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TRADE POLICY REFORMS: BANGLADESH'S EXPERIENCE

Abstract

Bangladesh deliberately pursued protectionist economic and trade policy in its early years. However, the country changed the direction shortly after the abrupt political changes during the mid-seventies and followed the course of reforms in the subsequent years. Although the icebreaking was quite slow, the reform processes accelerated in the early nineties that resulted in many important policy changes. Since then, Bangladesh put its best efforts to go with the pace of globalisation and moved rapidly to dismantle the earlier protectionist image of the country. The paper mainly focuses on how Bangladesh persistently adopted the reform measures in its trade policy and gradually approached towards the liberalising process through making adjustment to relevant policies and other agendas. It illustrates the changes made to some key trade policy areas, including import and export regimes, exchange rate policy, industrial policy, monetary and fiscal policies, etc.

1. Introduction

Economic theory suggests that the primary impact of trade liberalisation will be on the overall level of trade, with a roughly parallel increase in exports and imports as a percentage of GDP. This is likely to require a modest depreciation of the real exchange rate in order to ensure that exports increase as much as imports, and leave the balance of trade unchanged. The export increase is likely to be concentrated in a relatively narrow range of products, products which use intensively the country's abundant factor of production (unskilled labour in the case of Bangladesh), while the import growth is expected to be much more diversified and more capital intensive. Some import-substituting industries are likely to find themselves squeezed, but others will respond to the competitive

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challenge by modernisation. The net effect will be increasing growth rate, through various channels, including concentration on industries in which the country has a comparative advantage.[1] The degree to which trade reforms have been achieved is often measured by movement toward *neutrality* of incentives between/within exportables and importables, between export and domestic sales, and between non-tradables and tradables; and *liberality,* implying a definite reduction in the level of intervention in external transactions; and *openness,* as measured by the importance of trade in the economy.[2]

During the post-independence nation building process, Bangladesh was highly influenced by the then geo-political polarisations that lured the country to envisage its vision on socialist agendas in operating its national economy. That followed the nationalisation of about 92 per cent of the total fixed assets abandoned by the Pakistani entrepreneurs.[3] Subsequently, Bangladesh economy was extremely protected and inward looking until the end of the 1970s. Imports were highly restricted by high tariff line. In 1978, for example, tariff rates were hovering around 36 per cent ranging from zero to 400 per cent. The reason placed for pursuing such a restrictive trade policy was to protect domestic industries from competition and to raise revenue. This, however, resulted in an expansion of inefficient industries and misallocation of resources with adverse consequences on the export sector and the economy.[4]

The essence of trade liberalisation greatly lies in reducing the level of intervention and increasing reliance on the price mechanism vis-à-vis to remove anti-export biases. In the case of Bangladesh and its progress to date in liberalising trade, the relevant policy changes that are to be considered include lowering the tariff rates, removal of quantitative restrictions and/or export taxes, monetary and fiscal policies, industrial policy, and the exchange rate policy.

The paper has been organised into several sections. The paper starts with illustrating the development philosophy of the country pursued since the independence in 1971 with marking the key shifts that had taken place during the post-independent periods. The next section highlights the reforms undertaken in

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[1] J. Williamson, "Evaluating the Success of Trade Liberalisation in Bangladesh", *Peterson Institute for International Economics*, available at: http://www.iie.com/publications/papers/paper.cfm? Research ID=356, accessed on: 12 March 2011.

[2] World Bank, Poverty Reduction and Economic Management Division, South Asia Region, *Bangladesh Trade Liberalisation: Its Pace and Impact,* Report No. - 19591-BD, 1999.

[3] S. H. Rahman, "Trade and Industrialization in Bangladesh: An Assessment", in G. K. Helliner (ed.), *Trade and Industrialization in Turbulent Times*, London: Routledge, 1994, pp. 259.

[4] Centre for Policy Dialogue, *Growth or Stagnation? A Review of Bangladesh's Development 1996*, Dhaka: University Press Limited, 1997.

the import regime so far which is followed by the reforms of the export regime with the illustration of some key features of the latest export policy of 2009-12. In the subsequent sections a number of other key policy issues have been discussed in details which include the exchange rate regimes, industrial policy, monetary policy, and fiscal policy with the latest updates. Recent industrial policy and monetary policy statement of the government of Bangladesh declared in 2010 have also been reviewed and attached with the concerned sections. The paper concludes with noting a few observations and concerns for Bangladesh resulting from the liberalisation measures.

2. Development Thoughts

Bangladesh has been one of the fastest reforming countries in the world and adopted very quick reforms in financial sectors at the beginning of the early 1990s. Second Five Year Plan of 1980-85[5] of the Government of Bangladesh looked into the minimisation of the export-import gap and pursued a policy of import substitution in an effort to promote export growth. Later, in the Third Five Year Plan 1985-90,[6] the government of Bangladesh stressed for an adoption of policies aimed at stimulating export through the taking up of various promotional and development measures, i.e., providing concessional credit to exporters and improving direct incentive schemes like Export Performance Benefit (XPB) and the duty draw-back scheme etc. Fourth Five Year Plan 1990-95[7] and Fifth Five Year Plan 1997-02[8] embraced more open policies through a measure like Structural Adjustment Programme (SAP) and an introduction of a trade neutral policy environment for attaining the goal of export-led growth. In the Fourth Five Year Plan, for example, SAP covered the issues of export growth acceleration, competitive import substitution and the restoration of imports of non-essential goods. In the Fifth Five Year Plan, on the other hand, a number of import liberalisation measures have been adopted including tariff rates reduction, rationalisation of the tariff structure, removal of Quantitative Restrictions (QRs), direct export promotion measures and a flexible exchange rate policy. It has also concentrated on the removal of supply-side constraints, such as development of infrastructural facilities, strengthening the institutional framework and developing entrepreneurial capacity.

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[5]Planning Commission, Government of Bangladesh, *The Second Five Year Plan 1980-85*, Dhaka: Planning Commission, 1983.
[6] Planning Commission, Government of Bangladesh, *The Third Five Year Plan 1985-90*, Dhaka: Planning Commission, 1985.
[7] Planning Commission, Government of Bangladesh, *The Fourth Five Year Plan 1990-95*, Dhaka: Planning Commission, 1990.
[8] Planning Commission, Government of Bangladesh, *The Fifth Five Year Plan 1997-2002*, Dhaka: Planning Commission, 1998.

3. Reforming the Import Regime

In liberalising and simplifying the import regime, successive governments of Bangladesh took a variety of initiatives based on the stated development philosophy. One such initiative was the Trade and Industrial Policy (TIP) reform programme that was aimed at rationalising and strengthening existing incentives in the industrial sector. It also recommended simplifying of tariff, phasing out of the QRs on imports replaced by import taxes and the levies. Besides, it was also recommended that the dispersion of tariffs should be lowered and that the number and range of Nominal Rates of Protection (NRPs) should be reduced. Besides, TIP emphasised on lowering Real Effective Exchange Rate (REER) for non-traditional. An EPB worth 30 per cent of gross exports should also be granted according to the policy. But considering raising the government revenue, excise tax of 15 per cent should be levied on all final consumer goods except basic necessities.[9]

Government of Bangladesh appointed a standing committee on Tariff Rationalisation and Import Policy Reform in 1989 that corroborated the tenets of the TIP reform programmes and made a few consequential recommendations regarding the policy. Few important recommendations were: the level of effective protection provided to an activity should be in the neighbourhood of 30 per cent; non-tariff, quantitative import control measures, viz., the size of the negative and restrictive import list, should be gradually phased out etc.[10] In the mid-eighties the government initiated a gradual process of phasing out of the QRs on imports with the World Bank support under its Industrial Sector Adjustment Credit (ISAC)-1 programme. The number of items subject to QRs at the 4-digit Harmonized Systems code (HS code) was brought down from 574 in 1985/86 to 124 in 1998/99 and the average nominal rates of protection for all tradable fell from 89 per cent in 1990/91 to 28 per cent in 1998/99.[11] In addition, because of overall tariff rationalisation, the import-weighted average protection rate fell by 22 percentage points. Furthermore, as a result of the dispersion in reduced tariff rates, the number of tariff rates has been down from 8 in 1993 to 5 in 2003, and the maximum tariff rate has been brought down from 350 per cent to 32.5 per cent during the same time.[12]

In 1983-84, import licensing system was abolished and imports were permitted through Letter of Credit (L/C) authorisation form to be accepted by banks. However, prior to 1986 Import Policy Order (IPO) contained a lengthy positive list of importables and in 1985-86 fiscal years positive list in the IPO

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[9] N. Ahmed, *Trade Liberalisation in Bangladesh.* Dhaka: University Press Limited, 2001.
[10] Planning Commission, Government of Bangladesh, *The Fourth Five Year Plan 1990-95, op.cit.*
[11] World Bank, Poverty Reduction and Economic Management Division, *op.cit.*
[12] N. Ahmed, *op.cit.*

was replaced by two lists, namely, the negative list (for banned items) and the restricted list (for items importable on fulfillment of certain prescribed conditions). Nevertheless, up to 1988, IPO was issued annually which was relaxed in 1989 from when IPO has been issued biennially. Consequently, a five-year IPO provision has been launched since 1997. In the year of 2007, the interim government of Bangladesh proposed a three-year import policy order (from the year 2006 to 2009). During this time, efforts have been made to reduce the number of restricted items from 60 to 24.[13] The policy has relaxed some raw materials' imports in terms of tariff rate and also kept some items, i.e., polypropylene, coarse sugar, and pork, as banned items on religious ground.

Regarding customs valuation, a voluntary Pre-Shipment Inspection (PSI) scheme was introduced on a voluntary basis in 1993-94 which was previously based on Brussels Definition of Value (BDV) - a system developed by the World Customs Organization. But as Bangladesh is committed under the Uruguay Round Agreement on Customs Valuation to switch to an invoice-based valuation system by 2000, mandatory PSI has been introduced since 15 February 2000.

4. Promoting Exports

One of the key things that the trade policy reforms introduced was a set of generous support and promotional measures for exports. Regarding the importance of the issue, Bangladesh pursued many promotional measures for exports. Despite the fact that the economic and trade policy of Bangladesh had highly anti-export bias in the country's initial years, the Government of Bangladesh introduced the Export Performance Licensing (XPL) Scheme during the early 1970s in order to strengthen incentives for export oriented activities. In 1986, however, the XPL was replaced by the XPB Scheme. Under the scheme, exporters received the proceeds from their banks at the time of negotiation of the export documents; it could also be cashed in the secondary exchange market according to the scheme. However, XPB scheme has become redundant in 1992.

A special bonded warehouse scheme was introduced in 1978 to meet the demand of the emerging Ready Made Garments (RMG) sector. This enabled exporters to avail themselves of a straight authorisation to import duty free into established special bonded warehouse. Exporters can also choose the option of duty drawback system instead. The facility was entitled only to those who were using Back-to-Back L/C to export 100 per cent of their production in the garments sector. But since 1993, the provision became more relaxed and offered

[13] "Export Policy Announced: Agro, light engineering, IT get the thrust", *The Daily Star*, Dhaka, 01 June, 2007.

the facility to all 100 per cent exporters and "deemed exporters."[14] Along with the bonded warehouse scheme, RMG entrepreneurs also received the duty drawback facility since 1982/83 which enabled them to disburse imported goods without paying any duty or sales tax. From 1988 onwards, the scheme was further extended to indirect exporters using the inland L/C system.

Back-to-Back L/C system was introduced in 1987 to import raw materials on a deferred payment basis by the exporters. The provision enhanced export financing facility for a broader range of export industries. In 1986, the Bangladesh Bank introduced a cash compensatory scheme with a view to promoting backward linkage. The scheme allowed exporters a cash assistance of 15 per cent of free on board export value. Later, the rate of compensation was revised upward from 15 per cent to 25 per cent in 1994. Besides, in order to insure loans in respect of export finance, Export Credit Guarantee Scheme (ECGS) was introduced in 1978. This scheme provides exporters with credit at a concessionary rate of up to 90 per cent of confirmed L/C value. Furthermore, government of Bangladesh offered some fiscal incentives for the exporters as: for 100 per cent export oriented industries, duty-free imports of capital machinery is allowed; the entire export earnings from handicraft and cottage industries is rebated from income tax. Noteworthily, industries in Export Processing Zones (EPZ) enjoy tax holiday for 10 years, duty-free import of machinery and spare-parts, and exemption from Value Added Tax (VAT) and other duties.[15]

For enhancing further institutional support, Export Promotion Bureau (EPB) was established in 1977. EPB is more focused on specific issues, i.e., to help the government in formulating and implementing export policy, to train up local exporters and arrange trade fairs locally and internationally.

4.1. *Export Policy 2009-12*

Recently, the government of Bangladesh announced a three-year Export Policy for the Fiscal Year 2009-2012 towards setting up multiple targets to enable Bangladesh to keep pace with rapidly changing and competitive world trading system, create employment opportunities and alleviate poverty.[16] It emphasises expanding export and increasing productivity of export oriented industries. It had given more emphasis on production environment of the factories and on meeting the compliance requirements, improving the quality of products, strengthening efforts to diversify products and their markets, low

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[14] World Bank, Private Sector Development and Financial Division, Country Department 1, South Asia Region, *Bangladesh: Trade Policy Reform for Improving Incentive Regime*, Report No.- 15900-BD, 1996.
[15] N. Ahmed, *op.cit.*
[16] Ministry of Commerce, Government of Bangladesh, *Acts and Policies*, Dhaka: GoB, 2010.

interest loan facilities, infrastructure development, establishment of backward and forward linkage industries. It also encourages developing utility services, establishing modern laboratories for controlling the quality of export products and product-based clusters, ensuring easy access to the raw materials for export products and regular supply of updated information on market and technology to producers, and trying for overall development of the Chittagong and Mongla ports.

It recommended to the government to offer cash incentives for the export of some items, including plastic products, decoration items, environment-friendly herbal products, buttons made from coconut crust, coir products, toys and products made from bamboo and cane.

The policy included ship-building industry in the thrust sector alongside the existing six thrust sectors - agro-products and agro-processing commodities, light engineering goods, shoes and leather products, pharmaceutical products, software and ICT products, and home textiles. The number of special development sectors has been increased to eleven from nine, adding ceramic, melamine and plastic goods. In consistence with the previous export policy's inclusion of cash incentives for the thrust and special development sectors, the new export policy also considered cash incentives for the emerging sectors. Besides, the policy allowed exports of petroleum and petroleum products like naphthalene, furnace oil, lubricant oil, bitumen, condensate, Multi-isotope Trace Tool (MTT**)** and Molecular Sieving (MS**)**, with a no objection certificate from the energy and mineral resources division. Earlier, these were exportable without any condition.

Moreover, the export policy emphasised setting up of accredited testing laboratories to ensure the high quality of products and to increase exports of pharmaceutical products. The annual ceiling for sending specimens has been increased to US$30,000 from US$10,000.

5. Reforming Exchange Rate Regime

Until the early 1980s, Bangladesh maintained an overvalued and fixed exchange rate system in order to facilitate the inward-looking development strategy. The Taka was pegged to the Pound Sterling and the exchange rates with other currencies were determined by the rates between Pound and respective currencies in London. In 1980, the fixed exchange rate regime was replaced by a managed system of floating. The intervention currency was changed from the Pound to the US Dollar and the exchange rate of other currencies was determined on the basis of the US Dollar closing rates in New York vis-à-vis different currencies. Bangladesh had also maintained a dual exchange rate system for quite sometime by administering the Wage Earners Scheme (WES) since 1978 in order to attract remittances of the Bangladeshi workers abroad.

Since 1984, the government has continually expanded the list of items eligible to be imported through secondary market. Between 1983 and 1990, the percentage of total imports financed through this market rose from about 21 per cent to about 47 per cent.[17] This system produced multiple exchange rates. In January 1992, the official and secondary exchange rates were merged. This helped in eliminating the black market premium, which had emerged due to the multiple exchange rates.

Later, Bangladesh adopted a freely floating regime on 30 May 2003 by abandoning the adjustable pegged system. The transition to the floating regime was smooth and in the initial years the exchange rate remained stable, experiencing a depreciation of less than 1 per cent from June 2003 to April 2004. Exchange rate, however, kept on depreciating gradually from mid-2004 and it reached its peak at Tk. 70/US$ in 2006 from Tk. 58/US$, resulting in 20 per cent depreciation. Since 2007, it remained fairly stable and has been fluctuating between Taka 68 and 71.[18]

6. Industrial Policy

After the massive-scale nationalisation of the manufacturing sector in 1972, private entrepreneurships were almost restricted except some small, medium and cottage industries.[19] Yet, by 1974, investment limits on private investment from Tk. 2.5 million to Tk. 30 million and providing scope for domestic and foreign private investment.[20] This resulted in heavy financial loses for the whole economy.

After the abrupt regime change in 1975, the then government of Bangladesh gave up the policy of nationalisation and moved forward to the new *Industrial Investment Policy* declared in December 1975. The policy readjusted the private investment ceiling to Tk 100 million and withdrew the bar on private sector participation in large-scale manufacturing. Dhaka Stock Exchange (DSE) was also reactivated. Since 1977, approximately a billion dollars were pledged to private entrepreneurs in Bangladesh to promote investment.[21] For ensuring fair and equitable treatment to private foreign investment, the Foreign Private

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[17] S. H. Rahman, "Trade and Industrialization in Bangladesh: An Assessment", in G. K. Helliner (ed.), *Trade and Industrialization in Turbulent Times,* Chapter 8, 291, London: Routledge, 1994, pp. 259.

[18] M. Hossain and M. Ahmed, "An Assessment of Exchange Rate Policy under Floating Regime in Bangladesh", *The Bangladesh Development Studies,* Vol. 32, No. 4, December 2009.

[19] R. Sobhan, "The Political Economy of South Asian Economic Cooperation", *Bangladesh Journal of Political Economy*, Dhaka, 1990.

[20] N. Ahmed, *op.cit*.

[21] R. Sobhan, *Bangladesh: Problems of Governance.* Dhaka: University Press Limited, 1993.

Investment (promotion and protection) Act was formulated in 1980. In 1982, the New Industrial Policy (NIP) was adopted which was revised in 1986 and named Revised Industrial Policy (RIP). Both of these policies concentrated on quick denationalisation of public enterprises. It also removed some obstacles to local and foreign investments. And to improve flexibility in pricing, capital restructuring and setting up of an improved performance appraisal system of public enterprises, it played a very substantial role.

The major changes occurred in the industrial policy was in 1991. Government of Bangladesh introduced the Industrial Policy, 1991 (which was later revised in 1992) to promote market economy. This policy tends to make the government role 'promotional' rather than 'regulatory'. Almost all the sectors (excluding some sensitive sectors, i.e., production of arms and ammunitions, nuclear energy, security printings etc.) were open for investment according to the policy. Especially, 100 per cent Foreign Direct Investment (FDI) as well as joint venture both with local private sponsor and with the public sector was allowed. However, in the Industrial Policy, 1999, only four sectors were restricted for the investors.[22] Some sectors were encouraged to invest under Build-Operate-Own (BOO) and Build-Operate-Transfer (BOT) system.

6.1 *New Industrial Policy 2010*

The industrial policy 2010 is an apparent shift from the existing policy direction. The new plan has put stress on strengthening state-owned enterprises to both supplement and compete with the private sector whereas the previous policies laid emphasis on privatisation and denationalisation of State-Owned-Enterprises (SOEs).[23] It strikes that foreign entrepreneurs might be invited to run those loss-making state enterprises, or shares be offloaded to make it sure that those stay competitive, if needed. It has also noted that establishing Public Private Partnership (PPP) and running industries through private management will be given priority. However, it did not rule out the privatisation option but only if it has been assumed that it will bring benefits to official, employees and workers.

The policy also envisages a stimulus package for special economic zones and enhanced FDI benefits. The policy provides that regulated industrial units will require approval from the government, as those are specialised ones. Such regulated industries include fishing in the deep sea, bank and non-bank financial institutions and insurers in the private sector, power generation projects, natural gas exploration industry, extraction of coal and other natural mineral resources, big infrastructure projects like fly-over, elevated expressway, monorail, etc,

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[22] N. Ahmed, *op.cit.*

[23] Ministry of Industries, Government of Bangladesh, *Industrial Policy 2010*, Dhaka: GoB, 2010.

crude oil refinery, medium and big industries using natural gas, satellite channels and cargo and passenger aircrafts. The policy also identifies industrially-lagged areas besides the advanced ones, in order to give those a benefit of reduced tariffs on imported capital machinery and as many as 51 districts will be entitled to such facilities to accelerate industrialisation.

By giving due consideration to environmental concern, the policy noted that industries cannot be set up using agricultural land, cutting hills and hillocks, by filling rivers, canals or any other natural water bodies and relocation of the pollution-prone industries in metropolitan areas to safe zones has also been envisaged in the new policy. There are few other issues that have been incorporated in the new policy which are: (i) industries will not receive permission to set up if they are considered detrimental to national security, culture and economy; (ii) foreigners will be given five-year multiple visas instead of the existing three-year multiple visa system to encourage FDI inflow; and (iii) citizenship might be considered for any foreign national who invests US$0.5 million or transfer US$1 million to any recognised financial institution.

7. Monetary Policy

According to the Bangladesh Bank Order 1972, the principal objectives of the country's monetary policy are to regulate currency and reserves; to manage the monetary and credit system; to preserve the par value of domestic currency; to promote and maintain a high level of production, employment and real income; and to foster growth and development of the country's productive resources in the best national interest. Although the long term focus of monetary policy in Bangladesh is on growth with stability, the short-term objectives are determined after a careful and realistic appraisal of the current economic situation of the country.[24]

With the shifts of the policy stance of the government in various phases, necessary adjustments were made in the country's monetary policy. In the first years after liberation, the primary target of monetary policy was to regulate not the quantity of money, but the direction of the flow of money and credit in support of the government financial programme. In 1975, Bangladesh entered into a standby-arrangement with IMF and the country's monetary policy got a changed shape, which fixed an explicit target of safe limit of monetary expansion on annual basis. With this change, Bangladesh Bank started setting short-term objectives of monetary policy in close collaboration of the government and tried to achieve the target by using the direct instrument of control. The principal target of monetary control was broad money (M2) i.e., the sum of the currency in circulation and total deposits of money in banks. The targeted growth of M2

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[24] S. A. Khan and A. S. Sarker, *Monetary Policy of Bangladesh*, Banglapedia, 2006.

depended on a realistic forecast of the growth rate of real GDP, an acceptable rate of inflation and an attainable level of international reserves.

Bangladesh Bank took measures to monitor credit and monetary expansion keeping in view the price situation and international reserves position. Efforts were made to achieve the targeted growth of domestic credit and thereby, the money supply, through imposing ceilings on credit to the government, public, and private sectors. The major policy instruments available to Bangladesh Bank were to set credit ceiling on the banks and provide liberal refinance facility at concessional rate for priority lending. According to the national economic policy, the banks were to provide the desired volume of credit at an administered and low rate of interest. In that situation, Bangladesh Bank practically did not have any effective instrument for making adjustments in the growth of money supply or for transmitting market signals to effect changes in money supply. The monetary policy, therefore, could not function in its true sense. As a result, the banking system could not play its role as an effective financial intermediary.

In 1989, the government adopted a comprehensive Financial Sector Reform Programme (FSRP), following which the country's monetary policy assumed a new orientation towards promotion of market economy in a competitive environment. Bangladesh Bank started moving away from direct quantitative monetary control to indirect methods of monetary management since the beginning of 1990s. Although the fixation of target continued to remain as the central piece of exercise, the way to achieve it had been changed. Credit ceilings on individual banks and direct controls of interest rates were withdrawn. At present, the money supply is regulated through indirect manipulation of reserve money instead of credit ceiling. Major instruments of monetary control available with the Bangladesh Bank are the bank rate, open market operations, rediscount policy, and statutory reserve requirement.

Until 1990, the use of Bank rate, as the lending rate of the central bank for borrowings of the commercial banks to meet their temporary needs, was virtually non-existent in Bangladesh. The rate was changed in a few occasions only to align it with the refixation of the rates of deposits and advances. Moreover, the existence of refinance facilities at rates lower than the bank rate substantially eroded its significance. However, since 1990, this instrument has been put in use to change the cost of borrowings for banks and thereby to affect the market rate of interest. Bank rate was gradually lowered from 9.75 per cent in January 1990 to 5 per cent in March 1994. It was raised to 5.75 per cent from 10 September 1995 and further to 7.5 per cent and 8 per cent from 19 May 1997 and 20 November 1997, respectively. The rate was lowered to 7 per cent from 29 August 1999.

Open Market Operations (OMO) involve the sale or purchase of securities by the central bank to withdraw liquid funds from the banking system or inject the same into that system. OMO allows flexibility in terms of both the amount and timing of intervention, which did not exist in Bangladesh before 1990. Bangladesh Bank introduced a 91-day Bangladesh Bank Bill, a market-based tool for monetary intervention, in December 1990. The bank bill was subsequently withdrawn from the market. At present, OMO operations are conducted through participation of banks in monthly or fortnightly/weekly auctions of treasury bills.

After the introduction of FSRP, the refinance facility was replaced by rediscount facility at bank rate to eliminate discrimination in access to central bank funds. Refinance facility is now available for agricultural credit provided by Bangladesh Krishi Bank and for projects of Bangladesh Rural Development Board financed by Sonali Bank. Banks are advised to extend credit considering banker-customer relationship.

Cash Reserve Requirement (CRR) of the deposit money for banks has a significant potential to regulate money supply through affecting money multiplier, while Statutory Liquidity Requirement (SLR) is generally used to affect the lending capability of the bank. Bangladesh Bank used these two instruments very infrequently before 1990 and very often after 1990. The CRR and SLR were 8 per cent and 23 per cent, respectively on 25 April 1991 and were reduced to 7 per cent and 22 per cent, respectively on 5 December 1991. Later, these rates were changed twice and set at 5 per cent and 20 per cent, respectively on 24 May 1992. The CRR was further lowered to 4 per cent from 4 October 1999. The downward revision in CRR and SLR were made to enable the banks to increase their lending capacity.

7.1 *Monetary Policy Statement (MPS) 2010*

In the recent years of global economic meltdown and the rise of prices of the food commodities around the world, controlling inflation has been one of the major challenges for the Bangladesh Bank while issuing its recent monetary policy statements. Besides, it has also to keep an eye so that too much control does not become disincentive to the steady GDP growth of the country which has been remarkable in the recent years and expected to reach the 7 per cent threshold in the next couple of years. The declaration of the monetary policy statement for the first half (H1) of the fiscal year 2010 made by the Bangladesh Bank has programmed the monetary aggregates to accommodate both the GDP growth concerns as well as to keep the inflations within single digit. The following are the major highlights of the recent monetary policy stances of the government:[25]

i. Given the current large liquidity overhang in the system, the central bank believes that it can adequately serve demands of both public and private

[25] D. Bhattacharya and T. I. Khan, *Recent Monetary Policy Statement of Bangladesh Bank (July 2009): An Analytical Commentary*, Centre for Policy Dialogue, Dhaka, July 2009.

sectors. This is possibly the essence of the declared "accommodative monetary policy". This is in line with the need for a "moderately expansionary monetary policy" as expressed in the national budget for FY10.

ii. To keep domestic borrowing conditions easy in a recessionary global environment, the central bank has refrained from Reverse Repo operations since the last quarter of FY09 and has announced to continue it in the first half of the current fiscal year.

iii. Emphasis has been given on utilisation of the foreign exchange inflows in growth supportive investments than on accretion of ever higher reserves.

iv. The central bank signalled its intention of fostering cultural attitudes which predominantly rely on equity-based rather than debt-based investments. One wonders how this discretionary foreign exchange financing will take place.

v. The central bank underscored that it is set to strengthen its oversight on liquidity, capital adequacy and risk management in banks and financial institutions to protect the domestic financial sector from instabilities of the kind now afflicting markets in advanced economies. One does not find any specifics of these intended initiatives. This, however, requires review of the interfaces of the debt and equity market as well as its cautionary development.

vi. It was informed that the government along with the central bank has finalised steps for obtaining sovereign credit rating for Bangladesh to lower costs for private sector borrowers and banks. There are, however, no immediate plans for the government borrowing on non-concessional commercial terms from the international market. The central bank possibly wants to create this window to respond appropriately to challenges for future domestic and external developments.

8. Fiscal Policy

The fiscal policy of Bangladesh was also wavering at the early years of independence. Immense political pressure compelled the government to increase public sector employment and subsequent wages. Under the pressure, in 1974, the government implemented a Pay Commission Report, which increased the government's salary bill by around 50 per cent.[26] Government also offered huge subsidies to goods and services, agriculture and industrial inputs. That resulted into huge budget deficit which was in turn financed by printing money.

Besides, in those initial years, the government of Bangladesh had to spend a large amount of its resources in reconstruction and rehabilitation work. It had negative public savings and limited private investment. Despite large inflows of foreign aid, the increasingly large financing gap became the main concern for the government. The situation was further aggravated by frequent internal and

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[26] A. Hossain, *Inflation, Economic Growth and the Balance of Payments in Bangladesh: A Macroeconomic Study*, Delhi: Oxford University Press, 1995.

external shocks. Under the circumstances, government fiscal policies during 1970s and 1980s were largely oriented at rehabilitating the war-torn economy as well as stabilising it from various shocks. This had gradually led to weak fiscal structure and poor fiscal management. The tax structure was such that any increase in taxes due to built-in consequences of economic growth was virtually not possible. This was because of the fact that despite a moderate growth of the economy, income distribution was skewed, and had been pushing more and more people below the poverty line each year. As such, the proportion of population with taxable surplus went down overtime. More than 80 per cent of the total tax revenue came from indirect taxes, amongst which taxes on imports contributed about 60 per cent. Since most imports were in the government sector and basic need-oriented, it was hardly possible to increase import duty. Despite higher production costs, prices of most public goods could not be rationalised due to socio-economic reasons. As such, these were kept lower, which resulted in inadequate cost recovery.[27]

Current expenditure had always been underestimated in the country, while current surplus as well as foreign loans and grants were overestimated. Therefore, the overall fiscal deficit experienced a large variability all the time. The whole scenario may be described as such that the fiscal policies of the past could not be used as an adequate tool for 'fine-tuning' the economy towards achieving macro-economic stability and higher economic growth.

Regular deficit financing, normally undertaken through borrowings from abroad, from Bangladesh Bank, and from scheduled banks, has become a basic feature of the fiscal policy of the country. Opportunity of borrowing from the public by the government for financing budget deficit is very limited in the country as savings capability of the people is very low. Therefore, the opportunity of non-inflationary financing of budget deficit does not exist here. Availability of foreign borrowing depends on the international liquidity situation and the prevailing circumstances in the international capital market, which is always uncertain and volatile for a country like Bangladesh.

The commercial banks, because of their potential for central bank refinancing, are also not effective sources of non-inflationary finance. Given the circumstances, whatever is the size of the fiscal deficit in any particular year, a part of it cannot be financed by external borrowing and, therefore, must be financed out of central bank borrowing. As a result, the essential element of fiscal deficit in Bangladesh has become such that once a deficit is incurred, government borrowing from Bangladesh Bank became inevitable.

In the early 1990s, the government of Bangladesh undertook some comprehensive steps towards improving the country's fiscal front. The major objective of the fiscal policy was to restrict the growth of current expenditure to a

[27] S. A. Khan and A. S. Sarker, "Fiscal Policy of Bangladesh", *Banglapedia*, 2006.

level below the growth of the nominal GDP, thereby making more resources available to support Annual Development Programme (ADP) undertaken in each year. In line with the Enhanced Structural Adjustment Facility (ESAF) of the IMF, a number of reforms were initiated, the most important of which was the introduction of VAT in July 1991.

VAT was introduced at a uniform rate of 15 per cent at the manufacturing-cum-import level. Together with protection-neutral supplementary duties, this system largely replaced the earlier structure of differentiated sales tax on import and excise duties on domestic goods. In case of personal income tax, the major reforms involved the inclusion of entertainment allowances in the personal income tax base, deduction of investment in approved assets from the tax base, and an introduction of a withholding tax on dividend with limitation of special expenditure within a reasonable limit. Steps were taken to reduce interest rates on government savings instruments and subsidies for food and jute. A good number of public sector enterprises were denationalised through selling to the private sector.

These reform measures resulted in a remarkable improvement in the fiscal situation of Bangladesh after 1990. The growth of current expenditures was contained below the rate of GDP growth. Tax reform led to an increase in government revenues from much below 10 per cent of GDP in fiscal year 1989-90 to 11 per cent in fiscal year 1991-92. This trend continued and revenue collections reached more than 12.1 per cent of GDP by the FY 2010-11[28].This trend is continuing, although with minor fluctuations. Moreover, this was accompanied by changes in the tax structure of the country, reflected in the decline of the shares of customs duties and increase in the share of income and profit taxes in the total tax revenues in the subsequent period. As a result, the shortage of local funds that had constrained project implementation capacity of the country and had shrunk the country's absorptive capacity for project aid for a long period was largely removed.

The improvement of the government's fiscal performance was reflected in the budgetary outcome of the country. The overall budget deficit was 8.4 per cent of GDP during the 1980s and came down to 4 per cent in the fiscal year 2010, and thus provided a breathing ground for the government and helping to stabilise the economy to a great extent.[29] Up to 1989-90, foreign aid had financed the lion's share of fiscal deficit of Bangladesh. Since then there has been a considerable shift in the sources of funds for financing budget deficit. Domestic sources could provide only 15 per cent of the total deficit during 1989-90. In

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[28] Centre for Policy Dialogue, *State of Bangladesh Economy: Analysis of the National Budget FY 2011-12*, Dialogue Paper, June 2011.

[29] World Bank, Economic Policy and Poverty Team, South Asia Region, *Bangladesh Economic Update*, April, 2010.

contrast, in FY 2010-11, the comparative figures for domestic and foreign sources in funding the budget deficit were 75 per cent and 25 per cent, respectively.[30] However, an absolute decline in the flow of external funds on concessionary terms is also partly attributable to this situation. Increased dependence on local funds has largely reduced the uncertainties of the implementation of the budgetary programme. But this has also increased the risk of additional burden of higher interest costs from domestic borrowing.

Efforts to generate increased domestic resources are generally based on various tax reforms as well as reforms in the financial sector. On the expenditure side, the government has given increased emphasis on human resource development and poverty alleviation programmes. Top priority has been given to improve the quality and coverage of the education system as well as health and family planning services, and social safety net programmes to serve vulnerable groups. This is demonstrated in the increased budgetary allocation in these heads in recent years.

9. Conclusion

Despite pursuing drastic reform programmes, Bangladesh's success was fleeting with the failure to accelerate its domestic growth as expected. It also failed to diversify the economy and significantly stimulate investment and domestic savings. To assess whether failure to accelerating or decelerating the trade reform process has something to do with this trend requires an empirical analysis. However, during this period, there are many achievements that marked the decades of changes i.e., significant increase of food-grain production, tremendous growth of RMG sector, steady GDP growth for decades and the expansion of economy, and significant surge in the volume of trade etc. Nevertheless, the World Bank considers that the pace of trade reform has to be accelerated and there are still a lot of rooms for improvement. It has stressed the need for the country to continue pursuing its liberalisation agenda.[31] The point of concern for Bangladesh at this moment should be the rigorous assessment of the past reform measures in the trade policy and whether or how it actually contributed to the well-being of the people before considering the other viable options. The question of how the fruits of the trade reform process have been distributed and how the common people were benefited should also be taken into consideration to make the process more meaningful.

[30] Centre for Policy Dialogue, *op.cit*.
[31] World Bank, *Bangladesh: Strategy for Sustained Growth*, Bangladesh Development Series, Paper No. 18, 2007.