27. *Accumulation of physical capital and (quality-adjusted) labor has been instrumental in the growth acceleration since 1990, with some contribution from total factor productivity (TFP) growth (Figure 5).* Capital stock growth picked up from an average rate of 4 percent over 1980-89 to 6.6 percent over 1991-06. Growth rate of effective labor – measured as a combination of the labor force and education levels of the working-age population – also improved up by almost one-half percentage points in the latter period. While better access to education played a role, the dominant factor in this increase was labor force growth. Average annual growth of TFP (the efficiency with which capital and labor are used to produce output) picked up from virtually zero in the ten years prior to 1990 to 0.4 percent since.²⁰ To be sure, a lot of caution is warranted in interpreting TFP estimates because of data quality problems and the lack of information on the precise assumptions to deploy in calculating TFP. Nonetheless, the slight pick up in TFP growth since 1990 is a robust conclusion across all plausible variations in assumptions (see **Table 1** in **Annex 1**).



28. *Capital accumulation has been led by private investment and financed principally by gross domestic savings.* **Figure 6** shows the breakdown of investment by its private and public components, with the total and private investment rates moving in almost complete synchronization after 1990. The increase in the investment rate from 17 percent in FY90 to 25 percent in FY06 was accompanied by a concomitant increase in the gross domestic savings rate, from 13 percent to 20 percent (**Figure 7**).

¹⁹ *The Bangladesh Vocational Education and Training System: An Assessment*, World Bank 2006.

²⁰ In the absence of reliable labor force data that are also comparable across time, to calculate TFP growth we use working-age population (15-64 age group) as proxy for labor force, although estimates of even that vary by source. While the WDI database shows average working-age population growth of 2.7 percent during the 1990s and 2.8 percent in the 1980s, the ILO and the US Census Bureau each report corresponding growth of 3.4 percent, about one percentage point higher than in the 1980s. The TFP estimates shown here use the ILO data. The increase in TFP growth since 1990 would be close to 1 percentage point if WDI data were used instead.

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Figure 6: Public-Private Breakdown of Investment

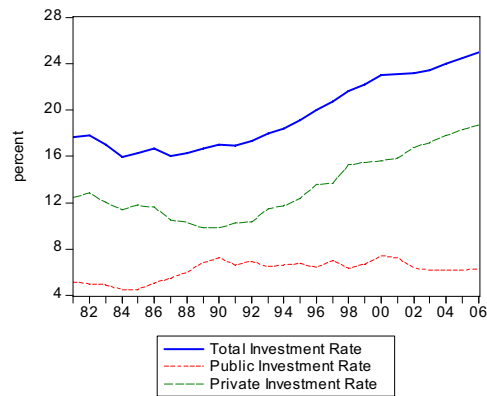
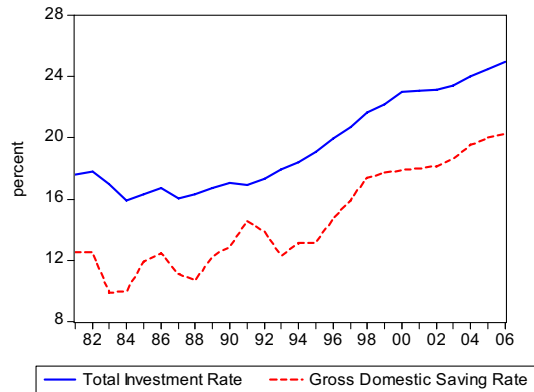


Figure 7: Trends in Investment and Savings



Source: BBS and World Bank staff calculations

29. **Labor force growth has been strong despite declining population growth** (from 2.5 percent in the 1980s to 1.5 percent in recent years) **because of the demographic transition that is resulting in a surge of youthful entrants into the labor force and, more recently, from sharp increases in the female labor force participation rate (LFPR).** Demographic factors such as increased life expectancy and markedly lower infant mortality have helped offset much of the slowdown in population growth, resulting in fairly robust working-age population growth. Furthermore, as a result of the increase in female LFPR, from 16 percent in FY96 to 26 percent in FY03, the female labor force almost doubled in size during these seven years, while the male labor force increased by just 17 percent.

30. **The initial surge in private investment and the improvement in TFP growth that supported the growth acceleration in the 1990s were propelled by broad-based market oriented reforms and macro stabilization measures.** These involved deepening of the reforms initiated in the previous decade and implementation of a fresh wave of macro and structural reforms. Key measures included:

- **Improved macroeconomic stabilization:** CPI inflation fell from an average rate of 10 percent during 1985-1990 to 4 percent during 1991-94, while the current account deficit as a share of GDP fell from 7 percent to 2.7 percent and fiscal deficit from 7.6 percent to 6.2 percent.²¹ The sharp reduction in the current account deficit allowed foreign exchange reserves to improve from an import cover of 2 months in FY90 to 8 months in FY94. Furthermore, the taka was devalued by 15 percent against the US dollar over FY91-92 to bring it closer to its market value.
- **Easing of trade and exchange restrictions:** The pace of trade liberalization was accelerated and preferential arrangements for garment exporters were continued to avail of the special access to developed country markets offered by the Multi-Fiber Agreement (MFA) quota system. The “Secondary Exchange Rate System” was abolished to unify the exchange rate system and most exchange controls on current account transactions were removed. Export performance responded immediately. After stagnating at about 5-6 percent of GDP between FY85-90, exports to GDP ratio increased to 11 percent by 1995.
- **Relaxation of several restrictions on private investment** in the Industrial Policies of 1991 and 1992, including licensing requirements for private investment, and opening up of telecommunications, power generation, and domestic air transport to the private sector. Partly in response to this stimulus, private investment, having declined from 11.8 percent of GDP 9.8 percent between FY85-90, increased to 12.4 percent by FY95.

²¹ Bangladesh: Recent Economic Developments and Priority Reform Agenda for Rapid Growth, World Bank 1995.

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- **Launching of the Financial Sector Reform Program (FSRP):** Controls on interest rates were relaxed with the launching of the FSRP in 1990, followed by replacement of the controls with interest rate bands in 1997 and finally withdrawal of the bands in 1999. In addition, credit quotas were abolished to reduce the directed lending. With easing of credit constraints faced by the private sector, private credit to GDP ratio increased from 15 percent in FY93 to 21 percent in FY95, after having increased by just 2 percentage points since FY85. This provided another major stimulus to private investment in the 1990s, as shown in **Chapter 8**.
- **Deepening of agriculture reforms.** Further liberalization of input and especially output markets was carried out in the early 1990s, building on the significant progress of the 1980s. In 1987, restrictions on import of small diesel engines were lifted followed by removal of import duty in 1989. Deregulation and privatization of public tubewells in the 1980s contributed to rapid spread of small-scale irrigation and provided the irrigation needed for adoption of the HYV rice crop in winter. Furthermore, fertilizer markets were liberalized in 1980s. Even though these measures could not prevent the poor performance of the rice crop in the first half of the 1990s, they laid the foundation for the recovery that followed in the latter half.

31. ***Successful and sustained macroeconomic stabilization (lower inflation and smaller internal and external imbalances), played an important part in nurturing the good growth.*** Since the early 1990s, inflation has not touched the two-digit mark, broadly reflecting responsible monetary and fiscal policies. Fiscal prudence has kept public borrowing in check and prevented any significant crowding out of private investment. Fiscal and monetary discipline, together with periodic real exchange rate adjustments, has helped keep the external sector more-or-less in balance. At the same time, improvements in disaster management have contained the economic loss from natural calamities. Since the early 2000s, growth has been further aided by the ***advent of some bold banking sector reforms*** that have sought to deemphasize the role of the public sector banks, strengthen competitive pressures, loosen government control, and tighten prudential regulations and regulatory quality. ***Trade liberalization has been further deepened***, albeit at an uneven pace. From the demand side, important impetus has been provided by ***sharp increases in worker remittances*** – that have also helped maintain macro balances by offsetting a declining trend in foreign aid – and the availability until recently of ***preferential markets for garment exports***.

32. ***Earlier emphasis on social development was also an important factor in sustaining the higher growth.*** As noted earlier, progress on a number of human development areas preceded the growth take-off in early 1990s, enabling a more robust growth response to the aforementioned market-oriented reforms. Underlying the various social development successes were conducive public policies that complemented the tremendous work of the NGOs and community-based organizations, many of which are world leaders in their fields in terms of innovative ideas and organizational management. The state also wisely created the space for the emergence of effective partnerships between large, well-functioning NGOs and relatively weak public agencies to deliver education, health services and micro-credit. Furthermore, the government pragmatically encouraged the private sector to deliver secondary and tertiary education. Government expenditure priorities, too, were broadly supportive, with health and education being allocated significant parts of the budget.

33. ***GDP growth has further benefited from the good progress on women's advancement.*** The mentioned increase in participation of women has been an important factor behind the strong labor force growth. Furthermore, the success of the garment sector – a major contributor to the overall growth performance – has been shaped by female workers, mostly from rural areas, who constitute about 90 percent of the sector's workforce. More fundamentally, an early focus on female education – through female stipend programs for school enrollment, for example – improved the productivity of the female workers and contributed to better health and education of children and lower fertility rates. The widely

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acknowledged micro-credit programs have also made significant contribution with their emphasis on underprivileged women.

34. *Having completed an array of first generation macro and structural reforms, Bangladesh is now confronted with some emerging structural issues that will require deeper and more complex reforms.* The finding on low TFP growth, which has shown only a mild response to the reform efforts, is worrisome. The finding is consistent, nonetheless, with the report's assessments of tightening infrastructure constraints (especially power, ports, and transportation), lackluster agricultural growth (especially a sharp drop in the critical fisheries sub-sector), increasing urban congestion pressures and weak urban governance and infrastructure, significant remaining trade barriers, limited success in attracting FDI into manufacturing, stresses in the financial sector, and acute skills shortages. Afflicting each of these is the oft-mentioned (for Bangladesh) weak governance. Interestingly, as elaborated later, closer inspection reveals that governance is not as universally poor as is commonly believed: on some aspects Bangladesh has even done rather well. Nonetheless, in a number of important areas governance is significantly lagging overall development and (if unaddressed) risks becoming a gradually tightening noose around the growth process, particularly in the next development phase – the country's transition to middle-income status.

III. Transition to Middle-Income Country Status: Issues and Challenges

III.1. A Scenario of Rapid Growth to Achieve MIC Status

35. At US\$470, Bangladesh's gross national income (GNI) per-capita in 2005 (calculated by the World Bank's Atlas method) was a little over half the US\$875 cut-off for MIC classification used by IDA. The challenge for Bangladesh is to build on the growth momentum since the early 1990s to close this gap as soon as possible. If the country's per-capita GDP grows at 3.5 percent (assuming GNI growth equals GDP growth), the average rate in the last ten years, it would take until 2023 to attain MIC status (as per the 2005 IDA classification). The transition to MIC status would be put on hold for another 5 decades if per-capita growth slips back to the 1 percent rate seen in the 1980s. Or, ***Bangladesh could become an MIC within a decade (by 2016) if per-capita growth could accelerate to 6 percent, implying GDP growth at a challenging (but not impossible) 7.5 percent.*** There is international precedence for such performance – for instance, average per-capita GDP growth in China has been close to 8 percent since 1975, while Korea and Thailand each attained per-capita growth in excess of 6 percent for two decades before the 1997 East Asian crisis. A possible hypothetical scenario of Bangladesh's transition to MIC status by 2016 is outlined in **Table 5**.

Table 5: A Hypothetical Scenario of Bangladesh's Transition to MIC Status²²

	1990-2006	2006-16
Per-capita GDP Growth (% , period average)	3.3	5.9
Capital Stock Growth (% , period average)	6.6	8.6
Labor (quality adjusted) Growth (% , period average)	3.7	3.6
TFP Growth (% , period average)	0.4	2.0
Investment Rate (% , end of period)	25	31

Source: BBS, Barro-Lee (2000), and World Bank staff calculations

36. ***The key requirement to attain this hypothetical scenario*** (or something close to it) ***is a far stronger performance of TFP.*** Progress on this will be predicated upon tackling the structural constraints summarized below and discussed in detail in Volume II of the report. ***In addition, capital accumulation will need to accelerate, with the investment rate needing to increase by over 5 percentage points.*** Demographic trends would be conducive, with a rising share of working-age population tending to raise household savings rates, as has happened in India and other countries. Increases in domestic savings would also depend upon improvements in the financial system. The budget is unlikely to be a major source of additional savings, as budget deficits are running at relatively low levels of 3-4 percent of GDP and pressure for higher public expenditure is likely to intensify even as revenue generation catches up from its current low levels. It would be important, however, to tackle the emerging losses of the energy sector state-owned enterprises (SOEs) – estimated at close to 1 percent of GDP in FY06 – to make space for private investment and more productive fiscal spending. FDI would also need to pick up, although that would require better economic governance and business environment. Remittances and donor support would continue to play an important role.

37. ***Continued strong labor force growth would be conducive, although a far greater emphasis on improving labor skills would be needed.*** As before, a special focus on women's advancement would bring considerable growth dividends. Only about one-quarter of the working-age women participate in the labor force, compared with at least double that in advanced economies. Educational attainment of the labor force should increase as a result of the higher-school enrollment rates over the past decade.

²² The TFP calculations in this table are based on the methodology described in **Annex 1**. Further, the share of capital in output is assumed at 0.35 and future growth rates of labor force and education levels are assumed to equal the average rates since the early 1990s.

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However, more emphasis on improving the quality of education and reducing its rural-urban divide, and making it more market relevant would be crucial.

III.2. Managing Three Key Transitions

38. *The above scenario needs to be mapped into a real agenda for reforms. For this, it is useful to first envision a middle-income Bangladesh and work backward from there.* Drawing on the major structural transformations already at play in Bangladesh and experiences of other successful developing countries, three inter-connected features seem integral to that vision:²³

- A middle-income Bangladesh will have reached a more advanced stage of her *transition out of agriculture and into manufacturing and services*. This would be driven by a globally competitive private manufacturing sector and a productive, diversified, and commercially-oriented agriculture sector.
- A middle-income Bangladesh would be significantly *more open to investment and trade*, where Bangladeshi firms will be plugged into global supply chains and the country will figure prominently on global investment maps.
- A middle-income Bangladesh will be *far more urbanized* than it is today, with a diverse set of dynamic urban centers emerging as viable alternatives to Dhaka, benefiting from much improved urban governance.

Transition 1: Facilitating Sectoral Shifts: From Agriculture to Manufacturing and Services

39. *In common with nearly all developing countries, Bangladesh's growth has been accompanied by a shift in output composition away from agriculture and in favor of manufacturing and services.* During the low-growth period of the 1980s, the sectoral shares did not change much. However, the sectoral shift has been quite noticeable since 1991 (Table 2), coinciding with higher growth. Looking ahead, high growth performance under any scenario would be underpinned by services and manufacturing, and agriculture would continue losing its share even if it does well: it is hard to envision agriculture outperforming manufacturing and services on a sustained basis under any high-growth scenario. It seems more plausible that manufacturing sector would be the one picking up the slack, given its relatively low share in GDP (17 percent) and also its strong growth momentum since the early 1990s.

40. *A key factor in Bangladesh's expected sectoral transformation would be robust factor productivity performance.* Sustained strong future growth depends on it. There are also compelling reasons at the sectoral level. No matter how rapid the transition, agriculture will continue to play a dominant role for quite some time. The sector accounts for over half of the total employment, which is not expected to dissipate soon. The sector is also under tremendous pressure due to a declining land base. Productivity growth is important, therefore, to maintain good growth and generate more productive jobs. Productivity growth would also help sustain and accelerate past trends of good growth in the industrial sector and by improving its competitiveness and preparing it for growing globalization.

²³ The Government's PRS highlights another major transformation with implications for long-term growth: the evolution of the *meso*-economy (rural market centers). This incorporates formal and informal activities in services, trade, construction and small industries that are rapidly expanding in the rural market centers. The transition, no doubt critical, is still not sufficiently understood. Its analytical underpinnings need to be deepened for incorporating it into the mainstream growth story.

Improving Productivity in the Manufacturing Sector

41. *Chapter 1 estimates the TFP of five major manufacturing industries over the 1999-2003 period using a firm-level survey of about 700 firms conducted for this report.* The industries covered were ready-made garments, textiles, pharmaceuticals, food, and leather/footwear – together these account for about 70 percent of the manufacturing sector and therefore give a good account of the sector.²⁴

42. *Analysis shows that the average annual (median) TFP growth over 1999-2003 was positive in four out of the five manufacturing industries under consideration – garments being the lone exception.*²⁵ Within the garment sector, the average growth in the sweaters sub-sector was positive and relatively quite high. *The results also show that allocation of resources within the pharmaceuticals, leather/footwear, and textiles industries during the sample period was inefficient:* in these industries, on average, firms that were less productive produced a higher share of their industry's output. However, this phenomenon is relatively insignificant in determining the overall productivity performance at the industry level, which is largely shaped by productivity at the firm-level.

43. *Careful econometric analysis identifies the factors that affect firm-level TFP performance, taking into account differences in firm characteristics – such as location, industry, age, and size.* The results suggest that in order to strengthen TFP performance of manufacturing firms, the following measures would be important:

- (i) The rapidly emerging *energy supply constraints will need to be addressed.* Results show that power supply problems are costing firms dearly in terms of TFP losses. A 1 percent increase in number of power outages in a year reduces the TFP of the average firm by 10 percent.
- (ii) *Concerted efforts are necessary to improve Bangladesh's attractiveness to FDI,* the level of which has been quite low (less than 0.5 percent of GDP for the most part). FDI has recently picked up in extractive industries (coal and gas), telecommunications, and energy production – increasing FDI's share in GDP to about 1 percent – but not in manufacturing, where the potential for productivity gains is significant. Results show that firms with any level of foreign ownership are 10 percent more productive on average than firms that are wholly domestically owned.
- (iii) *Phasing out the high anti-export bias is important.* For this, it would be essential to further lower and streamline tariffs, improve trade facilitation, and tackle behind-the-border barriers to competitiveness. Results show that firms that export majority of their output are about 10 percent more productive on average. This advantage to exporters may be due to technology transfers from foreign buyers and having to adopt the stringent technical and quality standards of developed markets, and from coping with tighter time and competitive pressures. As further shown by the results, the benefit of being an exporter also improves over time as valuable experience is gained in export markets. Export orientation of firms not only increases TFP levels, but also TFP growth rates.
- (iv) *Human capital deficiencies will need to be tackled.* Results show that firm productivity improves with various measures of human capital. Higher-education levels and experience of managers in particular benefit productivity of firms, highlighting the importance of improving access to quality tertiary education, while consolidating earlier gains on primary and secondary education.
- (v) *Policies would need to develop the knowledge economy* to strengthen the basis for more innovative activities and adaptation of more advanced technologies, which results show as having a positive impact on productivity of Bangladeshi manufacturing firms. Quality certifications, too, are found to improve firm productivity, and the application of these needs to be strengthened.

²⁴ The survey team comprised students of the Department of Economics, Jahangirnagar University, who worked under the supervision of Professor Abdul Bayes.

²⁵ The median TFP growth rate in an industry and in any given year is the growth rate such that half the firms in that industry and year have lower TFP growth rates and the other half have higher TFP growth rates.

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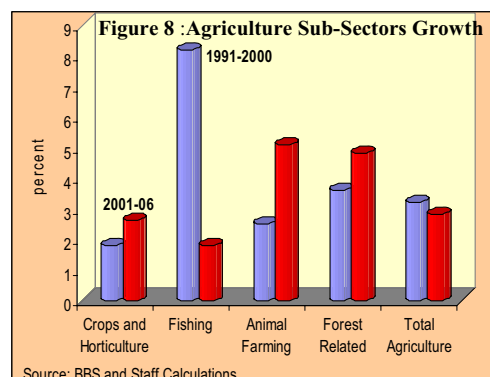
Such certifications guarantee the use of internationally recognized technical standards (e.g., ISO quality certifications) and are an important means of acquiring state-of-the-art technological know-how.

- (vi) *The poor law and order, often cited as major concerns by private investors in Bangladesh, will need to be improved.* Results show that these hurt firm productivity: firm TFP is found to be negatively associated with protection payment by a firm relative to its sales, a proxy measure of law and order problems.
- (vii) Interestingly, results find *firm size and productivity to be negatively correlated* – the youngest and oldest among the surveyed firms were the least productive. This suggests that Bangladeshi firms in general are unable to benefit from economies of scale. Although hard to prove at this point, it may be partly reflecting the severe corporate management deficiencies in the country.

Improving Productivity in the Agriculture Sector

44. ***Growth performance in agriculture has picked up across its major sub-sectors in recent years, with the important exception of the fishing sub-sector (Figure 8).*** As a result of the decline in fishing sub-sector growth – 1.8 percent in the 2000s compared with 8.2 percent during the 1990s – overall agriculture sector growth has deteriorated somewhat. Meanwhile, the agriculture sector is under significant pressure to improve its productivity due to a shrinking land base. In fact, the total land area sown is expected to decline at an even faster rate in the coming years.

Chapter 2 covers the key trends and sectoral issues.



45. ***The decline in fishing sub-sector growth was mainly caused by falling output levels of open water capture fisheries*** – a major income source for the poor. Catches of important fish types such as Hilsa, the Indian Salmon, the major carps (Rui, Catla, Mrigal, and Kalabaus) have all declined precipitously. For inland capture fisheries this has occurred mainly due to habitat losses, reduced dry season flows, and unregulated over-fishing. Future prospects for capture fisheries continue to be bleak. ***Aquaculture fisheries, on the other hand, have shown strong growth – 10 percent growth over the last decade – and continue to hold considerable promise. Shrimp production, in particular, has considerable potential, given its significant export potential.*** Significant potential for productivity improvements exists – for instance, current productivity in shrimp production (100-150 kgs/hectare) is far below that of Thailand (4-7 tons/hectare), the world’s leading shrimp exporter. Growth would have to come mainly from productivity gains as total pond area is not expected to increase significantly.

46. ***Bangladesh has a comparative advantage in rice production, particularly in the aman season, when there are few profitable alternatives on flooded land, the economic potential of which needs to be more fully exploited.*** Per-acre rice yields in Bangladesh, although higher than in India and Pakistan, are considerably lower than in the East Asian economies, suggesting unexploited opportunities to improve productivity. Expanding the use of the HYV variety of rice to the *aman* crop (where HYV is being used in only half of the area) holds most promise for improving rice productivity.

47. ***Ultimately, raising real agricultural incomes will require diversification into higher-valued crops and increased output of the livestock and fishing sub-sectors.*** In particular, Bangladesh would need to better avail of its long-term competitive advantage in inland aquaculture. Shrimp production in the past has suffered due to difficulty in meeting the sanitary and phyto-sanitary quality requirements of importers, which would need to be addressed for exploiting future growth potential. Shrimp exporters

III. Transition to Middle-Income Country Status: Issues and Challenges

also have a role to play.²⁶ They would need to adhere to self-imposed standards and the recognition and acceptance of third-party certification process by importers and regulatory agencies in importing countries. Further, farmers would need to adopt semi-intensive and intensive methods of shrimp farming in place of the prevalent practice of extensive methods.

48. ***The government's role in promoting agricultural diversification is important, albeit limited.*** Certainly, a significant expansion in agricultural research and extension efforts is needed. Currently, technology (agricultural research and extension) system is weak and suffers from inadequate and unstable funding, inefficient allocation and use of resources, weak management, and ineffective institutional arrangements for coordination of research.²⁷ Significant scaling up of public spending on research along with institutional reforms to increase the stability of funding and to strengthen research management are crucial. Moreover, sustained public investment in rural marketing infrastructure (particularly roads, bridges and telecommunications) combined with a favorable environment for private investment (e.g. in warehouses and cold storage facilities) are needed. This would reduce storage losses and price fluctuations for non-rice crops, particularly highly perishable fruits and vegetables, and improve farmer incentives for expanded production. Government also has an important role in providing a growth-friendly institutional environment and setting and enforcing transparent and consistent “rules of the game” for agro-food system and agro-enterprise development (**Chapter 2, Box 2.1**). To strengthen productivity of inland aquaculture, the post-handling and marketing and distribution of better quality fish seeds need to be improved, in addition to research and extension support from the government.

Transition 2: Trade Liberalization and Export Competitiveness

49. ***Starting in 1991, Bangladesh marked a clear departure from the highly protectionist, inward-looking import substitution policies of the earlier decades.*** Considerable, albeit uneven,²⁸ progress has been made since on liberalizing the trade and exchange regimes. Trade tariffs have been significantly reduced and rationalized, with the unweighted average customs (CD) duty falling from 100 percent in FY85 and 74 percent in FY92 to 15 percent in FY07, and the top CD rate from 350 percent in FY90 to 25 percent at present. Also, trade-related quantitative restrictions (QRs), which covered 21 percent of HS 4-digit tariff lines in FY90, have been virtually eliminated, and import licenses are no longer needed. Foreign exchange liberalization has included unification of exchange rates, removal of most foreign exchange restrictions for current account transactions (in conformity with the IMF's Article VIII), and adoption of a floating exchange rate. These reforms have sought to enhance competition and reduce anti-export bias and incentives for import substitution.²⁹ **Chapter 4** covers the trade liberalization agenda.

50. ***Trade liberalization and the resulting increase in export orientation*** – with merchandize exports to GDP ratio increasing from 6 percent in 1990 to 18 percent in FY06 – ***has very likely contributed to the growth acceleration since the early 1990s.*** The firm-level evidence presented in **Chapter 1** and earlier World Bank studies support this.³⁰ The growth impact of trade liberalization has been largely driven by the success of the RMG sector though, where the government moved early to avail of the opportunities presented by the MFA and more recently the Agreement on Textiles and Clothing (ATC) quota systems. More specifically, it provided 100-percent exporters duty-free access to raw materials and machinery

²⁶ *Bangladesh: Growth and Export Competitiveness*, World Bank, 2005.

²⁷ *Revitalizing the Agricultural Technology System in Bangladesh*, World Bank, 2005.

²⁸ The trade liberalization drive suffered a temporary setback in the FY96-02 period, with a hiatus, even some reversal, in the reform process, before it was rejuvenated in FY02. The number of HS 4-digit items subject to QRs increased from 111 in the 1993-95 Import Policy Order (IPO) to 122 in the 1997-02 IPO: this has subsequently been cut to 15 items, only 3 of which are for protection purposes. Similarly, the average rate of nominal protection increased from 31.9 percent in FY96 to 33.4 percent in FY98, before being brought down to 24.3 percent in FY07.

²⁹ Ahmed and Sattar (2003).

³⁰ *Bangladesh: Trade Liberalization-Its Pace and Impacts*, World Bank, 1999.

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through the use of the special bonded warehouses, offered back-to-back letters of credit, and shielded exporters from business environment weaknesses by developing Export Processing Zones (EPZs). A duty drawback system was also implemented for those exporting less than 100 percent.

Figure 9: Unweighted Average Nominal Protection

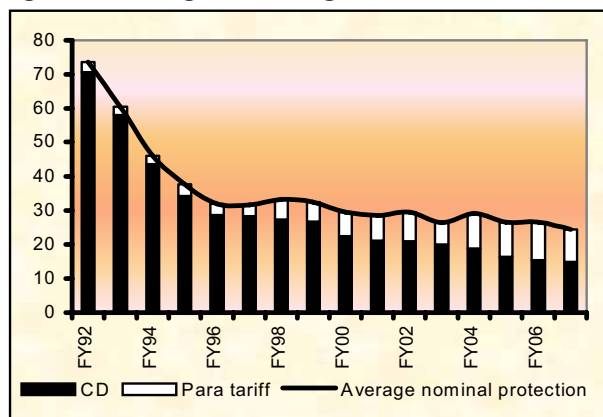
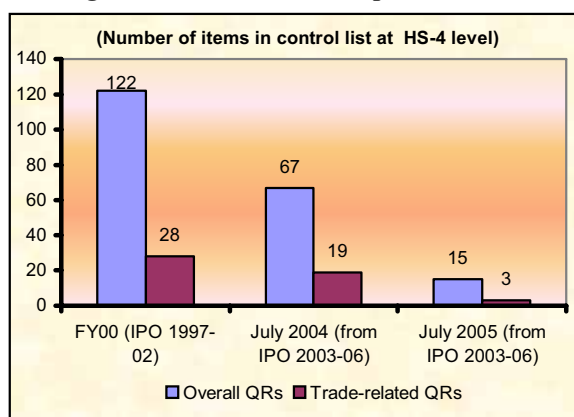


Figure 10: Evolution of Import Restrictions



Source: Bangladesh Bank and Staff Calculations

51. *Nonetheless, a substantial agenda for deepening trade liberalization and strengthening export competitiveness remains.* While the average customs duty rate has been steadily reduced by cutting the general maximum rate, a rampant increase in the use of other protective levies (para-tariffs) in the last decade has offset much of that (Figure 9).³¹ Para-tariffs now cover about 20 percent of tariff lines and account for just under 40 percent of total nominal protection provided by the statutory import duties, as opposed to 10 percent in FY96. Consequently, and the significant reductions in customs duties notwithstanding, average protection levels are the highest in the region and among the highest in the world (Figure 11). Furthermore, trade facilitation procedures are cumbersome and infrastructure bottlenecks to exporting are severe, as discussed later. As a result, the anti-export bias has leveled off at about 20 percent since the late 1990s, which works against the emergence of new export activities and expansion of the export activities to non-enclave areas. Unsurprisingly, Bangladesh's export orientation, although much higher than in 1990, compares unfavorably with other Asian economies that have moved more decisively in lowering trade protection and strengthening their export competitiveness (Figure 12).

³¹ Four kinds of para-tariffs have been used: Infrastructure Development Surcharge (IDSC), VAT, Supplementary Duty, and Regulatory Duty (removed in FY05). The FY08 budget proposes to merge the IDSC with the CDs.

III. Transition to Middle-Income Country Status: Issues and Challenges

Figure 11: Average Tariff Protection (2002-04, %)

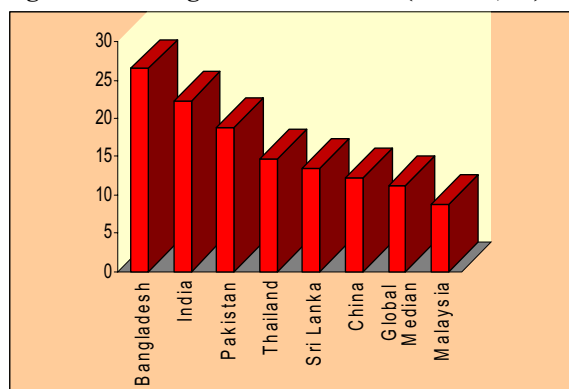
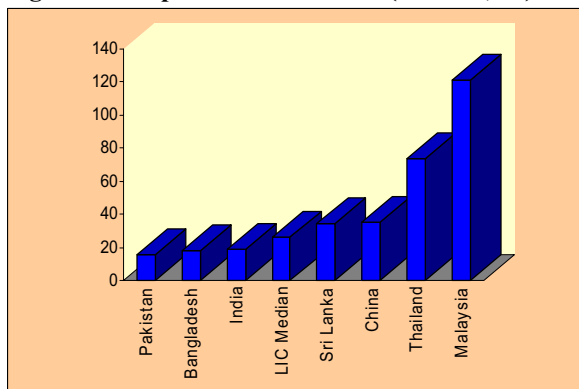


Figure 12: Exports to GDP Ratio (2004-05, %)



Sources. Fig 11: World Bank (2004): *Trade Policies in South Asia: An Overview*. Fig 12: WDI indicators.

52. **Moreover, the export base is heavily concentrated in RMGs – RMG exports account for about 75 percent of merchandise exports – where the extent of the anti-export bias is much lower.**³² Enclave arrangements and a duty drawback system can reduce the anti-export bias but do not offset it entirely. While the bonded-warehouse system and EPZs provide exporters duty/tax free access to inputs, they do not offer shelter from the broader disincentives caused by high levels of protection and anti-export bias. Moreover, the Duty Exemption and Drawback Office (DEDO) is extremely inefficient: it takes a minimum of six months for drawbacks to be paid, with half the applications still pending after two years.

53. **In order to diversify her trade base and improve export competitiveness, Bangladesh needs to implement a well-thought-out sequence of trade liberalization measures.** The country would need to accept that the process of increasing economic integration at the global level is likely to persist, intensifying competitive pressures among nations. Beyond that, global competition for Bangladesh's main export, RMG products, itself has stiffened with the phase-out of the global export quotas. Low wages notwithstanding, competitiveness of Bangladeshi exporters is undercut by low productivity, higher input costs, perceptions of poor product quality, inefficiencies in trade facilitation and long lead times, and weaknesses in the domestic business environment; areas where many of Bangladesh's main competitors for RMG exports (e.g., China, India, Sri Lanka, Vietnam) are generally doing better. In order to maintain her position as a leading RMG exporter and also to diversify her export base, Bangladesh would need to strengthen her export competitiveness by addressing each of these critical areas of concern.

54. **Key elements of the reform strategy to liberalize the trade regime would include:**

- A continued emphasis on unilateral trade liberalization and a somewhat cautious approach to the current fashion of regional and bilateral trade agreements.
- Establishment of a low and uniform tariff rate in not so distant future. Interim reform steps would include further simplification of the import tax regime, and reduction in the dispersion and average level of nominal (and thus effective) protection, preferably through a pre-announced medium- and long-term schedule of tariff reductions (as was done by India recently)
- Merger of para-tariffs with the customs duty, in order to have one tariff rate for each tariff line.
- Elimination of all end-user tariff exemptions and concessional tariffs.
- Discontinuation of protective use of VAT by ensuring that it is levied both on domestic production and imports of the same product.

³² Shrimp export has also shown considerable promise, with a two-and-a-half fold increase in value since 1990. But, most of this increase was over the FY90-97 period. Since then, problems with meeting international quality and phyto sanitary standards and low productivity stages have resulted in a virtual stagnation in shrimp exports.

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- Ensuring a well functioning duty drawback system such that rebates are paid quickly. The full implementation of the new duty drawback and bonded warehouse scheme is needed immediately.
- For any regional or bilateral agreement, it would be important to: minimize sectoral or product exemptions; have clear rules against tariff-rate quotas; have “rules of origin” that are liberal, simple, transparent, and uniform, and; extend such agreements to services trade and investment.

Transition 3: Managing the Net Benefits of Rapid Urbanization

55. *The process of rapid, largely Dhaka-centric, urbanization underway in Bangladesh (described briefly in Section 1), offers major opportunities and challenges, which need careful management.* The increasing returns to investment that typically arise from urban agglomeration can be an important stimulus for economic growth and productivity.³³ At the same time, uneven patterns of urbanization, characterized by excess concentration in the largest cities without concomitant improvement in their governance and infrastructure carry associated costs in the form of congestion, pollution, and transport and service delivery bottlenecks. The challenge before policymakers in Bangladesh is to strengthen urban management to avail of the agglomeration benefits, while avoiding policies that contribute to over-concentration and its negative effects. **Chapter 4** covers the issue in some depth.

56. *The urban management situation in Dhaka and, to a lesser extent, Chittagong, Khulna, and Sylhet typify these challenges.* Economic returns from Dhaka-based urban activities are clearly quite high, as reflected in the city’s economic dynamism which continues to be a magnet for migrants from elsewhere in the country. In addition to the agglomeration benefits, a combination of national institutional arrangements and public expenditure allocation decisions – for example, in the form of Dhaka-centric public investment in transport network – has contributed to the special appeal of Dhaka. At the same time, the costs of urban concentration in Dhaka are rising sharply, putting even more stress on the city’s (already stretched) service provision and infrastructure. A striking manifestation is the sky-rocketing real estate prices – already among the highest in the world! Moreover, traffic congestion is getting worse by the day and provision of infrastructure and urban services lags demand by a significant margin in Dhaka and other major metropolitans (**Table 6**). Firm surveys reflect similar dissatisfaction with infrastructure and access to land in Dhaka and Chittagong. Not surprisingly, Dhaka is consistently ranked as one of the least livable cities of the world.³⁴ The economic toll from these rising costs is also likely to be significant, as they increase the hurdle rate for new investments: i.e., many potentially high-return projects would not be deemed viable by investors because of the high costs.

Table 6: Satisfaction with Services (% of surveyed households)

<i>Services</i>	<i>Dhaka</i>	<i>Chittagong</i>	<i>Khulna</i>	<i>Rajshahi</i>
Police	2	0	1	2
Land Registration	2	1	10	4
Transport	7	3	19	6
Electricity Services	8	2	12	2
Judiciary	8	1	2	5
Health Care	11	4	18	9
Garbage Disposal	15	10	12	10
Sewerage/Sanitation	17	16	11	16
Education	21	5	28	12
Drinking Water	27	9	11	8

Source: Proshikha (2002)

³³ Production typically benefits from being located in densely populated urban areas that provide a pool of skilled workers and a network of complementary firms with backward and forward linkages for supply chains, knowledge flows, and a critical mass of consumers. *World Development Report 1999-2000*, World Bank, Washington, D.C.

³⁴ Ahmed et al, World Bank mimeo, 2006.

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57. ***Urban management is even weaker in the smaller cities, retarding their emergence as viable urban alternatives.*** Out of the 522 urban areas identified by the 1991 Census Commission, the six largest cities have a city corporation status and only 289 of the remaining urban centers have *Pourashava* or Municipality status, and the capacity and resource constraints of the latter are much more severe than in the metropolitans. It also seems that by creating many small *Pourashavas*, the government has not carefully considered scale economies in service provision or the implications of limited fiscal and administrative capacity in local governments, creating dependence on fiscal transfers from the center.³⁵

58. ***The fundamental underlying cause of the poor urban management record is weak governance,*** manifest in various forms: the lack of decentralization and local autonomy, major capacity and resource constraints, loosely defined and fragmented city management structures, and absence of a coherent national urban strategy. Bangladesh is among the most centralized countries in the world. Even where local governments have been established, they have neither the autonomy nor the capacity to develop economic policy or design and provide most public services. These functions lie mostly with the central government, which is responsible for not only the provision of basic services (police, fire protection, housing development), utilities, and higher education, but also their regulatory oversight.

59. ***Furthermore, responsibilities are fragmented among the large number of central and local agencies, often with overlapping functions and little coordination.*** In Dhaka, for example, currently, 16 organizations are directly involved with service provision and another 30 have indirect responsibilities, all with little coordination. An additional problem is the failure of national land development markets which, together with lack of fiscal decentralization, prevents land developers and local governments from actively developing alternate urban locations and spreading development across the urban hierarchy.

60. ***Weak fiscal and administrative capacity at local levels limits city governments' ability to deliver even the small subset of responsibilities entrusted them. Importantly, city governments do not have buoyant tax handles.*** Their main own revenue source is the property tax and associated fees for water, lighting and conservancy imposed on the same base, collectively called the holdings tax. In principle, the property tax should meet majority of their spending requirements. In practice, their ability to raise property taxes is constrained by administrative and technical shortfalls. City governments then need to rely on central government transfers for up to half of their revenues. These grants are typically tied to pre-specified projects and as such don't add to local capacity or autonomy. They are also proving increasingly unreliable: average grant per *Pourashava* has steadily declined over the last decade.

61. ***The urban management challenge is twofold. First, to improve access to and quality of basic services and infrastructure in Dhaka and other major metropolitans. Second, to improve the prospects for the smaller cities to emerge as viable urban alternatives.*** Cutting across both is the need to devolve key services to city governments, together with clear delineation of duties and accountability chains between the federal and city governments, among the various agencies involved, and between the service providers and the citizens. This has to be carefully sequenced with improvements in city governments' ability to perform, particularly by enhancing their own revenue sources and building their technical and administrative capacity. To improve own revenues, local governments first need to step up collection from existing tax bases, for which training of the appraisers and computerization of billing are likely to prove useful. However, these efforts can succeed only if the link between local taxes and quality of public services is strengthened.

62. ***A carefully thought-out national urban development strategy is needed for more balanced urban development across the country.*** This would seek to remove policy biases – such as those in public expenditure allocations and public investments in transport and communications networks – that

³⁵ Chowdhury (2004); *Bangladesh Municipal Finance Management Sector Study*, 1998, World Bank.

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work against the emergence of smaller cities, and to create incentive structures and competitive pressures among cities such that (public and private) investment and labor flows are guided by objective measures of city management. New investments are likely to help firms de-concentrate from the largest cities and locate in their peripheries, while still maintaining access to markets and their suppliers. As smaller cities improve provision of public goods and services, locations further away from large metropolitan areas will start becoming attractive. To be effective, better infrastructure and service provision *within* these areas need to accompany improvements in inter-regional transportation, which, in turn, will require large public investments and significant resources. Toward this, recently initiated efforts such as the Municipal Development Funds (MDF) appear to be steps in the right direction. The MDF was established in 1998 with initial funding of US\$70 million from the World Bank to provide financial support to *Pourashavas* for infrastructure development and service provision. The fund requires *Pourashavas* to improve performance on many counts before becoming eligible to apply for its resources.

III.3. The Enabling Environment for Making the Key Transitions

63. The management of these consequential long-term transitions will be shaped by some key cross-cutting reforms – particularly, measures to strengthen economic governance and the regulatory environment, ensure continued macroeconomic stability, address infrastructure constraints (especially power, ports, and transportation), deepen and make more efficient the financial sector, and address acute skill gaps. These, in turn, are described below.

Strengthening Governance and the Regulatory Environment

64. *Research over the last decade has shown increasingly compelling evidence that good governance matters to long-run growth.* It tells us little though about *why* governance matters and *how* it influences growth. For example, while the research shows that property rights are important to investors, it implies nothing about the form these should take. Understanding individual country contexts and how institutions work in particular historical and cultural settings is important to understanding better the governance-growth nexus. **Chapter 7** pushes the envelope in that particular direction for Bangladesh.

65. *The issues of governance, corruption and related matters have been major and growing areas of concern in Bangladesh.* Cross-country (perceptions-based) indicators of governance, such as the ones developed by World Bank Institute (WBI), generally find low and, in some areas, even declining governance standards in Bangladesh. Results from the 2003 Investment Climate Survey further bear these concerns out, showing the bureaucracy as delivering in some areas and not in others (**Table 7**).

Table 7: Investment Climate Survey

Indicator	Bangladesh	South Asia	All Countries
Senior Mgmt time spent dealing with regulation requirements (% time)	4.2	8.1	8.2
Officials' interpretation of regulations, predictable (% agree)	78.6	52.5	46.9
Economic and regulatory policy uncertainty (%)	44.3	23.2	30.5
Firms expected to give gifts in meetings with tax inspectors (% of firms)	85.8	44.3	21.7
Unofficial payments for firms to get things done (% of sales)	2.5	1.6	2.4
Value of gift expected to secure government contract (% of contract)	4.3	2.2	3.0
Corruption as a major or severe obstacle (% of firms)	57.6	25.3	29.9
Confidence in the judiciary system (% of firms)	17.02	48.5	56.7
Crime, theft and disorder a major or severe obstacle (% agree)	39.0	15.0	19.7
Losses due to crime (% of sales)	0.6	0.6	1.5
Tax administration a major or severe obstacle (% of firms)	49.7	22.4	25.9
Customs and trade regulations a major or severe obstacle (% of firms)	41.9	24.8	16.8

Source: World Bank and Bangladesh Enterprise Institute, *Improving the Investment Climate in Bangladesh, 2003*.

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66. Information from the World Bank's *Doing Business* 2006 database is also not encouraging (**Table 8**) overall. There are more procedures involved and it takes more time to start a business in China than in Bangladesh, and yet the associated cost in China is half that in Bangladesh. Firms are established are subject to frequent visits from a variety of government agencies (some 17 a year in 2003 compared to 7 a year in India in 2004). The number of procedures and their time requirement for registering a property is among the highest in the world – it takes less than one-fifth as much time to register a property in the median LIC as in Bangladesh. Bangladesh does a bit better on contract enforcement, where the number of procedures, time, and cost involved are each lower than in India, Pakistan and the median LIC. Exporters need a lot of signatures, which take a long time (35 days on average, compared with 20 days in China) and undercuts competitiveness of Bangladeshi exporters. Recovering a loan in a bankruptcy can take up to 4 years and cost up to 8 percent the value of the estate.

Table 8: Cost of Starting a Business in Bangladesh and Comparator Countries

	Starting a Business			Registering a Property		Enforcing Contracts			Export Procedures		
	Procedures	Time (days)	Cost (US\$)	Procedures (number)	Time (days)	Procedures (number)	Time (days)	Cost (%of debt)	Documents (number)	Signatures (number)	Time (days)
Bangladesh	8	35	358	11	363	29	365	21.3	7	15	35
China	13	48	175	3	32	25	241	25.5	6	7	20
India	11	71	383	6	67	40	425	43.1	10	22	36
Malaysia	9	30	972	4	143	31	300	20.2	6	3	20
Pakistan	11	24	146	5	49	46	395	35.2	8	10	33
Sri Lanka	8	50	105	8	63	17	440	21.3	8	10	25
Thailand	8	33	155	2	2	26	390	13.4	9	10	23
LIC Median	10	44	372	6	71	34	390	31	8	13	43

Source: *Doing Business Indicators 2006, World Bank.*

67. *The “Bangladesh Paradox” of good growth despite weak governance is then frequently posed as a serious puzzle.* Put sharply, how has Bangladesh managed to increase its per-capita GDP close to 90 percent since 1980, while Haiti (ranked equally low by the Transparency International index of corruption in 2004) has seen its per-capita GDP halved over the same period?

68. *A possible resolution to this conundrum is that governance in Bangladesh may not be uniformly weak across the board,* particularly in key areas of economic management that interface with the forces of growth. Unbundling of governance in Bangladesh does produce a mixed bag of goods (**Box 1**), which may help resolve the popular paradox.

69. While such analysis helps reconcile Bangladesh's good growth record with weak governance, there is little doubt that *improvements in key dimensions of governance will be necessary to carry through the second generation reforms, strengthen the investment climate, and lower the cost of doing business.* Like Indonesia and other South East Asian countries in the 1990s, Bangladesh is likely to soon discover that it is growing out of its current institutional environment. The governance situation may have been adequate to cope with an economy breaking out of stagnation and poverty, it is very likely a barrier to the acceleration of growth (as recognized in the government's PRS) needed to push Bangladesh firmly on the path of middle income status and poverty reduction. Tackling weaknesses in the core governance systems as well as in sectoral governance in critical sectors will be essential.

70. *The most serious and difficult of the core governance functions has to do with the political domain where confrontational politics and the high cost of election financing have pernicious consequences for the economy.* Bangladesh is not unique in its confrontational politics; developed and developing nations have shown this tendency. But the fractiousness contributes to political uncertainty and to perceptions of political instability to outside investors who may not always understand that much of this tends to be “sound and fury, signifying nothing”. Potential foreign investors taking a long term

view of investments in developing countries tend to stay away from what they see as a high risk environment which has a significant impact on growth.

Box 1: Unbundling Governance in Bangladesh: A Mixture of Strengths and Weaknesses

Five Unquestionable Areas of Strength

- The state created space for the emergence of a vibrant private sector through macroeconomic discipline.
- Successive governments have been relatively good at making wise public expenditure choices.
- Recognized its limitations, the state has created space and forged partnerships with NGOs and the private sector to help deliver social services.
- The state has greatly improved its capacity to manage natural disasters.
- Successive governments have encouraged the migration of Bangladeshi workers to West Asia and other destinations, and created a domestic economic environment that has encouraged these workers to remit large sums of money to Bangladesh.

Significant Governance Weaknesses

- Confrontational politics and the high cost of election finance have severe economic consequences.
- Governance challenges also severely impede public financial management.
- Major problems in tax administration (poor taxpayer services, lack of transparency in collection, inadequate audit and enforcement, and protracted taxpayer disputes) yield low revenue collection.
- Financial accountability is weak with flawed (albeit improving) procurement processes, poor financial controls and inadequate external checks and audits.
- Serious governance weaknesses in key sectors such as power (which is in a near state of crisis) and financial sector (which has seen recent improvements)
- Surveys show that the public in general views the civil service as being low quality, which further feeds this vicious cycle of poor governance.
- Finally, the justice sector has also been a source of weakness, although the Supreme Court and the senior judiciary are exceptions to this rule.

Source: World Bank, *Country Assistance Strategy for Bangladesh for the Period FY-06-09, 2006*.

71. ***Governance challenges also severely impede public financial management.*** There are major shortcomings in tax administration (poor taxpayer services, lack of transparency in collection, inadequate audit and enforcement, and protracted taxpayer disputes) and the resultant low revenue effort creates a chain of disincentives to good governance, from low salaries to civil servants to inadequate operations and maintenance expenditures and lack of effective checks and balances. Financial accountability is also weak with flawed procurement processes, poor financial controls and inadequate external checks and audits, although recent measures to adopt an international good-practice procurement law and strengthen the Public Accounts Committee (PAC) are major steps in the right direction. Bangladeshis in general view the civil service as being low quality, which further feeds this vicious cycle of poor governance.

72. ***Another major core governance area in need of urgent attention is the rule of law, central to the growth process.*** With the possible exception of the Supreme Court, all the key pillars of the justice sector are weak, inefficient and prone to corruption. The police are held in little confidence. In part this is a matter of staffing: its 80,000 complement makes the force quite the smallest in the sub-continent in relation to population. A weak prosecution service and an inefficient and allegedly corrupt lower court system contribute to the lack of justice. For ordinary citizens, access to justice is impeded by the high costs and the low probability of a successful resolution. For businesses, the inability to enforce contracts promptly and to secure property rights, particularly for land, greatly raises the cost of doing business. While domestic entrepreneurs learn how to survive the system, foreign investors unfamiliar with the country and with plenty of other places to invest in are greatly deterred by these failures.

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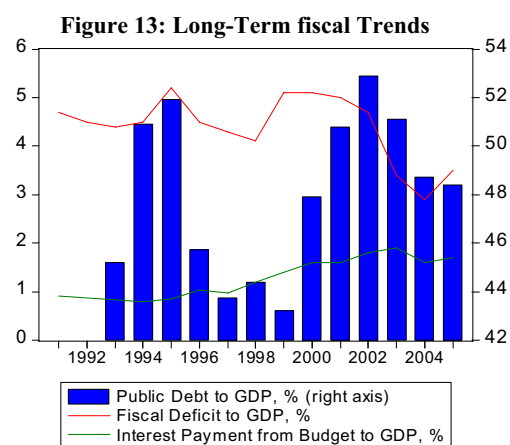
73. ***Addressing the governance challenge will require strong political leadership and emergence of a constituency that demands change.*** The reform agenda is large and cuts across a wide range of institutions and threatens powerful vested interests. Developing a strategic, sequenced approach that relies on success in a few key areas to generate momentum and demand for reform in other areas will be crucial. Summoning the political will to do this will not be easy, and will itself depend on strong political leadership and a public that demands reforms and shows lower tolerance for weak governance.

Continuing Sound Macroeconomic Management

74. ***Macroeconomic management has generally been an area of strength for Bangladesh. Monetary policy has broadly supported growth while doing a good job of containing inflation.*** Monetary management prior to 1990, in fact, was quite problematic, with money supply growth far in excess of nominal GDP growth. This and frequent supply-side shocks due to natural disasters resulted in inflation rates in the teens in the 1970s and 1980s. The record on monetary management since 1990 has been positive, with tighter control on reserve money growth and more flexible interest rate management which, together with decontrol of interest rates, resulted in positive real interest rates, keeping inflation rates in single digits.

75. ***The record on fiscal management is more mixed.***

Fiscal sustainability came under some stress in the FY99-02 period because of scaled up public spending and increased reliance on the more expensive domestic commercial borrowing which put interest payment on a rising trend (**Figure 13**). Fiscal prudence was soon restored, however, with the deficit being lowered to under 4 percent of GDP and commercial borrowing capped at 2 percent of GDP. Benefiting also from good growth, public sector debt has since been kept under 50 percent of GDP. Broad allocation of public expenditures has been quite sound, with 60 percent of expenditure accounted for by health, education, social protection, rural development, and infrastructure and a relatively small allocation of (1.1 percent of GDP, which is less than half the regional average) to defense. The quality of expenditure at project level is a concern, however.³⁶ Moreover, a poor tax collection record (tax collection equals 8.5 percent of GDP), among the weakest in the world, is not consistent with the higher allocations for social sector and infrastructure development that are needed for sustained growth.



76. ***The main source of fiscal risk are the large losses and unpaid liabilities of the SOEs, especially those in the energy sector.*** SOE losses for FY06 are estimated at about Tk 45 billion (US\$670 million), or 1.1 percent of GDP, compared with Tk 27 billion (0.7 percent of GDP) in FY05, and just Tk 6 billion in FY04. The Bangladesh Petroleum Corporation (BPC) alone accounted for more than 80 percent of these losses because of inadequate pass-through of the recent increases in global energy prices to domestic consumers. The other major loss making SOEs are Bangladesh Power Development Board (BPDB), Biman, the national airline, and BCIC, the public sector chemicals corporation. A hike in power prices in March 2007 and in fuel prices in April 2007 should help curtail losses at the BPDB and substantially at the BPC.

77. ***The losses of the SOEs have exacerbated the fragilities at the Nationalized Commercial Banks (NCBs), which are directed to provide loans to these agencies.*** The capital shortfall in the NCBs amounts

³⁶ *Bangladesh Public Expenditure Review*, World Bank, 2003.

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to about Tk 68 billion (around 1.5 percent of GDP), which adds to the fiscal risk and makes future divestment of these banks more expensive for the government.

78. Reflecting these large contingent liabilities, together with the weak revenue mobilization, *the recent debt sustainability jointly prepared by the World Bank and the IMF assessed the risk of debt distress to be “moderate”*.³⁷ Accordingly, to ensure continued public debt sustainability, authorities would need to step up their efforts to contain SOE losses with cost-reflective pricing and enhanced operational efficiency while steadily improving tax mobilization.

79. *The external debt situation is fairly benign, benefiting from a number of factors*. Overall fiscal and monetary prudence has helped contain excess demand, particularly since 2002. Temporary slackening of macroeconomic management had led to a build up of external pressures by end-2001: the current account deficit rose to over 2 percent of GDP in FY01 and foreign exchange reserves fell to a precarious level of US\$ 1 billion (or 1 month of import cover) by end-2001. More disciplined macroeconomic management together with stronger growth in exports and remittances and a pick-up in concessional and other long-term capital inflows have since restored external balances. The current account deficit has stayed under 1 percent of GDP and reserves now stand at over US\$4 billion (2.6 months of import cover). The situation was further aided by the free floating of the taka/US\$ exchange rate in 2003. Even prior to the free float though, periodic devaluations and low inflation rates ensured that loss of external competitiveness from real exchange rate appreciation was limited. External debt equals 30 percent of GDP, down from 45 percent in FY95 and 34 percent in FY02, most of which is concessional loans from international donors; the external debt servicing ratio is only 5 percent. *Recognizing these benign external conditions, the joint Bank-Fund debt sustainability analysis assesses the risk of external public debt distress to be “low”*.

Addressing Infrastructure Constraints: Emphasis on Power and Trade Facilitation

80. *Infrastructure bottlenecks related to power and trade facilitation (ports and transportation) are severe in Bangladesh and place a major (and growing) drag on economic performance (Chapter 9)*. Only about 35 percent of the population – four-fifths of urban population and one-fifth of rural population – has access to network power, and load-shedding to those with access is rapidly increasing. Firm level surveys consistently reveal access to power as being among the top obstacles to investment. Trade facilitation, critical for export competitiveness, is also not faring well. Chittagong port, which handles nearly 85 percent of the country’s merchandise trade, is highly inefficient. Moreover, transport networks connecting the ports with the hinterland are underdeveloped and beset with logistical problems.

Power Sector: Weak Governance, Poor Outcomes

81. *The most serious and immediate of the infrastructure constraints – with perhaps the most damaging impact on productivity and investment – is the widespread and growing shortage of electricity*. In 2005, the power sector generated 160 kwh of electricity per-capita, among the lowest levels in the world (**Figure 14**). It is estimated that only about 35 percent of the population has access to network power. Moreover, load shedding – the practice of cutting off customers during periods of peak demand – is at historic highs and growing fast. While peak demand exceeds 5,000 MW, the country has experienced load shedding during peak times of as much as 2,800 MW.

82. *The 203 Investment Climate Assessment survey confirms the concern about power at the firm level*. Electricity supply easily topped the list of “major or severe obstacle” with 73 percent of firms citing it as a major obstacle to investment (**Figure 15**), versus 38 percent in the region. The average firm interviewed experiences power losses for 2 of every 3 days in a year, versus one in five days in the region.

³⁷ World Bank and IMF, 2006, *Bangladesh: Joint Fund-World Bank Debt Sustainability Analysis (DSA)*.

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This necessitated reliance on expensive captive power generation: 71 percent of firms shared or owned a generator (versus 56 percent of firms in the region), which added an estimated 50 percent to their electricity costs. Lack of access to power is a lot more constraining for rural enterprises. A recent survey found only 32 percent of rural firms with access to electricity compared to 60 percent in urban areas.³⁸ For those fortunate enough to have access, reliability is a major issue – power outages and surges are all too frequent. This, again, affects the rural enterprises more as only 1.8 percent of them own a generator.³⁹

Figure 14: Electric Power Consumption (kwh per-capita)

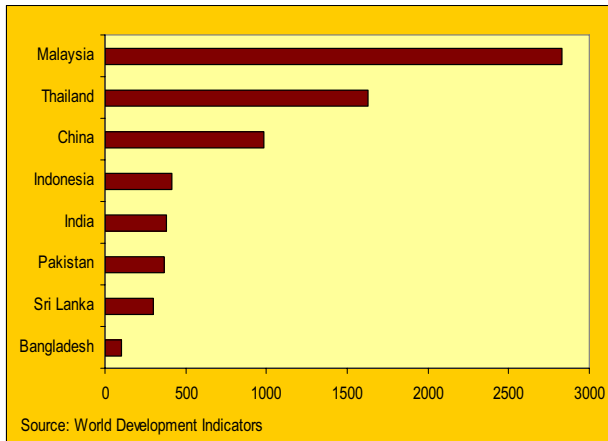
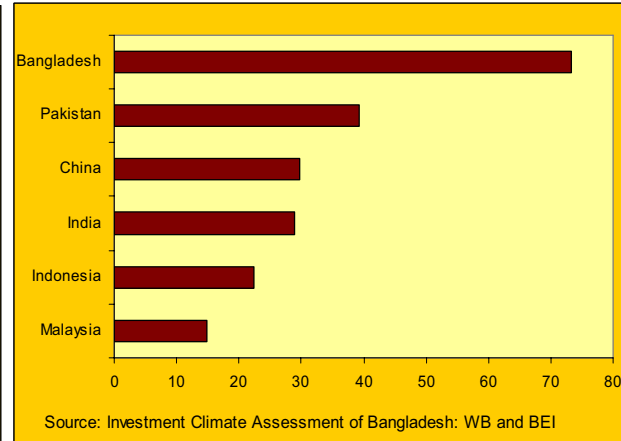


Figure 15: Percentage of Managers Ranking Power as Major Constraint



83. *Not surprisingly then, the growing power shortages hit the economy hard.* Evidence in **Chapter 1** shows that productivity of manufacturing firms is seriously impaired by power supply disruptions. The developing power crisis also adversely affects agriculture production: power shortages hurts irrigation of the *boro* crop, as irrigation pumps run mainly on power, while power voltage fluctuations often put the pumps out of order.

84. *Most of Bangladesh's power sector problems are rooted in a long history of badly run government power enterprises and governance weaknesses, which also undermined the 1990s initiative to encourage private power generation.* Half a dozen independent power producers (IPPs) were established in the late 1990s adding up to about 1,260MW. But since then no new deal has been closed. Underlying this failure is alleged interference in the technical evaluations by vested interests and rumors about particular parties having been chosen for political reasons. Potential investors are also put off by the BPDB's growing financial shortfalls and the resulting problems in meeting its financial obligations.

85. *Part of the government's response to power shortages has been increasing the supply of natural gas, at highly subsidized rates and with scant regard to sustainability and costs.* This policy stance, unless corrected, is likely to prove fatally flawed. Bangladesh is running out of natural gas, for commercial rather than geologic reasons; projections show that without significant power and gas sector reforms the country can experience major gas shortages as early as the next decade.

86. *Also critical are political economy factors that have caused under-pricing of energy products.* In common with many other developing countries, Bangladeshi authorities, unable to provide adequate services, have sought to deflect political pressures by maintaining artificially low tariffs. Average retail power tariffs are around 3.4 cents/kWh, quite low by international standards and insufficient to cover costs. About US\$1 billion in accumulated power sector debt is not serviced by the utilities, which,

³⁸ *Promoting the Rural Non-Farm Sector in Bangladesh*, World Bank, 2004.

³⁹ *Ibid.*

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ultimately, is covered from the budget. An important consequence of under-pricing of power, therefore, is crowding out of productive public expenditure.

87. *The government is beginning to address some of these constraints, although the pace of reforms has been uneven and slow on account of inadequate prioritization, resistance by various vested interests, and lack of clear political support.* The government's 2000 Vision Statement and Policy Statement sets forth reasonable objectives, and its implementation strategy is laid out in the recently adopted "road map" for the years 2006-08. Some important initial implementation measures include:

- *Bangladesh Energy Regulatory Commission (BERC) was established in 2004*, and is expected to play the lead role in setting tariffs, issuing licenses and providing regulatory oversight.
- *The industry structure has been changed noticeably*, leaving BPDB with 60 percent of generation (compared to 86 percent in FY99) and 30 percent of distribution. Major steps include:
 - horizontal unbundling of BPDB's distribution activities into four regional entities: one each for the West Zone, Northwest Zone, South Zone, and Central Zone;
 - creation of the Dhaka Electric Supply Company Ltd (DESCO) out of DESA assets to cover parts of the key Dhaka market;
 - creation of the Power Grid Company of Bangladesh (PGCB) to handle all of BPDB's transmission assets;
 - creation of Ashuganj Power Station Company Limited (APSCL) to takeover the 724MW Ashuganj Power Station, and;
 - transfer of 9,000 km of distribution lines from BPDB to the more efficient Rural Electrification Board (REB).
- *Management in PGCB, DESCO, and APSCL has been contracted competitively from the market.* Both PGCB and DESCO are now profit-making enterprises.
- *Three distribution companies – DESCO, West Zone, Northwest Zone – have been corporatized.* Corporatization of the remaining three – DESA, South Zone, and Central Zone – is planned over the next three years. Corporatization of BPDB is also being studied.
- *A Captive Power Policy was adopted in FY06* with the objective of tapping potential captive capacity into the public grid.
- *Arrears to major power utilities companies have been reduced*, from 8 months equivalent of receivables in end-FY03 to less than 3 months.
- *A financial restructuring and recovery plan (FRP), prepared by a group of reputable international consultants, has been adopted by the government in principle, and initial implementation of the plan has begun.* Debt restructuring under the FRP is expected to make the sector more appealing to private investors and also allow a more gradual adjustment of tariffs.

88. *Recent government-commissioned studies indicate that new investment of US\$1.5 billion may be needed annually in the foreseeable future to develop the gas and power sectors.* Most reasonable forecasts suggest that Bangladesh would need at least one utility-scale plant in the 500 to 700 MW range every year to catch up with demand. Attracting large-scale private investment in gas exploration and production and in gas-fired power generation will be key – clearly, the public sector is not in a position to undertake investment of the needed magnitude. But to achieve that, it would be important to:

- *Address the critical issue of efficient pricing as a priority item.* The way forward on pricing must involve: (i) explicit commitment to cost-reflective pricing in power and to economic costing of natural gas, including reinstatement of the pricing formula that ensures automatic pass-through of future fuel and foreign exchange related costs; (ii) adoption of a credible timeline to increase

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power prices to full cost recovery levels and gas prices to its economic value, and; (iv) hard-wiring of budget support during the transition to full price adjustment.

- ***Over the longer run, address governance problems in the sector.*** In generation procurement, appointment of internationally reputed advisors would help address the worst of the transparency issues. To address corruption in service delivery and in network expansion, it would be important to commercialize the utility companies and fully support and empower their managers. That will mean de-politicizing the rural electrification program and putting law and order resources behind managers seeking to enforce payment from delinquent customers.
- ***Implement complementary reforms, particularly corporatization and financial restructuring of power sector entities and strengthening of the BERC,*** which would each be meaningful and achievable only in the aforementioned framework of price reform, better governance, and clear investment requirements stemming from gas exploration and production and power generation programs. Efficient and cost-reflective pricing would also be the cornerstone of implementing the FRP, the first-phase steps of which would include reconciliation of inter-company arrears, restructuring of balance sheets, and analytical inputs for determining future tariff increases.

Trade Facilitation and Growth

89. ***Trade facilitation shortfalls are assessed to be a major bottleneck to Bangladesh's export competitiveness.***^{40,41} A recent study finds that Bangladesh's garments exports could increase by 30 percent if various capacity constraints at the port are addressed.⁴² With tightening margins and ever shrinking order cycles in the post-ATC world, the costs to Bangladesh's external competitiveness from related distortions are mounting and it is essential that they be tackled on a priority basis.

90. ***Various inefficiencies and high shipping and port costs at the Chittagong port – which handles nearly 85 percent of the country's merchandise trade flow – continue to undermine the country's international competitiveness.*** The port ranks among the world's least efficient container ports – the 2001-02 Global Competitiveness Report ranked it 72nd out of the 75 ports it rated. Average container dwell time was reported at 18 days compared to 10-12 days for other ports in the region.⁴³ Similarly, the average wait time for a loaded import container was found to be 20-25 days compared with international standards of 4 days for imports and 2-3 days for exports.⁴⁴ Moreover, container handling costs in Chittagong port are estimated to be four times higher than in Colombo and twice as high as in Bangkok. No doubt, many of these performance measures have improved in recent months – since January 2007 – in large part because of the crackdown on union activity among dockworkers and retrenchment of about 4,000 workers under the heavily unionized Dock Workers' Management Board (DWMB) that was declared defunct. Many of the retrenched workers have been hired back by the 12 private berth operators asked to takeover port operations in place of the old stevedoring system. According to officials, efficiency at the port has improved by about 30 percent because of these measures. These are welcome improvements in the labor efficiency at the port, although the sustainability of the new structure put in place on an experimental basis remains to be seen.

91. ***What is causing the malaise at Chittagong Port? Clearance procedures at the ports and customs are complex and the port lacks physical and logistical capacity.*** The documentation needed for

⁴⁰ *Bangladesh: Growth and Export Competitiveness*, World Bank, 2005.

⁴¹ Trade facilitation involves procedures for import-export transactions at ports, efficiency of transport networks linking ports with hinterland, logistics services, and implementation of food safety and quality standards.

⁴² www.textileandapparel.com/story/2005/12/8/20246/8014.

⁴³ Asian Development Bank, Chittagong Port Trade Facilitation Project.

⁴⁴ "Improving Trade and Transport Efficiency – Understanding the Political Economy of Chittagong Port", Bangladesh Development Series Paper No. 6, The World Bank Office, Dhaka, December 2005.

customs is lengthy and must be submitted in hard copy. Even with the required Pre-Shipment Inspection (PSI) system now in place, customs continues to check 5-10 percent of the shipments that have a CRF (Clean Report of Findings) and up to 100 percent of the packages in these consignments. In addition to the resulting delays, the mere specter of such an inspection is sufficient to elicit informal payments.

92. ***Moreover, a number of physical constraints add to the costs.*** Chittagong's is not a deep-sea port, and transshipment via the Singapore/ Tanjung Pelapas and Colombo ports add to shipping costs and lead-time. Although the port handles about 400,000 containers per year, only recently has it procured fixed container handling equipment such as ship-to-shore gantry (SSG) cranes and rubber-tired gantries (RTGs); and that too in insufficient quantity. The port also lacks an effective and modern logistics tracking system. Furthermore, most containers arriving at the port are unstuffed and shipped as break-bulk in ten-ton trucks even though they are FCLs (Full Container Loads) and should be delivered directly to their destinations or to a customs facility near that destination. There are three main reasons for this practice. First, the interconnecting infrastructure (rail and trucking), including and especially along the critical Chittagong-Dhaka corridor, is unable to carry the container load. Road transport, which handles bulk of the load, cannot carry containers because of their large size, while movement of containers by rail is slow and greatly constrained by the limited infrastructure. Second, importers must provide a bank guarantee to remove the container from the port unless shipped to the Dhaka Rail inland container depots (ICDs) – although the larger freight forwarders can make do with a company guarantee. Third, there are no customs facilities for clearing cargo near where most of the importing production units are located.

93. ***A recent World Bank report⁴⁵ finds the situation a classic example of the 'tragedy of the commons' in that individual stakeholder interests predominate to the detriment of overall port interests and those of the national economy.*** Lack of incentives for those providing port services and of transparent competition in private service provision contribute to the resistance to change. Moreover, the substantial incomes to workers from speed payments add to the resistance. One estimate shows that bribes and related costs account for about one-eighth of the total port-related expenses for imports and about one-tenth for exports, not including duties and taxes.⁴⁶ Chittagong Port Authority (CPA), on the other hand, lacks the legal authority to coordinate and steer through a radical reform program.

94. ***There is some evidence that the CPA management is beginning to take up a more proactive role.*** In addition to the earlier mentioned measures to improve labor efficiency and break the hold of union activity, it has introduced some private contractors for operations such as internal container distribution, running of the new road truck terminal, and rail container loading. It has proposed a separate concession arrangement for the operation and management of the new Moorings Container Terminal, which will provide five new dedicated container berths with 22 hectares of back-up land. However, the scope and reach of such institutional innovations and operational practices are still quite limited.

95. ***To carry out the requisite policy and institutional reforms at Chittagong port, it would be important to let private service providers be the catalysts, thereby also improving the conditions for much needed investment in the port's physical capacity.*** The following measures appear to be key:⁴⁷

- ***Modernize the container terminal operations, to take advantage of the recently procured SSGs and RTGs.*** This measure seems to have the highest immediate pay-off. Effective use of the equipment will involve computerization, restructuring of the workforce, and close interaction with the shipping lines. Such modernization will benefit from the recent measures to engage

⁴⁵ *Ibid.*

⁴⁶ *Bangladesh: Growth and Export Competitiveness*, World Bank, 2005.

⁴⁷ Although the reform agenda focuses on the Chittagong port, the malaise affecting other, smaller ports, including Mongla port, is of a similar nature and, therefore, much of the reform agenda is also applicable to these.

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private berth operators and depoliticize the labor force. These need to be sustained and deepened, and complemented with handover of the port management to an experienced private contractor.

- **Increase the penalties on service providers for creating congestion.** Stakeholders currently do not face adequate penalties against defaulting actions that reduce the port’s overall efficiency – even the limited penalties that are there on paper are not imposed uniformly.
- **Improve efficiency of customs clearance processes.** As noted, a relatively high proportion of imports are inspected by customs despite having in place a PSI system. While the introduction of the ASYCUDA++ system should help improve selectivity, some remaining incentive distortions faced by customs officials need to be tackled.

96. **Other complementary key reform measures needed to improve trade facilitation include:**

- **Increase customs bonded facilities, including road-based and ICDs, in the Dhaka region.**
- **Improve interconnection transport infrastructure.** Bangladesh can also consider emulating India in separating container-unit train services from the less profitable and time-sensitive ones and placing them under commercial management. Decision-makers should further consider more fully exploiting the inland-water transport network.

Creating a Deeper and More Efficient Financial System

97. **Financial sector development is critical for sustained growth and poverty reduction.** Well developed financial systems ease the exchange of goods and services by providing payment services, help mobilize and pool savings from a large number of investors, acquire and process information about enterprises and possible investment projects, thus allocating society’s savings to its most productive use, monitor investments and exert corporate governance and help diversify and reduce liquidity and inter-temporal risk. The importance of a deeper and more efficient financial sector for growth and productivity performance of an economy has been empirically well established in the literature.⁴⁸ Time series evidence in **Chapter 8** corroborates these findings for Bangladesh.

98. **Financial intermediation in Bangladesh, as in majority of the developing world, is heavily dominated by commercial banks.** The sector comprises four groups of “scheduled banks” (**Table 9**): four nationalized commercial banks (NCBs), five government-owned development financial institutions (DFIs), thirty private commercial banks (PCBs), and nine foreign commercial banks (FCBs). While there are a number of investment banks, merchant banks, leasing and finance companies, insurance companies, and stockbrokers, these remain small in comparison with the banking sector.

Table 9: Structure of the Banking System (end-2005)

Bank Types	Number of Banks	Number of Branches	% of Industry Assets	% of Industry Deposits
NCBs	4	3386	37	41
DFIs	5	1342	10	6
PCBs	30	1643	46	46
FCBs	9	41	7	7
Total	48	6412	100	100

Source: Bangladesh Bank Financial Sector Review, May 2006

99. **Since 2001, Bangladesh has embarked on bold banking reforms, most prominently by deemphasizing the role of the NCBs, strengthening competitive pressures, loosening government control, and tightening prudential regulations and regulatory quality.** Key measures on the latter

⁴⁸ See, for example, Goldsmith (1969), Levine (1997), King and Levine (1993) and Rajan and Zingales (1998).

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include increase in the capital adequacy ratio to international norms, tightening of loan classification, issuance of risk guidelines, and improvements in corporate governance of banks. Loan growth restrictions have been imposed on the four NCBs. Divestment of Rupali Bank, an NCB, to a strategic buyer is now close to being finalized. The three other NCBs have been corporatized and two of these would be partially privatized in the coming years; in the fourth NCB, the Sonali Bank, the government intends to sell only a minority share. The expected successful divestment of Rupali Bank, in itself an important milestone for banking sector reforms, should provide impetus for and set a useful precedence in following through with the rest of the NCBs.

100. *Performance in the banking sector has responded well to the reform measures.* Especially robust has been the response of private banks, which have dramatically increased their market share and turned around their operational and financial performances. While the share of the NCBs in the total assets fell from 54 percent in 1998 to 37 percent in 2005, PCBs and FCBs increased their share to over one-half by 2004. Similar trends are seen for bank deposits and loans: with PCBs and FCBs gaining market share at the expense of the NCBs and DFIs. Furthermore, NPL ratios have declined markedly since 2001 across all four groups, while capital adequacy ratios have noticeably picked up for the DFIs and FCBs (**Table 10**).

Table 10: Performance Measure in the Banking Sector

Bank Type	Capital to risk weighted assets ratio							Ratio of gross NPL to total loans						
	2000	2001	2002	2003	2004	2005	2006	2000	2001	2002	2003	2004	2005	2006
NCBs	4.4	4.2	4.1	4.3	4.1	-0.4*	1.1	38.6	37.0	33.7	29.0	25.3	21.3	22.9
DFIs	3.2	3.9	6.9	7.7	9.1	9.2	9.5	62.6	61.8	56.2	47.4	42.9	34.9	33.7
PCBs	10.9	9.9	9.7	10.5	10.3	9.2	9.8	22.0	17.0	16.4	12.4	8.5	5.6	5.4
FCBs	18.4	16.8	21.4	22.9	24.2	25.1	22.7	3.4	3.3	2.6	2.7	1.5	1.3	0.8
Total	6.7	6.7	7.5	8.4	8.7	7.3	8.3	34.9	31.5	28.0	22.1	17.6	13.5	13.1

Note: NPL numbers are without adjustment for actual provision and interest suspense.

* Negative CAR for NCBs in 2005 because of negative capital of Agrani bank

Source: Bangladesh Bank Quarterly, various issues.

101. *Nonetheless, major challenges remain.* In the banking sector, the problem is not so much size and depth, which are more or less at par with comparator countries and increasing consistently, but rather quality and efficiency. The sector, having been plagued by systemic distress over the last 20 years, is only beginning to emerge from a crisis and has a long road ahead to full recovery.⁴⁹ The NPL ratios, despite improvements, remain precariously high in the NCBs and DFIs, while provisioning by the NCBs and the problem PCBs has typically fallen well short of requirement. Among the PCBs themselves, there is considerable variation in performance, with several older PCBs having been under intensive Bangladesh Bank care for over a decade, while others show healthy balance sheets. The non-bank segment of the financial system, with the important exception of microfinance, is grossly underdeveloped. The stock market is small (market capitalization is below 10 percent of GDP) and inactive, and long-term savings institutions such as insurance companies and pension funds are virtually absent. On the other hand though, Bangladesh has the highest microfinance penetration in the world and is home to some of the world's leading microfinance institutions, including the Grameen Bank, winner of the 2006 Nobel Peace Prize.

102. *With the reform process initiated since 2001, the government has sought to move away from an heavy interventionist approach in the banking sector to a more market enabling one; which global experiences tell us is generally the most effective option.* Bangladesh Bank has laid the first fundamentals

⁴⁹ Applying one of the criterion for a systemic banking crisis, gross NPL ratio of more than 10 percent of aggregate loan portfolio, the Bangladeshi banking sector has been in one since 1983.

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for a more market-based supervision by introducing some important measures towards market-based supervision. Importantly, it has made it mandatory for banks to go public and for banks and non-bank financial institutions (NBFIs) to publish their annual financial statements in newspapers. It has also set higher disclosure and auditing requirements for financial institutions than faced by non-financial corporations, and maintains a separate list of approved auditors for banks.

103. ***Nonetheless, lack of autonomy and certain amount of political capture of Bangladesh Bank continues to vitiate market discipline and works against its move toward the market enabling approach.*** For instance, the institution has not been immune from political interference in the bank licensing process. Fortunately, the practice has ceased in recent years, but the past practice has resulted in a number of weak PCBs, plagued by insider lending and other owner abuses. Political capture of the regulatory entity also prevents proper resolution of failing banks. Although there is an explicit deposit insurance scheme, it has not been used. Rather, Bangladesh Bank has extended an implicit guarantee to all banks. Over the past years, no domestic bank has been allowed to fail; weak banks are referred to the Problem Bank Monitoring Department within Bangladesh Bank where they are subject to special supervisory oversight and certain regulatory restrictions and enjoy regulatory forbearance. The situation is also not helped by an environment of weak contract enforcement and poor accounting and auditing standards.

104. ***All in all, an effective long-term expansion of the financial system will require a more substantial change in the role of the government, from an operator and arbiter to a facilitator.*** The ongoing move to a privately-owned financial system is an important one, although international experience also advises caution (but not necessarily delay) in the privatization process: a failed privatization process can be worse than government ownership. Privatization is also not a panacea, as privatizing into a non-competitive environment will not necessarily bring intended benefits. ***Moving forward, de-politicization of entry of banks, market monitoring of banks, and reform of the exit process would be key.*** The licensing process has to be put on objective, non-political basis. Most importantly the government would need to move away from the implicit guarantee system to applying the existing limited explicit deposit insurance for depositors, while simultaneously relying more on market participants to monitor and discipline banks instead of micro-managing financial institutions. This redefinition of the government's role applies also to other segments of the financial system, such as capital markets and micro-finance, and needs to be seen as an essential element in the overall governance reform agenda.

105. ***Financial sector reforms in Bangladesh, in fact, may be viewed as being at the heart of the country's anti-corruption agenda⁵⁰ and can help catalyze broader governance reforms in the rest of the economy.*** A proper and transparent divestiture process of the NCBs and de-politicization of financial sector regulation and supervision can be a model for the redefinition of the government's role in the economy at large. An autonomous and accountable Bangladesh Bank can be a model for institutional reform in other government entities. Finally, reform of corporate governance in banks can pave the way for similar measures in the non-financial sector.

Addressing Labor Market Issues: Focus on Skills Shortages

106. ***Labor it is often said is Bangladesh's most precious resource.*** This precious resource, under the right conditions, has the potential to unleash a rapid transition toward prosperity, as the East Asian economies have shown without having the benefit of a natural resource bounty. A relative abundance of labor provides Bangladesh with a comparative advantage in production of labor-intensive goods. But global comparative advantage does not automatically translate into global competitiveness, which

⁵⁰ As the famous bank robber Willie Sutton is claimed to have said: "because that's where the money is", when asked why he robbed banks.

depends on a host of factors that affect productivity. As a corollary, measures to improve the productivity performance can be expected to stimulate labor-intensive manufacturing, as was the case for garments.

107. ***The overall productivity and competitiveness of an economy depends, among other things, upon the efficiency of the labor market and the quality of the labor force.*** Oppressive labor market regulations are often enough to put the brakes on growth even if other everything else falls into place. A skilled and well-trained labor force, on the other hand, makes for more productive workers and enables greater technology adaptation and spillovers. Taking it a step further, a well-developed knowledge economy infrastructure, including the availability of workers with the requisite skills and training, promotes innovation and adaptation of cutting-edge global technology.

108. ***On balance, labor laws and regulations in Bangladesh do not appear to be serious hindrances to the functioning of the labor market, although worker rights need better protection*** (see **Chapter 3** for details). Laws and rules are relatively light and, if anything, suffer from ineffective enforcement – certainly there are no signs of the draconian labor regulations seen in India. Firms retain considerable flexibility to hire and fire, which is also confirmed by the *Investment Climate Assessment* and *Doing Business* survey results. At the same time though, lack of organized union activity in the formal private sector, where only about one worker in twenty is covered, also has its down sides, especially since it arises from government restrictions that the International Labor Organization’s (ILO) Committee of Experts on the Application of Conventions and Recommendations has deemed excessively restrictive. Such limited union activity handicaps workers’ ability to engage in collective bargaining and protect their rights, and hinders the formation of an effective mechanism to resolve labor disputes. The impasse in 2006 over garment workers’ demand for higher wages highlights the problem. It is not clear though whether the resolution to this is government intervention and, if at all, in what shape and form.

109. ***A particular concern afflicting the labor market is acute skills shortages.*** Not only are the education levels among the workforce low, the education and vocational training system are not geared toward the market needs. On average, the employed labor force has only 4 years of schooling. It is a major loss to productivity when even this scarce human capital is not properly utilized: only about one-fourth of the unemployed hold a SSC, HSC or higher degree. Furthermore, just over 1 percent of the labor force has had technical training or vocational education, and even among those, the relevance of their skills seems questionable.⁵¹ Because of its poor quality, the vocational education and training (VET) system suffers from low capacity utilization and pass rates and weak demand for its graduates. Econometric results in **Chapter 3** find that workers training tends to improve demand for labor and also workers’ wages. A focus on market oriented vocational skills and good quality secondary and tertiary education, therefore, appears essential in addition to consolidating earlier gains on primary education.

110. Other key identifiable distortions in the labor market include:

- ***There is a clear segmentation of the public and private job markets*** – this is apparent in the considerable wage premium (over 30 percent) for public jobs, after taking into account worker characteristics such as education, skill, gender, etc. Analyses have shown the disparity to be arising from the lower-end (classes III and IV) public sector jobs. Not only does this lead to rationing of the high premium public sector jobs, it also distorts wage signals across the economy.
- ***Another segmentation is between urban and rural areas:*** Econometric analysis in **Chapter 3** shows that urban areas provide more employment opportunities (more hours of employment) and a significant wage premium. The barriers to rural-urban mobility of labor – that would also be productivity improving – likely have to do with the shanty living conditions in the cities,

⁵¹ For detailed discussion of skills and training shortages in Bangladesh and underlying policy and institutional constraints, see *The Bangladesh Vocational Education and Training System: An Assessment*, World Bank, 2006.

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especially for fresh migrants and the poor, and the higher cost of living. An urban agenda of the sort discussed in **Chapter 5** would work to improve this.

- **Female workers continue to face considerable barriers in the labor market.** Improvements notwithstanding, only a quarter of working-age females participate in the labor force and wages for female workers are significantly lower than for male workers with similar characteristics. This emanates mostly from the social barriers commonly seen in developing countries, but it is hard to imagine a path of rapid development, if three-quarters of females are not there to participate in and shape it. The solutions of more education and female empowerment are happening but could be speeded up.

111. **Advancement of a domestic knowledge economy that promotes innovation and helps adapt cutting edge global technologies and information is critical for productivity growth.** Not only is this the emerging consensus in the economics literature,⁵² evidence of the linkage can be traced even for Bangladesh. The far reaching effects of knowledge and technological dissemination are powerfully illustrated in the profound impact that adaptation and expanded use of the HYV variety of rice have had on rice productivity. Further, results in **Chapter 1** show that R&D activities improve productivity of Bangladeshi manufacturing firms, and that more advanced technologies tend to improve TFP performance, although only in the presence of absorptive capacity in the form of R&D activity.

112. **Given the importance of a more developed knowledge economy for productivity, its current low level is surely a critical constraint on productivity.** As seen in **Table 11**, Bangladesh lags her comparators on a number of indicators capturing the essence of the innovation system and information and communication technology. A more in-depth assessment of this area would be an important topic for future analytical work in Bangladesh.

Table 11: Cross-Country Comparisons of Technology and Knowledge Related Measures

Innovation System	Bangladesh	India	Pakistan	LIC Average
Science and Engineering Enrollment Ratio, 1998-2003 (as % of tertiary enrollment students)	13.08	20.08	..	19.25
Scientific and Technical Journal Articles Per Million Population, 2001	1.33	10.73	1.99	3.42
Royalty and License Fees Receipts (US\$ millions) Per Million Population, 2003	0.03	0.03	0.05	0.12
High-Technology Exports as % of Manufact Exports, 2003	0.03	4.75	1.15	2.88
Tertiary Enrollment (% gross), 2002	6.24	11.44	2.77	8.24
Information and Communication Technology				
Internet Users Per 10,000 people, 2004	20.04	323.7	127	236.35
ICT Expenditure as % of GDP 2003	2.7	3.7	7.3	5.84
International Telecommunications, Cost of Call to US (\$/3 min), 2003	2.1	3.2	..	4.24
Phones Per 1000 People, 2004 (mainlines + mobile phones)	34.4	84.4	62.9	83.35
Computers Per 1,000 Persons, 2004	11	12.1	4.2	15.91

Sources: UNESCO, WDI, ITU, and World Bank's KAM database.

⁵² E.g. Romer (1986, 1990), Grossman and Helpman (1991), and Coe and Helpman (1995)

IV. Concluding Remarks and Summary Policy Recommendations

113. Economic growth has proven to be the most potent force in the fight against poverty. Across the globe, examples abound of countries – most notably, the East Asian Tiger economies – that achieved high GDP growth over sustained periods and made visible dents in their poverty rates. Conversely, economies – including the majority of those in Sub-Saharan Africa – where growth failed to take off, saw minimal reductions and, in some cases, even increases in poverty. Bangladesh’s own experience bears out the significance of growth for poverty reduction: the poverty rate has fallen by close to 20 percentage points since the early 1990s, benefiting from a sharp acceleration in per-capita GDP growth. Recognizing this, the government’s PRS rightly seeks acceleration of GDP growth in order to meet its stated objective of reducing the poverty rate to under 25 percent by 2015.

114. Bangladesh has achieved good growth despite a record of weak governance – cross-country perception-based indicators usually place Bangladesh at the bottom of the league on corruption and other governance measures. Viewed by some observers as the “Bangladesh paradox”, this dichotomy actually reflects a mixture of weaknesses and strengths such as the positive resolve that produced a series of first generation macroeconomic and structural reforms which stimulated the good growth response. No doubt, the growth response to these reforms was reinforced by an early focus on human development, with Bangladesh’s world-class indigenous NGOs and community organizations playing a crucial role. However, successive Bangladeshi governments have also played an important part. For one, and in sharp contrast with their counterparts in majority of the developing world, they allowed sufficient space to the social organizations to evolve and flourish, with both sides often successfully partnering to deliver essential social services such as primary and secondary education, family planning, and primary healthcare. The state further contributed by broadly prioritizing the social sectors in budgetary allocations. It is also worth noting that despite the bitter confrontational nature of the politics, the major parties have not shown fundamental disagreements over the course of economic reforms, which has ensured sustainability of the reforms: reforms may be gradual in pace, but essentially without any major backtracking, no matter which political party is in power.

115. The growth challenge facing Bangladesh today is a positive one. It is not about jumpstarting growth, as in a number of other LICs, but rather about sustaining the good growth record, and, to the extent possible, accelerating it. The country can reasonably strive to become an MIC in a decade or sometime soon after; which would also ensure that the government’s poverty reduction goal – of reducing the poverty rate to 25 percent by 2015 – will be met. However, as argued in this report, fast-paced convergence to MIC status is unlikely without deepening of the industrial base and of economic integration with global markets, and unleashing of the growth potentials of the major urban centers. The reform agenda in support of these transitions, discussed at some length in the report, entails continuation of macroeconomic stability, with emphasis on strengthening tax mobilization and tackling energy sector losses, deepening of financial sector and external trade reforms, and rebalancing the policy focus toward hitherto neglected structural areas: economic governance, urban management, infrastructure (especially power sector, ports, and transportation), and labor skills. The latter would be especially important for more robust factor productivity growth, seen as being necessary for sustained long-term growth.

116. Specific policy recommendations are summarized in the matrix at the end of the Executive Summary. Most of the recommendations are underpinned by analytical work in the various chapters of this report and/or in other recent World Bank economic reports.