Volume 1
Number 1 & 2
Year 1999
ISSN 1529-0905

Journal of BANGLADESH STUDIES

BDI
Bangladesh Development Initiative

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THE EMERGENCE OF MARKET-ORIENTED REFORMS IN BANGLADESH: A CRITICAL APPRAISAL

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Abstract

This paper critically examines the emergence of market reforms since the mid 1970s. These reforms received increased attention in the 1990s. Forty percent of the country's manufacturing assets and four major commercial banks, which are financially insolvent, are yet to be denationalized. The size of the government has increased. Foreign investment which has increased very recently, is being encouraged to develop the infrastructure, telecommunications, gas and power sectors. Lack of transparency, accountability, government's determination, and investors' enthusiasm, as well as political unrest and the opposition from labor unions are acting as impediments to market-based reforms in Bangladesh.

Introduction

When most of the developing countries became liberated from colonial rule in the middle part of this century, it was a norm to adopt 'socialism' as the most viable economic system. The conventional wisdom at the time was that socialism was the only mechanism through which *economic justice* could be delivered to the vast majority of the people. Bangladesh was no exception when it won independence in 1971.

However, the belief about the merits of socialism was short-lived. There was a divergence between the principles and practices of socialism from the outset. Although the state became the owner of the major assets and resources of the economy, mismanagement, pilferage and corruption became rampant. Output and productivity were down, and losses began to soar. Socialism as promised or envisioned, failed to benefit the average person. In short, the common masses came to realize that under (the disguise of) socialism, they were worse off.

With a change in the government, the weaknesses of socialism were confronted and reforms began to be introduced as early as 1976 with the denationalization of state-owned enterprises (SOEs). With the fall of the Berlin Wall in 1989, and as capitalism triumphed over the globe, market reforms in Bangladesh began to receive increased attention.

The experiences with the socialist experiment and the emergence of markets are discussed next. A survey of the literature is presented in section three. Section four presents the rationale and the march towards market reforms in Bangladesh. Section four concludes the paper.

The Socialist Experiment and the Emergence of Markets

Centralized planning failed in allocating resources efficiently. The prices of goods and services were set by the government. As expected, these prices (and costs) did not reflect actual market conditions. The state- owned enterprises (SOEs) were also poorly managed--often by incompetent, inexperienced, and unqualified personnel. Unrealistic pricing and output targets were set without regard to market realities. As a result, the SOEs produced high priced, inferior products.

Due to a lack of incentives and the presence of strong labor unions, productivity of labor was less than wage compensation. Furthermore, because of cost overruns and declining revenues, state enterprises were incurring huge losses. The government was compelled to subsidize these losses.

Increased government intervention induced a higher level of corruption. which flourished for several reasons: 1) The public sector wages were so low that a family could not survive on a typical official's salary. Since wages were not performance-based, public officials' incomes were not linked to what they produced. As such, a public official's only recourse was to create additional red tape and delays to induce bribery. 2) The distortions in the policy and regulatory regime created the atmosphere for corruption and the institutions of restraint were weak. 3) Kickbacks and bribery were pervasive and involved officials from top to bottom in the government. The public officials had wide discretion and little accountability and there was lack of transparency and enforcement of laws. The presence of corruption violated public trust and inhibited economic growth. When bribery became unpredictable, it made it difficult to estimate the costs. In order words, price failed to serve as a signaling mechanism.

The failure of the state in managing the economy efficiently paved the way for the emergence of markets.

Survey of Literature

Although the issue of market-oriented reforms in Bangladesh has drawn increased attention in the 1990s, the number of academic papers written on this topic is very limited.

Akram (1999) provided a critical overview of the privatization policy in Bangladesh. The government's stated current privatization policy is to augment the role of private sector in promoting economic development. In the paper, he presented the various methods of privatization by the government like international tendering, auctioning, negotiated sales, and employees stock option program (ESOP) of SOEs. The terms and conditions of sale and bank guarantees as stipulated by the government were spelled out. The criteria utilized in market valuation and tendering was laid out. It also provided the speed and time framework of privatization of SOEs as envisioned by the government.

He pointed out that the present policies could be improved if, for example, the methods, terms, and conditions of sale of the SOEs are modified, well defined and upheld. He cautioned that ESOPs as a method to dispose SOEs may be motivated by political expediency. If the goal of using ESOPs is to encourage employees to become owners, then the authorities should earmark a limited number of shares for purchase by the employees at a discount.

In his paper, he also argued that discipline in the financial sector is a necessary condition for the success of the privatization program. The capital market in Bangladesh remains underdeveloped. There is lack of complete and perfect knowledge to investors. The financial data and statements of listed companies are unreliable and inaccurate; and the methods used for preparing financial statements lack credibility because generally accepted accounting principles are not applied.

The article stressed that the objective of the privatization policy should be to increase economic growth through improved management of resources. The policy should ensure that owners of divested units benefit from risk-taking. Under no circumstances, should the potential buyers be led to believe that these units are being doled out by the government. In essence, the privatization policy should not be regarded as an end itself, but as a mechanism for improving economic efficiency and boosting economic growth.

Ahmad (1998) argued against the denationalization of SOEs in Bangladesh. He pointed out that SOEs were set up in newly independent developing countries, where local entrepreneurship was lacking. As was the norm, these developing countries embarked upon an import-substitution industrial policy. Many of the import-substituting SOEs enjoyed protection both from foreign and domestic competition. SOEs' inefficiencies resulted from these two sources. He believes that in a liberalized milieu, these inefficiencies will disappear. Referring to the divested units in Bangladesh, he pointed out that some owners of these divested units used them as speculative investment. These owners lacked the commitment in managing them as profitable units. Wherever possible, the assets of divested units were later liquidated.

Based on the above analysis, he suggested that losses of the SOEs could be checked by promoting a more competitive environment in the economy. Mere transfer of ownership of SOEs to the private sector will not turn losses into profits.

The World Bank (1995) examined the reforms of SOEs and financial sectors in Bangladesh. The study stated that the SOEs represented the biggest public failure in Bangladesh. Their losses were financed out of the public exchequer, thus weakening the financial system. The slow progress in divestment was not a cure for the deep-seated woes of the SOEs. Through 1993, the privatization efforts were slow. The study also provided the strategy for reforming and improving the efficiencies of SOEs. The claim that 500 odd small and medium industries that were divested were later closed was rebutted by this study by pointing out that in a competitive market, entry and exit are not uncommon. When businesses were shut down, it should not be seen as a sign of weakness. Instead, this transition may represent a shift of resources to more efficient uses of the physical assets.

The report also pointed out that Bangladesh has a small and underdeveloped financial sector. The major barrier to financial sector development has been the government's ownership of the dominant financial institutions and its role in allocating credit. The study concluded that SOEs act as a strong impediment to faster, private-sector led growth in Bangladesh. However, international experience clearly suggested that privatization, when done right, worked well.

Humphrey (1990) suggested that privatization in Bangladesh was a mixed bag. The emergence of the private sector did not bring prosperity to a backward, subsistence economy. The success or failure of the privatization program was contingent more upon macro rather than micro factors. He recommended that the primary focus should be on the privatization of the overall economy instead of confining it to the sectoral level. He found that privatized jute and textiles firms outperformed their counterparts consistently and concluded that privatization alone cannot promote economic prosperity; it must be backed by economic and fiscal policies, as well as political will.

The Rationale and the March Toward Market-Oriented Reforms

Before evaluating the progress that has been achieved in market reforms, it is important to reinforce its principles briefly. In an unrestricted market, prices of goods and services are freely determined by its demand and supply or by the interaction of buyers and sellers. With profits, businesses expand, with losses they shut down. Prices serve as a signaling mechanism, which leads to an efficient allocation of resources. Profit-motives, risk-taking and innovations are ingredients of wealth creation and economic growth. Deviation from market principles can lead to economic disasters as evidenced, for example, in South Korea recently.[1] To limit the scope of this paper, the progress towards market reforms had been evaluated under four categories: denationalization, public finance, financial liberalization, and foreign direct investment.

Denationalization: According to the *Privatization Yearbook* (1996, p. 252), at the height of nationalization in 1973, the state owned 92 percent of the country's manufacturing assets and ran over 800 manufacturing companies. The first round of market reform began in 1976. The government returned very small units of abandoned property to Pakistani owners. The second phase of denationalization took place in the first half of the 1980s and covered mostly jute and textile mills owned by Bangladeshi owners before Independence. In the second half of the 1980s, there was wider participation of investors in the process. By 1985, 26 textile mills and more than 30 jute mills were nationalized. The divestiture of state-owned enterprises (SOEs) from 1975 through 1980s was not drastic. These divestitures added less than Taka 2 billion to the government's capital receipts, as reported by The World Bank (1995, p. 105).

To expedite the privatization effort, the Industrial Policy of 1991 was enacted under which only air travel, railways, production and distribution of power, and defense industries were reserved for the public sector. SOEs in other sectors were to be privatized step by step. Full foreign ownership of businesses was also permitted.

By mid 1990s, the government still owned over 200 insolvent SOEs with about 40 percent of the country's manufacturing assets.

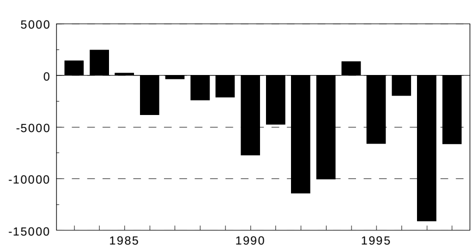
The financial performance of SOEs as shown in Chart 1 has been dismal. According to the World Bank (1999), "the gross losses of the SOEs during fiscal year 1996-98 could have financed 90 percent of the cost of constructing the Bangobandhu Multipurpose Bridge--estimated projected cost $0.9 billion."

In recent years, the private sector has been encouraged in power, telecommunications and domestic air transport sectors. The government is yet to divest the utilities and energy sectors.

According to The World Bank-Asian Development Bank (1998, p. 14), the Privatization Board has initiated the privatization of 32 public enterprises since 1996. Only 5 small enterprises have actually been handed over to the private sector.

There are several reasons why the denationalization drive has slowed: i) complex bureaucracy, red-tape and institutional problems, ii) the failure to build a consensus among labor unions, SOEs and the public, iii) the lack of enthusiasm on the part of prospective buyers to

Chart 1: Profit/Losses of SOEs
(Millions of Taka)



Source: The World Bank

purchase financially-strapped SOEs for sale, and iv) because the Privatization Board lacked both the mandate and operational freedom.

It is true that there may have been some unpleasant experiences with several divested units in the past, in that some owners of these units had utilized them for speculative purposes. However, these judgmental errors or loopholes in the divestiture policy should not become an alibi to derail or abandon the privatization program. Although such a practice by unscrupulous investors should not be condoned, several points are worth mentioning. 1) Like any policy, the divestiture policy is subjected to trail and error. Drawing lessons from previous mistakes, the divestiture policy should ensure that divested units do not end up with speculative investors in future. 2) What makes a market economy more vibrant is the presence of the so-called "creative destruction." Some existing firms or industries disappear while new ones emerge and resources are reallocated continually. 3) Historically, Bangladeshis were never a nation of entrepreneurs. Business, whether as a profession, career or trade was looked down upon in the Bangladeshi society. Only the mediocre member in the family may have moved on to pursue non-productive business or rent-seeking activities. Thanks to the garment industry, Bangladeshis, for the first time, are developing their entrepreneurial knowledge, spirit and know-how. It is naive to expect that Bangladeshis would become successful entrepreneurs overnight; it is also naive to expect *all* divested units to remain in business or generate profits forever.[2]

What should be done with the existing insolvent SOEs? The government should absorb the losses and liquidate them as soon as possible. Delays in its divestiture merely burden the public exchequer. Until they are sold off, the SOEs should strive to *break-even* financially at the very least. Bangladesh can implement the steps being undertaken, particularly, in South Korea .

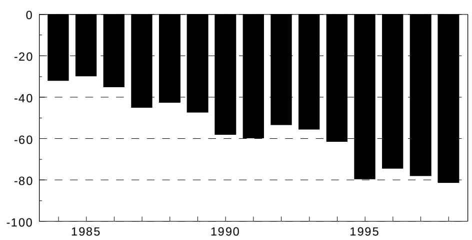
Public Finance: The size of the government's encroachment in the economy can be measured by analyzing its fiscal policy. One of the ways this policy can be quantified is by the size of budget deficits and the budget deficit/Gross Domestic

Product ratio shown in Charts 2 and 3 respectively.

The relationship between economic growth and budget deficit/GDP ratio is shown in Charts 4 and 5 respectively.

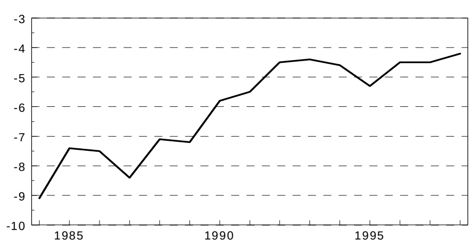
Increases in the budget deficits are likely to choke off or "crowd-out" the private sector. What are its implications? In the wake of limited savings, government expenditures may be financed out of these limited funds, depriving the private sector

Chart 2: Budget Deficits
(Billions of Taka)



Source: The World Bank

Chart 3: Budget Deficit as a Share of GDP
(In percent)



Source: The World Bank

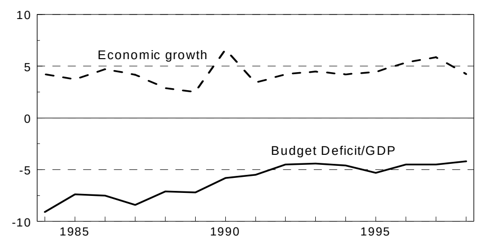
from borrowing. That is, the public sector *merely* grows at the expense of the private sector. The overall growth of the economy remains unaltered. The government can also finance its expenditures through "deficit-financing" which can turn out to be inflationary.[3]

As Chart 2 indicates, the budget deficit has increased in absolute amounts. However, the budget deficit/GDP ratio has been declining which is shown in Chart 3.

From 1984 through 1992, the budget deficit/GDP ratio grew smaller despite steady economic growth rates, (see Chart 4). However, the growth rates and budget deficit/GDP ratio from 1992 through 1998, have remained relatively stable. It can be observed from Chart 5 that the budget deficit/GDP ratio and inflation apparently appeared to be unrelated.

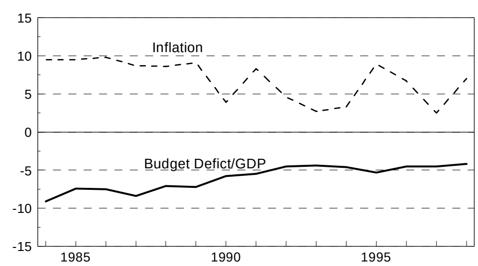
What conclusions can be drawn? 1) The decrease in the budget deficit/GDP ratio should not be construed with complacency. 2) Increased efforts

Chart 4: The Relationship Between Economic Growth and Budget Deficit/GDP
(In percent)



Source: The World Bank and the IMF

Chart 5: The Relationship Between Inflation and Budget Deficit/GDP
(In percent)



should be made to ensure that this proportion is reduced even further, because levels of concessional aid flows to Bangladesh have diminished in recent years. 3) If the government were to absorb the losses of SOEs before selling it to the private sector, the budget deficit would likely soar. 4) These budget deficits can be reduced by downsizing the government. The size of the government has effectively doubled. According to the *World Development Report* (1997, p. 86), the number of ministries increased from 21 to 35 over twenty years (1971-1991), and directorates increased from 109 to 221 between 1990 and 1994. In addition to its expansionary effects on government expenditures, this expansion has made regulation more intrusive. 5) The period from 1992 through 1998 indicates that the growing budget deficits were, most likely, constraining economic growth, (see Charts 4 and 5).[3, 4] 6) Bangladesh experiences both 'cost-push' and 'demand-pull' inflation. 7) To be consistent with the market philosophy, tax revenues and government expenditures should be as small as possible in size, coupled with a non-inflationary balanced-budget. 8) The government should refrain from economic activities which are well-suited for the private sector. By and large, the government's activities should be confined to the provision of public goods and the safeguard of the legal system.

Financial Liberalization: *The Economist* (May 15, 1999, p.90) lists six dimensions of financial liberalization. These are i) abolishing credit controls ii) deregulating interest rates iii) allowing free entry into the banking/financial-services industry iv) making banks autonomous v) putting banks in private ownership and vi) freeing capital-flows. Based on these criteria, financial liberalization in Bangladesh is evaluated in this section

Because of the government's ownership of dominant financial institutions from 1971 through early 1980s, financial sector liberalization hardly took place. Government determined and allocated funds to sectors, projects and vested interests. It was not until early 1980s, that two government-owned banks were denationalized by selling them to their former owners. Interest rates on deposits were raised to reflect positive real return on deposits. Private banks were allowed to enter the financial industry.

Despite government's slow progress in reforming the financial sector over the years, the banking sector is dominated by four nationalized commercial banks (NCBs) even today. These banks provided credit to borrowers and sectors as determined by the government. Non-performing loans account for around 33 percent of the combined portfolio of the NCBs (and domestic private banks). This is due to the fact that the NCBs are saddled with bad debt from SOEs. As reported in the *Economic Intelligence Unit* (1998-99, p. 26), several large private-sector defaulters wield much political influence.

In the early 1990s, as much as Taka 50 billion was spent by the government for the recapitalization of the NCBs which have become capital-deficient again.[5] Eventually, the NCBs have to be privatized. The World Bank (1999, p. 43), in the meantime, recommends that branches with chronic losses should be closed. Surplus staff should be laid off. NCBs should be manned by new professional management and retrained staff. Based on the Companies Act, the NCBs should be registered as companies with the objective of disposing them off to prospective buyers. The portfolios and units of NCBs may require restructuring. Recapitalization of NCBs which is estimated to be Taka 85 billion or about 5 percent of GDP should be contingent upon good governance and genuine reform culminating in privatization.

The Bangladesh Bank--the nation's central bank– operates under the Ministry of Finance. Among others, the Bangladesh Bank is responsible for formulating and implementing the monetary and exchange rate policies.[6] Ideally, the government should support and uphold the Bangladesh Bank to the standards of central banks in the United States, Switzerland and Germany in terms of institutional, regulatory, administrative and operational framework.

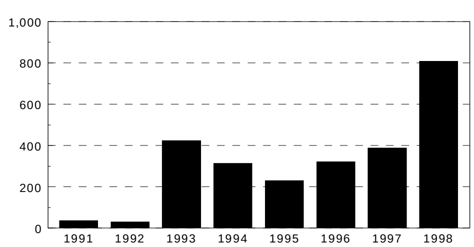
The Bangladesh Bank has abandoned setting floor rates from February 1997. This decision by the central bank now enables the interest rate to be determined more or less by market forces. The Bangladeshi Taka is pegged to a basket of currencies of Bangladesh's major trading partners. The 1997 Asian financial crisis has discouraged the central bank to make Bangladeshi taka fully convertible. The government has made current-account fully convertible in 1994 and capital-account partially convertible in 1996.

Foreign Domestic Investment (FDI): The importance of foreign investment in Bangladesh can hardly be exaggerated. To attain an economic growth rate in the 7-8 percent range, investment has to be increased significantly. Because of declining levels of official development assistance in recent years and inadequate domestic savings, FDI presents opportunities for overcoming domestic resource constraints. The Board of Investment was created as a 'one-stop shop' where investors can cut through red-tape associated with foreign trade and business start-ups. Chart 6 shows that the foreign domestic investment has increased manifold in recent years.[7]

Recently, the government has opened up the infrastructure and telecommunications sector to the private sector, both domestic and foreign. With nearly 13 trillion cubic feet of proven and recoverable gas reserves (perhaps as large as Indonesia's), more than half of $388 million in fiscal year 1997 came to the gas sector alone. Contracts for four barge-mounted power plants have already been signed and other contracts are in the pipeline.

Deregulation of the telecommunications sector has created scope for private operators to run mobile cellular phones systems, operate rural telephone

Chart 6: Foreign Direct Investment
(Millions of US$)



Source: The World Bank

exchanges, provide paging and trunk facilities and become Internet service providers. Initially, the foreign investors are Norway's Telenor and Malaysia's Telecom. Because of the inability of Bangladesh's Telegraph and Telephone--the public sector operator--to provide services to its clients, the private sector is likely to fill in the vacuum. Bangladesh is among the first developing countries where private sector has become involved in promoting the telephone industry.

There is also a rising trend of FDI flows in manufacturing and services outside the export processing zones (EPZs). A private container-handling terminal at Chittagong is expected to draw $200 million over the next two years.

Bangladesh still remains attractive to foreign investors for the following reasons: i) the government has been liberalizing rules favoring FDI slowly but surely, ii) the change of government in 1990 and 1996 through democratic means,[8] iii) cheap labor, untapped resources and the potential to make profits, and iv) continual improvements in transportation and communications. However, red-tape, corruption and the political instability in the form of strikes or "hartals" are keeping foreign investors at bay.[9]

Conclusion

Bangladesh has made some progress in introducing market-oriented reforms. Much remains to be done, and the sooner the better. The government should continue to expedite denationalizing industries (SOEs), financial institutions (NCBs), transportation (ex. marine shipping) and communications. The denationalizing policy should ensure that divested units are not sold to speculative investors. Until the existing SOEs are divested, these government enterprises should operate to break-even financially. By and large, the means of production should be left to the private sector.

The role of the government in the economy should be minimal. Government policies do not create jobs or wealth. It is the private sector coupled with prudent fiscal and monetary policies that foster the economic of people. Government intrusion should be curtailed by dismantling redundant ministries and directorates. Government policies should be business-friendly and free of red-tape. Corruption should be curbed by downsizing the government and transparency and accountability should be introduced at all levels.

The compensation of the government employees should be based on market conditions or some form of performance-based incentives. It is imperative that the (opposition) political parties refrain from observing strikes. These behaviors create uncertainty, which discourages domestic investors from engaging in entrepreneurial activities, and also drives away foreign investors. Bangladesh can draw vivid lessons from the 1997 financial crisis in East Asia. The symptoms that led to this crisis are more or less prevalent in Bangladesh today. Before it erupts into a crisis, the government should take pre-emptive measures similar to the ones taken particularly in South Korea and Thailand, following the outbreak of the contagion.

End Notes

[1] For example, Bangladesh can learn from the experiences of the 1997 financial crisis of South Korea. A lack of market-based resource allocation and a highly regulated economy were among some of the causes why South Korea was struck by the financial crisis. For example, about 50 percent of Gross Domestic Product in South Korea was controlled by a handful of conglomerates or *chaebol*. Because of their close ties to the government, they had easy access to capital. The collusive ties between government, banks and conglomerates, that built up Korea Inc. also lay behind its recent economic crisis. They lacked the agility to rapidly changing opportunities and needs. However, following the election of President Kim in late 1997 and the pressure from the International Monetary Fund, reforms started to take place. The Korean economy recovered very quickly. Despite opposition from labor unions and vested interest groups, cash-strapped or debt-laden chaebol is being divested. Daewoo-the second largest chaebol deserves illustration. It epitomized the best and worst of the Korean economy. Because of their close ties to government and access to capital, the conglomerates had a clear incentive to expand imprudently causing moral hazard. Daewoo piled up a corporate debt of $47 billion, more than the national foreign debt of Poland or Malaysia. On August 16, 1999 creditors of Daewoo group approved a restructuring plan that shrinks the failing conglomerate from 25 affiliated companies down to six automobile-related units. In sum, the Kim government has made it clear that there would be no more state-directed financing to help chaebol expand into strategic industries. Also, the government would not provide guarantees to support their ill-conceived and over-ambitious expansion plans. Under his tenure, he is letting market forces alone to allocate resources, deregulate and open the Korean economy fully to outside participation.

[2] In the United States, only 20 percent of the firms survive after completing the first year in business.

[3] Weather-related problems and political chaos--hartals, strikes have constrained economic growth too.

[4] In the October 4, 1998, issue of "*The Wall Street Journal* ," an op-ed article "Less Government, More Growth" by Gwartney revealed that in his study of 23 members of the Organization for Economic Cooperation and Development (OECD) from 1960 through 1996, there was a striking positive relationship between the size of the government and economic growth.

[5] The banking sector in Bangladesh may be sitting on a time bomb. Compared to Western standards, the percentage of non-performing loans is too high. Also, the internationally accepted 8 percent capital-adequacy ratio is not being adhered to. Bangladesh can avoid an impending disaster by taking the necessary and bold steps. The subsequent measures undertaken in some of the Asian countries affected by the 1997 financial crisis can serve as a guide.

[6] The functions and responsibilities of the central bank are not clearly spelled out. It lacks the autonomy in licensing new banks, monetary and exchange rate policies and supervision of NCBs. It has no control over its own budget or in the determination of its own staff's salary.

[7] This figure looks encouraging when compared to the $600 million of foreign investment which flowed into our giant neighbor India not too long ago in 1993.

[8] Under a democratic setting, any person or political party has the right to vent out its disagreement or discontentment. However, they have no right to do so through disrupting production activities or daily work-schedule.

[9] If the next general election tentatively scheduled for 2000 is free and fair, and the government is democratically elected, confidence among both foreign and domestic investors would rise. Because three consecutive free and fair elections would suggest that democracy in Bangladesh is more or less firmly footed.

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I would like to thank Professor Syed Saad Andaleeb and two other referees for their helpful comments. The usual disclaimer applies.