

BANGLADESH: STRATEGY FOR SUSTAINED GROWTH

EXECUTIVE SUMMARY

I. Introduction

1. If Bangladesh were a long-distance runner, its supporters would be applauding the speed and stamina that have brought it from the back of the pack to a place within sight of the leaders. At the same time, they might be wondering when Bangladesh will get its second wind and propel to the head of the field. That challenge is the subject of this report on Bangladesh's record of growth, its potential for more rapid growth, and the policies which can help the nation realize its potential.

2. *The premise of the report is that Bangladesh, given a second wind, could join the ranks of middle-income countries (MICs) within a decade (by 2016) or some time soon after.* It has the necessary assets: much-improved economic fundamentals; success in implementing many first-generation reforms; a young, rapidly growing labor force; and an established entrepreneurial culture. Despite the widely acknowledged and critical weaknesses in governance, Bangladesh also has an impressive record of achievement, especially in harnessing sound economic and social policies to pioneering social entrepreneurship.

3. To pick up pace in the development marathon, Bangladesh will need to deepen its industrial base, further its economic integration with global markets, and unleash the growth potentials of its major urban centers, Dhaka especially. Reform measures essential to these objectives include continuing macroeconomic stability, with emphasis on strengthening tax mobilization and tackling energy sector losses; deepening 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 – that are especially important for strengthening factor productivity. Progress in these and other areas can bring the kind of sustained, rapid growth which the government has put at the center of its poverty-reduction strategy.

II. Growth and Development: An Overview

4. Background: Desperately poor when it won its independence in 1971, over-populated, and reeling from overwhelming war damage to its institutional and physical capital, Bangladesh looked to become, as Henry Kissinger forecast, “an international basket case.” Thirty some years later, doubts and doubters have been disproven. Life expectancy in Bangladesh has risen from 50 to 64 years. Population growth rates of 3 percent a year have been halved. Unemployment that ran at 25-30 percent has shrunk to 4 percent. Child mortality rates of 240 per 1,000 births have been cut by 70 percent. Literacy has more than doubled, and Bangladesh is on track in meeting its Millennium Development Goal on gender parity, having already achieved the goal in primary and secondary schooling. These and other gains, aside from being the result of targeted government efforts and exemplary social entrepreneurship, owe a primary debt to income growth, the strongest engine for raising living standards and reducing poverty.

5. Thanks to that motor, *Bangladesh's real (inflation-adjusted) per-capita Gross Domestic Product (GDP) has more than doubled since 1975.* Until 1989, however, GDP growth per-capita ran at a positive but mediocre average yearly rate of 1.2 percent. Where reform episodes had been sporadic in that first, slow phase of growth, the second phase, the period since 1990, while deepening some earlier market deregulation and privatization measures, saw a new wave of reforms in the areas of macro stabilization, trade liberalization, and financial deregulation that produced per-capita GDP growth of 3.3 percent. Not

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only is that rate almost triple the previous average; it is also more than double that of the median country worldwide and three times that of the median low-income country (LIC).

6. ***The economic advances during the 1990s, when productive reforms coincided with political democratization, underpinned and benefited from progress on human development.*** A steep decline in the poverty rate – from an estimated 70 percent in 1971 to 58 percent in 1992 and to 40 percent in 2005 – is in large measure due to accelerated income growth in the last decade and a half. It and the advances in health, education, and population growth, however, also reflect the sound social investments made in Bangladesh's first two decades and innovative social programs, exemplified by world-renowned organizations such as the Grameen Bank – winner of the 2006 Nobel Peace prize along with its founder, Prof. Mohammad Yunus – and the Bangladesh Rural Advance Commission (BRAC).

7. ***Impressive as progress has been, Bangladesh still faces great challenges.*** Its per-capita GDP in 2005 in purchasing power parity (PPP) terms was just under US\$2,000 compared to India's US\$3,486, China's US\$6,572, and Malaysia's US\$10,843. Adult illiteracy persists at 50 percent, and both child malnutrition and maternal mortality rates are among the world's highest. Strong, sustained growth has produced remarkable advances. To move Bangladesh into the company of MICs, economic growth must become even stronger.

8. ***Deconstructing Growth: Among the unusual and significant features of Bangladesh's economic growth are its notable and improving stability and its broad-based nature.*** Although hit hard and often by cyclones and floods, Bangladesh, remarkably, is one of a handful of countries to have avoided even a single year of negative per-capita growth since 1990. Across districts and economic sectors – manufacturing, construction, and services – the pace of growth has largely mirrored that of GDP. Only agriculture, whose share of GDP has dropped from 30 percent in 1990 to 20 percent, has turned in an uneven performance: lackluster growth in the first half of the 1990s, a relatively strong rate of 5 percent in the last half, and a return in the 2000s to its long-term pattern of just under 3 percent.

9. ***Unsurprisingly, the country's urban centers, foremost among them Dhaka, have led growth.*** In terms of population, cities have grown at roughly three times the speed of overall population. Dhaka, with 12 million inhabitants, has seen an eight-fold increase in its population since 1970 and is estimated to be one the two fastest growing mega cities in the world. Lagos, Nigeria is the other. Not least because of the surge in readymade-garment (RMG) exports and the directly related housing construction boom, urbanization has been accompanied by job creation strong enough to accommodate over 10 million new entrants to the work force between 1996 and 2003.

10. ***Despite that success and although real wages increased across all economic sectors, the income of self-employed workers – almost half the workforce – declined between 2000 and 2003.*** With skill levels critically low, moreover, the 8 percent unemployment rate among 20-24 year olds is uncomfortably high. Joblessness runs even higher among workers with higher secondary or degree education. Economic expansion, in other words, has not yet lifted the generally poor quality of education and worker training.

11. ***Explaining Acceleration of Growth Since 1990:*** Three factors go into picking up the pace of growth. The two that have played the dominant role since 1990 are physical and human capital, the latter measured in terms of the quality of the workforce, its size and skill levels. The third factor, the efficiency of production technology, as measured by total factor productivity (TFP), also contributed by growing at a slightly faster pace than in the 1980s. The pick up in physical capital accumulation – a 6.6 percent average growth rate over 1991-2006, compared to 4 percent in the preceding decade – was led by private investment and financed principally by higher domestic savings. The acceleration in human capital

growth was largely on account of the strong increase in the size of the labor force. A demographic transition has brought a surge in youthful entrants to the labor force, where, more recently, women have sharply increased their presence.

12. ***The lesson of the 1990s is that broad-based, market-oriented reforms and macro stabilization measures propelled both private investment and technology infusion.*** The key reforms included:

- Stabilization efforts that tamed inflation, sharply reduced the current account deficit and significantly devalued the taka to bring it closer to its market rate;
- Trade and exchange liberalization, including tariff cuts, reduction of quantitative restrictions, exchange-rate unification and continued preferential arrangements for garment exporters;
- Relaxation of such restrictions as licensing requirements on private investment while opening telecommunications, power, and domestic aviation to the private sector;
- Initiation of financial sector reforms such as interest rate deregulation and abolishment of credit quotas – measures that eased private-sector access to credit; and
- Building on earlier agriculture-sector reforms, especially by continuing programs to spread small-scale irrigation, widen access to small diesel engines, and liberalize fertilizer markets.

13. ***These and other policy initiatives jump-started growth in the 1990s. Their continuation has sustained good growth since.*** Lasting fiscal and monetary prudence, bolder banking sector reforms and continued trade liberalization have combined with the fruits of Bangladesh's early emphasis on social development to support sustained high rates of economic growth.

14. ***With most of those first-generation reforms soundly in place, a new set of challenges require deeper and more complex policy innovations.*** Emerging structural issues – critically weak economic governance; overburdened port, power, and transportation facilities; urban congestion and mismanagement; acute skills shortages – along with lackluster agricultural performance and limited success in attracting FDI in manufacturing act as brakes on growth. Only by confronting these and other constraints can Bangladesh grow rapidly enough to achieve MIC status by 2016 or some time soon after.

III. Gathering Speed: Scenario for Rapid Growth

15. Bangladesh, with per-capita gross national income (GNI) of \$470 in 2005, could become a middle-income country – defined by the International Development Association (IDA) as one with per-capita gross national income (GNI) of \$875 – by 2023 if the average per-capita GDP growth holds at the 3.5 percent level of the last 10 years (assuming GNI growth equals GDP growth). 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 it raised per-capita growth to 6 percent, implying GDP growth at a challenging but not impossible 7.5 percent.*** There is international precedence for such performance – GDP growth in China has averaged over 9 percent since 1975, while Korea and Thailand each attained 8 percent growth for two decades before the 1997 East Asian crisis.

16. ***To make the rapid transition to MIC status, Bangladesh will need, above all, to employ its resources (labor and capital) much more productively.*** It will also need to increase the investment rate by more than 5 percentage points, relying on higher domestic savings. Three mutually reinforcing long-term transitions would be integral to achieving these outcomes: (i) a shift from agriculture to industry and services; (ii) deepening of integration with global markets; and (iii) emergence of diverse dynamic urban centers. The management of these transitions, in turn, will require better economic governance and business environment without which FDI will continue at low levels; continued macroeconomic stability;

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a commercially viable energy sector that supports the economy's vast energy needs; deeper and more efficient financial sector; and, a greater emphasis on the quality of education and labor skills.

17. Shifting the Sectoral Balance from Agriculture to Manufacturing and Services: This transition, already underway in Bangladesh, as in other developing countries, would be driven by a globally competitive private manufacturing sector and a productive, diversified, and commercially-oriented agriculture sector.

18. ***Improving the productivity of the manufacturing sector***, according to analysis of a survey of some 700 firms in 5 major manufacturing industries carried out for this report, will require particular attention to:

- (i) *Addressing burgeoning energy supply constraints* that undercut productivity. A 1 percent increase in number of power outages in a year reduces the productivity of the average firm by 10 percent.
- (ii) *Improving Bangladesh's attractiveness to FDI*. Quite low historically (less than 0.5 percent of GDP for the most part), FDI has picked up recently in extractive industries (coal and gas), telecommunications, and energy production, but not in manufacturing, where FDI brings significant productivity gains – firms with any level of foreign ownership are found to be 10 percent more productive on average than firms that are wholly domestically owned.
- (iii) *Phasing out the high anti-export bias*. By further lowering and streamlining tariffs, improving trade facilitation and tackling other behind-the-border barriers to export competitiveness, manufacturing firms stand to gain. The results show that firms that export majority of their output are about 10 percent more productive on average. Results also show that the benefit of being an exporter improves over time, as valuable experience is gained in export markets.
- (iv) *Building human capital*. Higher-education levels and experience of managers benefit productivity, a survey finding that highlights the importance of improving access to quality tertiary education, while consolidating earlier gains at the primary and secondary levels.
- (v) *Responding to the lagging knowledge economy*. New measures are needed to encourage the application of greater innovation and the adoption of more advanced technologies. Survey results show both having a positive impact on productivity of Bangladeshi manufacturing firms.
- (vi) *Strengthening law and order*. Private investors often cite protection payments, for example, as harmful to firm productivity, and the analytical results support that assessment.

19. ***A drive to boost industrial productivity needs to be matched by initiatives to do the same for agriculture***. Targets for initial action are the underperforming (but high potential) fishing sub-sector and rice production, where only half the cultivated area uses the HYV rice variety in the *aman* season.

20. ***Ultimately, raising real agricultural incomes will require diversification into higher-valued crops and increased output of the livestock and fishing sub-sectors***. Bangladesh needs to especially capitalize on its long-term competitive advantage in inland aquaculture by overcoming shrimp farmers' past difficulties in meeting importers' sanitary and phyto-sanitary quality requirements and assisting them in adopting semi-intensive and intensive methods of shrimp farming. To raise 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.

21. ***The government's important but limited role in promoting agricultural diversification includes a significant expansion in agricultural research and extension efforts***. Additionally, institutional reforms to increase the stability of funding and strengthen research management are crucial as is sustained public investment in rural marketing infrastructure (particularly roads, bridges and telecommunications).

22. **Liberalizing Trade and Spurring Export Competitiveness:** The considerable, if uneven, progress Bangladesh has made since 1991 has brought tariffs down, eliminated trade-related quantitative restrictions and import licenses, unified exchange rates, and instituted a floating exchange-rate policy. ***Largely driven by the success of the RMG sector, the resulting increase in export orientation – with merchandise exports to GDP ratio increasing from 6 percent in 1990 to 17 percent in 2006 – has very likely contributed to the acceleration of GDP growth over the same period.***

23. ***Nonetheless, substantial further reforms are needed to deepen trade liberalization and boost export competitiveness.*** 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 so many of the gains that average protection levels are the highest in the region and among the highest in the world. Furthermore, trade facilitation procedures are cumbersome and infrastructure bottlenecks to exporting are severe. The resulting anti-export bias has leveled off at a high level, which works against the emergence of new exports activities. Unsurprisingly, Bangladesh's export orientation, albeit much higher than in 1990, compares unfavorably with that of other Asian economies.

24. ***Moreover, RMG exports account for about 75 percent of merchandise exports, reflecting the much lower anti-export bias institutionalized in enclave arrangements and a duty drawback system.*** They reduce but do not entirely offset the bias, and the Duty Exemption and Drawback Office (DEDO) for those who are not 100 percent exporters is so inefficient that it takes a minimum of six months for drawbacks to be paid. Half the applications remain pending even after two years.

25. ***To diversify its trade base and improve export competitiveness, Bangladesh needs a well-thought out sequence of trade liberalization measures.*** Key elements of such strategy would include:

- A continued emphasis on unilateral trade liberalization matched by caution in pursuing the current fashion of regional and bilateral trade agreements.
- Establishment of a low and uniform tariff rate sooner rather than later, following interim reform steps that further simplify the import tax regime and reduce the dispersion and average level of nominal (and thus effective) protection. India's recent introduction of a pre-announced medium- and long-term schedule of tariff reductions offers a useful model.
- 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.
- Levying VAT on both domestic production and imports of the same product, thus eliminating its protectionist impact while improving fiscal revenues.
- Ensuring full and immediate implementation of the new duty drawback and bonded warehouse scheme and quick payment of rebates under the duty drawback system.

26. ***Making the Most of Rapid Urbanization: Careful management is needed to balance the major opportunities and equally large challenges for Dhaka-based economic activity.*** Dhaka's economic dynamism makes it a magnet for migrants, while a combination of national institutional arrangements, such as centralization of political and administrative power in the city, and public expenditure allocation decisions – as in Dhaka-centric investment in transport – augments its special appeal. At the same time, the city's already stretched service provision and infrastructure are under mounting stress and vastly unresponsive. Real estate prices skyrocket as traffic congestion worsens and infrastructure decays.

27. ***Weak governance is the fundamental underlying cause of poor urban management.*** Because Bangladesh is among the most centralized countries in the world, local autonomy suffers, major capacity and resource constraints build up, and city management structures are loosely defined and fragmented. Denied buoyant tax handles, cities depend for own-source revenue on the property tax and associated fees for water, lighting and conservancy. Because of administrative and technical shortfalls, these taxes prove inadequate to cover most spending requirements, forcing city governments to rely on central government

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transfers that often account for half of their revenues. Such grants typically come tied to pre-specified projects. Adding little to local capacity or autonomy, they are also proving increasingly unreliable.

28. ***The urban management challenge, therefore, is twofold: the first relates to improving access to and the quality of basic services and infrastructure in Dhaka and other major metropolitan areas, and the second to improving 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 with urban management functions, and between service providers and citizens. This devolution has to be carefully sequenced so that improvement in city governments' ability to perform is matched by enhancing their own revenue sources and building their technical and administrative capacity. Local governments will first need to increase revenues from existing tax bases, training appraisers and computerizing billing to strengthen collection machinery at the same time. Crucially, they will need to build stronger links between the taxes they exact and the quality of public services they deliver.

29. ***Bangladesh needs a well-reasoned and carefully considered national strategy to bring more balance and energy to urban development across the country.*** Such a strategy would seek to remove policy biases that work against the emergence of smaller cities, misdirecting public expenditure allocations and public investments in transport networks. It should also create incentive structures and competitive pressures among cities such that public and private investment and labor flows respond to objective measures of city management. Investments in inter-regional transport and communications are likely to make cities more attractive to investment and reduce excessive concentration in the largest ones. To be really effective, improvements in inter-regional transportation need to be accompanied by improvements in local infrastructure and service provision, which will require significant additional resources. Toward this, recently initiated efforts such as the government-owned Municipal Development Funds (MDF) appear to be steps in the right direction.

IV. Enabling the Key Transitions

30. ***The three key transitions discussed above are long-term endeavors.*** To ensure their success Bangladesh will need to strengthen economic governance, maintain macroeconomic stability, improve infrastructure, strengthen the financial sector, and narrow the acute skill gaps.

31. ***Strengthening Governance is Essential: The first steps need to tackle the governance-related problems*** that foster regulatory uncertainty, corruption, crime and disorder, and distrust of the judiciary. Despite laudable progress in maintaining macroeconomic discipline to foster a vibrant private sector, in making wise public expenditure choices, and in forging partnerships with NGOs and the private sector, Bangladesh is widely perceived by potential investors – foreign and domestic – as an expensive and risky place to do business. Weak governance, in short, undermines prospects for the accelerated growth Bangladesh seeks.

32. ***The toughest challenges lie in the core governance areas – the confrontational nature of politics, flawed revenue administration and financial accountability, and distrust of supposed rule-of-law guarantors.*** The fractiousness of Bangladeshi politics contributes to political uncertainty and heightens perceptions of economic risks among investors, especially foreigners. The low revenue effort that stems from weak administration creates a chain of disincentives to good governance, from low salaries for civil servants to inadequate operations and maintenance expenditures. Flawed procurement processes, poor financial controls and inadequate external checks and audits reflect weaknesses in financial accountability. The quality of civil service and most judicial and law enforcement institutions – courts, police and prosecutors – are consistently rated poorly in citizen surveys. While domestic entrepreneurs learn how to survive the system, foreign investors unfamiliar with Bangladesh and armed with many other investment choices see such failures as serious deterrents.

33. ***Only strong political leadership supported by a constituency that demands change can advance reforms that cut across a wide range of institutions and threaten powerful vested interests.*** It will be essential to develop a strategic, sequenced approach so that successes in a few key areas generate momentum and demand for even broader reform. Summoning the necessary political will is a major challenge, but Bangladesh has proved equal to similar tests in the past.
34. ***Continuing Sound Macroeconomic Management: One such demanding responsibility that Bangladesh has generally met with strength is macroeconomic management.*** At least since 1990, monetary policy, for example, has broadly supported growth. By keeping tight control on reserve money growth and permitting more flexible interest rates, monetary managers have held inflation rates to single digits. ***The record on fiscal management is more mixed.*** Higher public spending and increased reliance on costlier domestic commercial borrowing in the FY99-02 period began to escalate the government's interest obligations. Fiscal prudence was soon restored, however, by lowering the deficits to under 4 percent of GDP and limiting commercial borrowing to under 2 percent of GDP. Public sector debt has since been contained below 50 percent of GDP, but poor tax collection – among the weakest in the world – could imperil the higher allocations for essential social sector and infrastructure development.
35. ***Large losses incurred by energy-sector state-owned enterprises (SOEs) – due to underpricing of energy products in domestic markets – and the resulting impact on the NCBs that are directed to finance these losses pose an emerging fiscal risk.*** SOE losses – 80 percent of them by the Bangladesh Petroleum Corporation (BPC) – for FY06 are estimated to have increased to about Tk 45 billion (US\$670 million), or 1.1 percent of GDP, almost 8 times their level in FY04. The sizable level of outstanding SOE liabilities, which are contingent liabilities for the budget, together with the weak revenue mobilization, make the risk of debt distress “moderate”. To keep public debt in line, authorities need to step up efforts to contain SOE losses, mainly through efficient and cost-reflective pricing of energy products, while steadily improving tax mobilization.
36. ***Overall fiscal and monetary prudence has helped contain excess demand, particularly since 2002, and kept the assessed risk of external public debt distress “low.”*** Disciplined macroeconomic management together with stronger growth in exports and remittances and a pick-up in concessional and other long-term capital inflows over the last 4 years have restored external balances that were precarious at the end of 2001. 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) compared with US\$1 billion in FY02.
37. ***Overcoming Infrastructure Constraints: Inadequate energy supply, congested ports and underdeveloped transport networks connecting the ports with the hinterland impose a major (and growing) drag on economic performance.*** Firm-level surveys consistently cite access to power among the top obstacles to investment. Trade facilitation, critical for export competitiveness, cannot proceed strongly as long as Chittagong port, which handles nearly 85 percent of the country's merchandise trade, is plagued by labor problems, poor management, and lack of equipment.
38. ***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. Only about 35 percent of the population has access to network power, and outages during periods of peak demand are scoring historic highs and growing fast. The average firm interviewed experienced power losses 2 of every 3 days in a year, and most reported sharing or owning a generator, raising their electricity costs by half.
39. ***A long history of political interference has produced badly-run government power enterprises and undermined the 1990s initiative to encourage private power generation.*** Legitimate private investors are reported to have been put off by the interference of vested interests in technical evaluations

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and by rumors about particular parties having been chosen for political reasons. Part of the government's response to power shortages – increasing the supply of natural gas at highly subsidized rates – risks depleting gas reserves and bringing on major gas shortages as early as the next decade. To deflect shortage-induced political discontent, the authorities have been maintaining artificially low tariffs, a costly and unsustainable expedient. The Bangladesh Power Development Board (BPDB) gives bulk buyers annual subsidies in excess of US\$100 million.

40. ***Unevenly and slowly and against the resistance of various vested interests, the government is beginning to address some power-sector shortcomings.*** Among the important implementation measures undertaken are establishing the Bangladesh Energy Regulatory Commission (BERC) in 2004 and restructuring the industry so that the BPDB's share of generation drops to 60 percent from 86 percent in FY99 while various autonomous companies take over all of BPDB's transmission assets, 9,000 km of its rural distribution lines, and parts of the key Dhaka market.

41. ***With an estimated US\$1.5 billion in new investment needed annually to build utility-scale plants that can catch up with demand, Bangladesh needs to address the critical issue of efficient pricing as a priority.*** Since public resources are in no position to finance such projects, large-scale private investment in gas exploration and production and in gas-fired power generation is required. To attract it, Bangladesh must immediately raise power and gas prices to cover, at a minimum, all operating costs and adopt a credible timeline to increase power prices to full cost recovery levels and gas prices to economic value. Well-targeted subsidies could be used to protect the poor from the tariff increases. Over the longer term, addressing the major governance problems, especially the lack of transparency in the procurement process for new power plants, in the sector is a must.

42. ***Bangladesh's drive toward export competitiveness is hostage to major bottlenecks*** – from customs procedures in the ports to inefficient transport networks and even the administration of food safety and quality standards. The Chittagong port, which handles about 85 percent of the country's merchandise trade flow, ranks among the world's least efficient container ports. Average container dwell time there is reported at 18 days compared to 10-12 days for other ports in the region, and container handling costs are estimated to be four times higher than in Colombo and twice as high as in Bangkok. No doubt, the engagement of private berth operators, crackdown on union activity among dockworkers, and restructuring of the labor force since January 2007 has improved many of the performance measures. According to officials, efficiency at the port has improved by about 30 percent because of these measures. These are welcome improvements whose sustainability needs to be ensured.

43. ***The hold-ups at the Chittagong port can be traced largely to complex clearance and customs procedures and deficient physical and logistical capacity.*** The documentation needed for 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 prospect of such an inspection is sufficient to elicit informal payments. 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. Resistance to change comes from workers who garner substantial income from speed payments and from the absence of incentives – or competition from private service providers – for current employees to improve their performance.

44. ***Introducing private service providers could serve as a catalyst for the requisite policy and institutional reforms at Chittagong port.*** Handing over management of the port to an experienced private contractor could open the way for modernizing 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 shipping lines, all very difficult measures under the current public-sector management.

45. Additionally, service providers whose defaulting actions reduce the port's efficiency should face elevated penalties stringently enforced; customs clearance processes should be modernized for efficiency; the number of customs bonded facilities, including road-based and inland container depots (ICDs), in the Dhaka region should be increased; and interconnection transport infrastructure should be modernized, diversified to exploit inland waterways, and perhaps to separate, as India has, container-unit train services placed under commercial management from the less profitable and time-sensitive railway services.

46. Creating a Deeper and More Efficient Financial Sector: ***Bold banking reforms adopted since 2001 have deemphasized the role of the NCBs, strengthened competitive pressures, loosened government control, and tightened prudential regulations and regulatory quality.*** Although political interference, resistance from labor unions, and judicial roadblocks have slowed restructuring and divestiture, measures to bring the capital adequacy ratio up to international norms, to tighten loan classification, to issue risk guidelines, and to improve banks' corporate governance have already brought positive results. In response, private banks have dramatically increased their market share to over 50 percent of banking sector assets and turned around their operational and financial performances.

47. ***Nonetheless, major challenges remain.*** After 20 years of systemic distress, the sector is only beginning to emerge from crisis and has a long road ahead to full recovery. Despite improvements, non-performing loan (NPL) ratios remain precariously high in the NCBs and development banks, while provisioning by the NCBs and the problem private banks has typically fallen well short of requirement. The non-bank segment of the financial system, with the important exception of microfinance, is grossly underdeveloped.

48. ***The reform process initiated since 2001 has moved move away from heavy intervention in the banking sector to more emphasis on bringing market forces into play.*** Bangladesh Bank, despite political interference in the bank-licensing process, has made some important progress toward market-based supervision. In addition to setting higher disclosure and auditing requirements for financial institutions, it maintains a separate list of approved auditors for banks, requires them to go public and – along with non-bank financial institutions (NBFIs) – to publish their annual financial statements in newspapers. Still, thanks to undue political influence, troubled banks enjoy such protection that no domestic bank has been allowed to fail.

49. ***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 – along with the redefinition of government's role in capital markets and micro-finance – is an important one, although international experience also advises caution (but not necessarily delay) in the privatization process. To move forward, Bangladesh should de-politicize the entry of banks by subjecting licensing to objective, non-political standards, institute market monitoring of banks, and reform the exit process. Most importantly, the government needs to move away from implicit guarantees against failure to the use of existing, limited, but explicit deposit insurance, while simultaneously relying more on market participants to monitor and discipline banks.

50. Addressing Skills Shortages in the Labor Market: Under the right conditions, labor – often viewed as Bangladesh's most precious resource – could power the kind of rapid transition toward prosperity that resource-poor East Asian economies have made. Its relative abundance of labor endows Bangladesh with a comparative advantage in production of labor-intensive goods, but that advantage only translates into global competitiveness when it rests on a foundation of high productivity. The efficiency of the labor market and the quality of the labor force are important components of the overall productivity

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and competitiveness. Oppressive labor market regulations are often enough to put the brakes on growth even if everything else falls into place.

51. ***On balance, Bangladesh's ineffectively enforced labor laws and regulations are less of a hindrance to the functioning of the labor market than are deficiencies in protecting worker rights.*** Overall, labor laws and rules are relatively light, and firms retain considerable flexibility to hire and fire. At the same time though, lack of organized union activity in the formal private sector, where only about one worker in twenty is covered, has its down sides, especially since it arises from government curbs that International Labor Organization (ILO) experts have decried for being 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.

52. ***A focus on market-oriented vocational skills and good quality secondary and tertiary education are essential not just to consolidate earlier gains in primary education but to boost productivity and, with it, global competitiveness.*** Skilled and well-trained workers, now in acutely short supply in Bangladesh, are more productive workers and better able to adapt superior greater technology. Not only are the education levels among the workforce low – only four years of schooling on average – but the education and vocational training systems are also not geared toward market needs. Productivity suffers heavily when even this scarce human capital is not properly utilized, as highlighted by data showing that almost one-fourth of the unemployed – 30 percent in the case of women – hold an 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. The low quality of the vocational education and training (VET) system is reflected by its low capacity utilization and pass rates and further by the weak demand for its graduates.

V. Conclusion: Summary policy recommendations

53. ***Economic growth has proven to be the most potent force in the fight against poverty.*** Mirroring experience across the globe, Bangladesh's own record 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.

54. ***Despite serious weaknesses in governance, corruption most notably, Bangladesh has achieved good growth since 1990.*** What some observers call the “Bangladesh paradox” actually reflects a mixture of weaknesses and strengths such as the positive resolve that produced a series of first-generation macroeconomic and structural reforms. They, in turn, stimulated the positive growth response. Successive Bangladeshi governments have maintained the initial momentum, allowing – unlike their counterparts in most of the developing world – sufficient space for 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. Moreover, the major political parties, despite their acrimonious relationship, have not shown fundamental disagreements over the course of economic reforms. The pace of the reforms may be gradual, but their sustainability is not in doubt.

Bangladesh's challenge is not to jumpstart growth but to maintain and, to the extent possible, accelerate it. The country can reasonably strive to become an MIC in a decade or sometime soon after; thereby ensuring that the government will meet its goal of reducing the poverty rate to 25 percent by 2015. To win that next stage of the development marathon, Bangladesh will need to tackle a new set of challenges with deeper political commitment. The measures that are needed – detailed in the report and summarized below – are not simple steps, nor easy ones. Bangladesh, though, has already shown an impressive capacity to implement policy innovations. There is every reason to believe it can continue that performance

Specific Policy Choices for Making the Transition to MIC Status

Objective	Recommended Policy Measure
<i>Reverse the declining productivity growth trends in agriculture</i>	<p><i>Expand the use of the HYV variety of rice to the aman crop.</i></p> <p><i>Place special emphasis on addressing the emerging quality and productivity concerns in the shrimp industry</i>, especially inland aquaculture, where Bangladesh has long-term comparative advantage. In addition to research, information, and extension support the government can assist by taking measures to improve post-harvest handling and marketing and distribution of better quality fish seeds.</p> <p><i>Expand agricultural research and extension efforts in rice as well as high valued crops, livestock and fish.</i> Implement phased increases in expenditure on agricultural research. Establish an endowment Trust Fund and carry out necessary institutional reforms to increase stability of funding and to strengthen research management.</p> <p><i>Improve marketing infrastructure</i> (particularly roads, bridges and telecommunications) to promote growth of non-crop agriculture, including the poultry and fish sub-sectors, as well as the rural non-farm sector.</p> <p><i>Create a more favorable environment for private investment</i>, especially in warehouses and cold storage facilities, to reduce storage losses and price risk for highly perishable fruits and vegetables. Provide a growth-friendly institutional environment, by setting and enforcing transparent and consistent “rules of the game” for agro-food system and agro-enterprise development.</p>
<i>Strengthen export competitiveness by phased and transparent liberalization of the trade regime</i>	<p><i>Place continued emphasis on unilateral trade liberalization.</i></p> <ul style="list-style-type: none"> • Establish establishment of a low and uniform tariff rate (by FY12) as the key ultimate objective, to be preceded by the following measures: • Unify all para-tariffs and merge these with the CDs (by FY09) • Reduce the maximum tariff rate to 15% by FY10. <i>This would, of course, require parallel progress in expanding the base of VAT and direct taxes, while the tax administration is further strengthened.</i> • Eliminate all end-user tariff exemptions/concessional tariffs (FY09 budget) • Discontinue protective use of VAT (FY09 budget) • Lobby strongly in the USA for duty-free entry of RMG exports, already extended to LDCs in Africa under the Africa Growth & Opportunity Act (AGOA). <p><i>Improve efficiency of the duty drawback system</i>, to ensure quick payment of rebates.</p> <p><i>Work with regional partners to ensure full use of ‘regional cumulation’ allowed by the EU</i> towards meeting the latter’s ‘rules of origin’ conditions. In particular, ensure that in any regional PTA/FTA “rules of origin” are liberal, simple, transparent and uniform.</p>

Bangladesh: Strategy for Sustained Growth

Address skills constraints

Improve labor skills to make them more relevant to market needs.

- Consolidate gains in primary and secondary education with emphasis on improving the overall quality and removing urban-rural disparity in quality
- Improve the quality and market relevance of the vocational education and training (VET) system (see the *Bangladesh Vocational Education and Training System: An Assessment*, World Bank 2006, for an elaboration of the following)
 - Develop a policy framework, in coordination with the private sector, clarifying roles & responsibilities of various VET agencies (immediate).
 - Make available information on training programs and facilitate regular and independent impact evaluations of training programs (immediate).
 - To improve overseas employability of workers: allow accreditation from internationally recognized agencies; strengthen linkages between VET system and overseas employment agency (immediate)
 - Allow greater autonomy for VET institutions (immediate)
 - Set-up an autonomous Board of VET (3-5 years)
 - Develop a Qualifications Framework to establish uniform course assessment requirements and course entry prerequisites (3-5 years)
 - Support demand-driven and employer-financed initiatives such as the Chittagong Skills Development Center (CSDC) (3-5 years)

Address weaknesses in Bangladesh's core governance areas that matter directly for future sustained growth

Strengthen institutional arrangements for public expenditure, financial management, and procurement, using the agreed PFM indicators as benchmarks. Specifically:

- Implement the Action Plan to strengthen public financial management
- Deepen and mainstream the MTBF being piloted in 14 ministries
- Complete computerization of public accounting system
- Ensure timely completion of the PAC strengthening project.
- Implement the Procurement Law and ensure compliance with its rules

Strengthen revenue mobilization by deepening the tax administration modernization program. Specific actions would include:

- Develop new functional areas in NBR, including taxpayer services, audit, ICT
- Reorient NBR composition along functional lines, starting with its Board
- Improve HR policies and procedures to ensure more professional and competitive recruitment and promotion, training, compensation, and career development
- Undertake periodic taxpayer surveys to measure progress.

- Establish unique taxpayer identification numbers for both Income Tax and VAT
- Undertake necessary legislative reforms to correct major tax policy distortions

Improve quality and efficiency of the civil service. Strengthen the personnel management system, ensuring a more merit and performance based system of promotions, a strategic use of postings and transfers, a revised compensation package, particularly for the senior cadres of the civil service who are relatively poorly paid.

Address the pricing and governance issues in power generation and gas production, needed to attract private investment into the sector

Address the critical issue of pricing of power and gas:

- Immediate increases in power and gas prices to at least cover all operating costs
- Reinstate the pricing formulae that ensure automatic price adjustments, and adopt a credible timeline to increase power prices to full cost recovery and gas prices to its economic value
- Hardwire budget support to cover utilities' losses in the transition period

Address the governance issues afflicting the power sector

- In generation procurement, appoint internationally reputed transaction advisors
- Empower utility managers to run fully commercial operations. Put law and order resources behind managers to enforce payments from delinquent customers

Implement other complementary reforms:

- Corporatize the power sector entities
- Fully operationalize the Energy Regulatory Commission
- Implement the recently adopted financial recovery and restructuring plan

Improve the functioning of the Chittagong port and carry out complementary measures to strengthen trade facilitation

Implement necessary policy and institutional reforms at Chittagong port, necessary to attract much needed investment in the port's physical capacity

- Handover management of port to experienced private contractor
- Modernize the container terminal (especially computerization and restructuring of workforce) to take full advantage of the SSGs and RTGs
- Increase penalties on service providers for creating congestion

Implement complementary trade facilitation measures

- Increase customs bonded facilities, including road-based and ICDs, in the Dhaka region
- Improve inter-connection transport infrastructure, especially by modernizing the Bangladesh Railways as per current agreement with development partners

Bangladesh: Strategy for Sustained Growth

Deepen and make more efficient the financial system

Successfully complete the ongoing restructuring of the NCBs, with the eventual objective of divestment over the medium term (3 years)

- Set objective performance benchmarks in the managers' contracts, linking performance with future pay scale and continued employment (immediate)
- Introduce government-funded VRS to rationalize NCB staffing sizes (immediate)
- Ensure divestment of each NCB to a strategic buyer, particularly by:
 - reducing government share in divested NCBs to virtually nil;
 - resolving SOE bad debt ahead of the divestment

With respect to private sector banks, move away from system of implicit guarantee to applying the existing limited explicit deposit insurance for depositors, while simultaneously relying more on market participants to monitor and discipline banks. The following concrete steps can be considered:

- Develop objective criteria for bank licensing, to de-politicize the process
- Subject all banks to special audits to assess their long-term viability
- Resolve non-viable banks, preferably through market-based solutions such as M&A or purchase and assumption
- Review and reform as necessary the legal framework for bank failure resolution

Strengthen regulatory & supervisory frameworks for capital & insurance markets

- Strengthen information disclosure, by ensuring timely and accurate filing of annual audited financial statements by incorporated companies.
- Review and reform as necessary legal impediments to the SEC's ability to carry out its oversight role, while weaning it away from excessive intervention in certain areas – prescribing dividend payouts, interfering in selection of CEOs etc

Maintain the past record of macroeconomic stability and sustainability

To ensure continued fiscal sustainability:

- Reinstate the pricing formulae for energy products. Align energy prices to full cost recovery levels, and earmark budgetary resources to cover energy SOE losses in the interim
- Improve tax collection (reform measures are noted above)
- Strengthen debt management capacity, especially the recording of contingent liabilities

Ensure continued monetary prudence with more flexible use of interest rates.

Continue reliance on market-based mechanisms in foreign exchange markets